

CA Inter Audit

Full Notes from ICAI Module

Relevant for New Course applicable from May-2024 attempt

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Index (Click on the Chapter Name to jump to that Chapter)

Chapter No.	Chapter Name	Pg. No.
1	Nature, Objective and Scope of Audit	2 - 12
2	Audit Strategy, Audit Planning and Audit Programme	13 – 20
3	Risk Assessment and Internal Control	21 – 52
4	Audit Evidence	53 – 94
5	Audit of Items of Financial Statements and CARO, 2020	95 - 144
6	Audit Documentation	145 - 148
7	Completion and Review	149 - 170
8	Audit Report	171 -193
9	Special Features of Audit of Different Types of Entities	194 - 229
10	Audit of Banks	230 - 249
11	Ethics and Terms of Audit Engagements	250 - 260

- In these notes, all the important topics/ concepts/ questions are covered.
- It is useful for revision and to refer day before exam.
- Students are advised to refer/ read ICAI Module at least once to get in depth knowledge of the subject.
- To watch full video lectures on Auditing and Ethics from ICAI Module click on the below link/ scan following QR Code:

<https://www.youtube.com/playlist?list=PLux8FsMkulSVY8Y8f4b8YmgJJqoZsaomv>



- To watch revision video lectures on Auditing and Ethics from compiled notes click on the below link/ scan following QR Code:

<https://www.youtube.com/playlist?list=PLux8FsMkulSVowfZ87jRGVACDjOU4sx4O>



- Click on the link/ scan the QR code to watch videos on RTP question:

<https://www.youtube.com/playlist?list=PLux8FsMkulSULbYGEyNsGbpEyxqUyT4m4>



*If any QR code is not scannable, try to zoom from your camera and scan it again! Still, if you are unable to scan the same, kindly contact at cakyhyt@gmail.com.

Chapter 1 - Nature, Objective and Scope of Audit

Weightage of Chapter – 4-6 Marks

Meaning of Audit (ICAI Module Pg. No.: 1.5):

-	It is an independent ¹ examination of financial information ²
-	of any entity, whether profit oriented or not, and irrespective of its size or legal form ³
-	when such an examination is conducted with a view to expressing an opinion ⁴ thereon.

Important Notes to above Meaning:

1. Independence, here, implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.
2. Financial Information includes Financial Statement (FS) as well, Financial Information can be part of FS or more than FS.
FS includes –
 - Balance Sheet/ Statement of Assets and Liabilities
 - Profit and Loss Account/ Income and Expenditure Account
 - Cash Flow Statement
 - Statement of Changes in Equity (Only in case of Ind AS FS)
 - Notes to Accounts
3. It can be profit oriented company or NGO, it can be sole proprietor or partnership firm or LLP or Company or any form of organisation.
4. Types of Opinion:

(i) Unmodified Opinion:

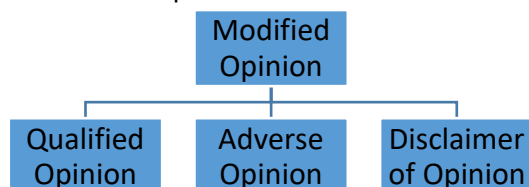
The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

(ii) Modified Opinion:

If the auditor:

- (a) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement⁵; or
- (b) is unable to obtain sufficient appropriate⁶ audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Sub-types of Modified Opinion:



To understand sub-types of Modified Opinion, we need to understand the definition of Pervasive.

Definition of Pervasive:

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgement:

- (i) Are not confined to specific elements, accounts or items of the financial statements; or
- (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Sub-types of Modified Opinion:

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

5. 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.
6. Sufficient refers to Quantity of Audit Evidences while Appropriateness refers to Quality of Audit Evidences. One evidence may be providing more comfort to auditor than the other evidence. The evidence providing more comfort is qualitative and, therefore, appropriate. Evidence should be both sufficient and appropriate.

Click on the Link/ Scan to watch concept-wise video

Meaning of Audit :

<https://youtu.be/Y10UuDwr8Gs>



Types of Opinion:

<https://youtu.be/Tth0rG8kkXY>

Objectives of Audit (ICAI Module Pg. No.: 1.8): (RTP M-24 Q. 1)

As per SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" overall objectives of the auditor are:

- (a) To obtain reasonable assurance⁷
 - 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 framework⁸; and

- (b) To report on the financial statements,
- and communicate as required by the SAs, in accordance with the auditor's findings⁹.

Important Notes to above Objectives:

7. Difference between Reasonable Assurance and Absolute Assurance

Reasonable Assurance	Absolute Assurance
It is a high-level of assurance but it is not complete assurance.	It is a complete assurance or a guarantee that financial statements are free from material misstatements.

8. Financial Reporting Framework means a framework adopted in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.
For E.g. – Schedule III of the Companies Act, 2013 which prescribes the format of FS for companies.
9. The auditor's opinion is communicated and reported in written report which is known as audit report.
10. Generally, auditor is appointed by the owners of the organization. In case of companies, the auditor is appointed by the shareholders in Annual General Meeting (AGM), however if it is Government Company then Comptroller and Auditor General (CAG) appoints the auditor. In case of firm/ LLP, partners appoint the auditor.
11. Audit report is submitted to the person, who appoints the auditor. So, in case of Companies, it is submitted to shareholders, in case of firm/ LLP, it is submitted to partners.

Click on the link/ scan the QR Code to watch video on Objectives of Auditor:

<https://youtu.be/b1Pcq-ruYzE>

**Scope of Audit – What it includes (ICAI Module Pg. No. 1.10):**❖ What includes:

- To cover all aspects of the entity relevant to the financial statements being audited.
- To reasonably satisfy about the information contained in underlying accounting records and other source data is reliable and sufficient basis for preparation of financial statements. For that auditor may study and assess accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.
- To decide whether relevant information is properly disclosed in the financial statements considering statutory requirements. It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements. (MTP 1 M-24 Q. 4 (c))

❖ What it does not include (ICAI Module Pg. No.: 1.12) :

- Auditor is not expected to perform duties which fall outside domain of his competence.
- An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

❖ Example:

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

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

Proper disclosure of financial information is well within scope of audit, hence, the company's point of view is improper.

Important Notes to above Scope:

12. An audit is not an official investigation into alleged wrong doing. Auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation. (Theoretical Question 4, ICAI Module Pg. no. 1.39)
13. Difference between Audit and Investigation (MTP 1 S-24 Q. 2 (c))

Audit	Investigation
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.	A critical examination of the accounts with a special purpose.
The scope of audit is general and broad.	The scope of investigation is specific and narrow.

Example:

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

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

Click on the link/ scan the QR Code to watch video on Scope of Audit:

<https://youtu.be/Z2l1wskEHZg?si=YJzhXJuZALZWInZI>



Inherent Limitations of Audit (ICAI Module Pg. No.:1.14) (M-24 Que 2(c) – 3 Marks):

There are some inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. As per SA 200, the auditor is not expected, and cannot, reduce audit risk to zero because of inherent limitations of an Audit. These fundamental limitations (Inherent Limitations of Audit) arise due to the following factors: -

(i) <u>Nature of Financial Reporting: (MTP 2 M-24 Q. 4 (c))</u> • FS involves many judgements by management which are subjective or have a degree of uncertainty which leads to misstatement⁵ in FS. • Also management design Internal Controls to avoid misstatements in FS, however their implementation has their own limitation which leads to misstatement⁵ in FS.
(ii) <u>Nature of Audit Procedures: (MTP 1 M-24 Q. 2 (c))</u> There are practical and legal limitations on ability of auditor to obtain audit evidence. For example: • Auditor forms his opinion only by testing samples. (Practical Limitation) • Management may not provide complete information as requested by auditor. Even for that auditor cannot force to management, it can only be reported. (Legal Limitation) • Management or part of management may be involved in fraud, sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine. • It is quite possible that entity may have entered into some transactions with related parties which involve some wrong doing.
(iii) <u>Not in nature of investigation:</u> As already discussed, audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
(iv) <u>Timeliness of financial reporting and decrease in relevance of information over time</u>
(v) <u>Future events:</u> Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. Hence, going concern assumption is tricky part in FS.
<u>Example:</u> Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm. However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance (i.e. secretly involved in immoral act) with accountant through banking channel. The partners of firm blame auditors for futile (i.e. ineffective) audit exercise.

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

Click on the link/ scan the QR Code to watch video on Inherent Limitations:

<https://youtu.be/wp3L37G4GHA?si=0KsYUeFmMkPk-XyZ>



Assurance Engagement (ICAI Module Pg. No.:1.22) :

Meaning:

An engagement in which a practitioner⁽ⁱ⁾ (i.e. Practicing CA) expresses a conclusion designed to enhance the degree of confidence of the intended users⁽ⁱⁱ⁾ (Eg. Shareholders in case of companies) other than the responsible party⁽ⁱ⁾ (Eg. BOD/ Management in case of companies) about the outcome (i.e. Opinion) of the evaluation or measurement of a subject matter⁽ⁱⁱⁱ⁾ (Eg. FS) against criteria⁽ⁱⁱⁱ⁾ (Eg. Law, Standards etc.).

- It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

Elements of an Assurance Engagement (ICAI Module Pg. No.:1.23) :

(i) **A three party relationship involving a practitioner, a responsible party, and intended users:**
(Theoretical Question 3, ICAI Module Pg. No.: 1.39)

- A **practitioner** is a person who provides the assurance. The term practitioner is broader than auditor. (i.e. Practicing CA)
- A **responsible party** is the party responsible for preparation of subject matter. E.g. BOD/ Management in case of companies.
- **Intended users** are the persons for whom an assurance report is prepared. These persons may use the report in making decisions. E.g. Shareholders in case of companies.

(ii) **An appropriate subject matter:**

It refers to the information to be examined by the practitioner. For E.g. FS.

(iii) **Suitable criteria:**

These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

(iv) **Sufficient Appropriate Evidence:**

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

(v) **A written assurance report in appropriate form:**

A written report is provided containing conclusion that conveys the assurance about the subject matter.

Click on the link/ scan the QR Code to watch video on Assurance Engagement:

<https://youtu.be/qRYUysyAqNo>



Types of Assurance Engagement along with Engagement Standards: (Theoretical Question 2, ICAI Module Pg. No.: 1.39) (RTP S-24 Que 9) **(MTP 2 S-24 Q. 2 (a))**

(i) <u>Audit:</u>
- Reasonable Assurance Engagement of Historical Financial Information. - Standards on Auditing (SAs) are applicable. (RTP M-24 Q. 2)
(ii) <u>Review:</u>
- Limited Assurance Engagement of Historical Financial Information. - Standards on Review Engagements (SREs) are applicable. (RTP M-24 Q. 2)
(iii) <u>Assurance Engagements dealing with matters other than historical financial information:</u>
- Examination of prospective financial information (like forecast) or assurance regarding operations of controls - It provides Moderate Level of Assurance. ^{16 & 17} - Standards on Assurance Engagements (SAEs) are applicable.

Important Notes to above Types:

14. Difference between Reasonable Assurance Engagements and Limited Assurance Engagements (ICAI Module Pg. No.:1.25) :

Reasonable assurance engagement	Limited assurance engagement (MTP 2 M-24 Q. 1 (d))
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

Example:

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

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

15. Difference between Historical Financial Information and Prospective Financial Information

Historical Financial Information	Prospective Financial Information
Financial information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods.	Financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both

It is rooted in past events which have already occurred.	It is related to future events.
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16. In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence (ICAI Module Pg. No.:1.26)
- to the **effect that management's assumptions** on which the prospective financial information is based are not unreasonable,
 - the prospective **financial information is properly prepared** on the basis of the **assumptions** and
 - it is **properly presented** and all **material assumptions** are adequately **disclosed**.
17. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved. Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection. Hence, such type of assurance engagement provides only a "moderate" level of assurance. (ICAI Module Pg. No.:1.26)

Click on the link/ scan the QR Code to watch video on Types of Assurance Engagement:

<https://youtu.be/mv1CsV3Gfug?si=f9Wr2Lxoq-A7ZGRz>



Standards on Related Services (SRS) (ICAI Module Pg. No.:1.30) :

- These standards apply in engagements to perform agreed-upon procedures regarding financial information.
- Agreed-upon procedure which can be some kind of preparation or to perform certain procedures on financial information, however it is not an assurance engagement.
- For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, or a financial statement, say, a balance sheet or even a complete set of financial statements.
- Such type of compilation engagements fall in the category of related services and practitioner issues a report clearly stating that **it is not an assurance engagement and no opinion is being expressed**.

Engagement Standards and Quality Control Standards: (ICAI Module Pg. No.:1.28 and 1.31)

Engagement Standards:

- Standards on Auditing (SAs) – Audit of Historical Financial Information
- Standards on Review Engagements (SREs) – Review of Historical Financial Information
- Standards on Assurance Engagements (SAEs) - Assurance Engagements dealing with matters other than historical financial information
- Standards on related services (SRSs) - Agreed-upon procedures regarding financial information

Quality Control Standards:

- Standards on Quality Control (SQC) have been issued to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements.
- Only 1 standard - SQC1 is issued in this regard which is part of Ch. 11.
- It requires auditors/ practitioners to establish system of quality control so that firm and its personnel comply with professional standards and regulatory & legal requirements and reports issued are appropriate.

Important Points to above Standards:

18. Engagement standards are specific to the engagement like Audit, Review etc. while Quality Control Standards are applicable to firm providing engagement services. Hence, SQC 1 is applied to all services covered by Engagement Standards.
19. Why are Standards needed? (ICAI Module Pg. No.:1.31)
 - Standards ensure carrying out of audit against established **benchmarks** at par with **global practices**.
 - Standards **improve quality of financial reporting** thereby helping users to make diligent decisions.
 - Standards **promote uniformity** as audit of financial statements is carried out following these Standards.
 - Standards **equip** professional accountants with **professional knowledge and skill**.
 - Standards ensure **audit quality**.
20. Standards are compulsory to be followed, however, if there is any situation where it is not possible to follow any part/ procedure of the standard, then practitioner is required to document how alternative procedures performed to achieve the purpose of required procedure. Also, reason for departure has also to be documented unless it is clear. Further, his report should draw attention to such departures. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards. (ICAI Module Pg. No.:1.32)

Example:

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

Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained.

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

<u>Click on the link/ scan the QR Code to watch video on Engagement and Quality Control Standards:</u>	
<u>https://youtu.be/qHfGkzIGsu4?si=ggo70XrftyocMuV9</u>	

Other Important Points for MCQs/ Descriptive Questions:

21. Users of financial statements may be shareholders, employees, customers, government and regulatory authorities, bankers etc.
22. Engagement means a formal agreement between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.
23. The purpose of external audit engagements (i.e. Statutory Audit) is to enhance the degree of confidence of intended users of financial statements. Such engagements are also reasonable assurance engagements.
24. Audit is mandatory for all companies in India under the Companies Act, 2013, Income Tax Act, 1961 mandates Tax Audit to assessee falls under specified criteria, LLP Act, 2008 mandates Audit under the act to LLP falls under specified criteria. These are examples of Mandatory Audit as it is specified by Statute.
25. Many entities may get their accounts audited voluntarily because of benefits from the process of audit like to get loan, subsidy, grants etc.

Summarized IMP Points of MCQs, Correct Incorrect, Test Your Understanding and Theoretical Questions:

- (1) Choosing of appropriate accounting policies is responsibility of management as preparation and presentation of FS is the responsibility of Management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management.
- (2) Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money.

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

Click on the link/ scan the QR Code to watch other videos of Chapter 1			
Miscellaneous Topics: https://youtu.be/l7ux48m1cy0		Benefits of Audit: https://youtu.be/0es1oYeEmFs	
Case Study 1: https://youtu.be/i98JW_zGCoE		Case Study 2: https://youtu.be/k_892aqatVg	

Test Your Understanding Questions:<https://youtu.be/5FyGeoB4zcs>**Test Your Knowledge Questions:**<https://youtu.be/mfkPxQ3vAtM>

Chapter 2 – Audit Strategy, Audit Planning and Audit Programme

Weightage of the Chapter: 8-12 Marks

Matters to be considered before planning: (ICAI Module Pg. No. 2.5) (MTP 2 M-24 Q. 2 (b)) (M-24 Que 3(a) – 4 Marks)

Planning includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

Click on the link/ scan the QR Code to watch video on above topic:

https://youtu.be/InCIDpTPjSQ?si=rUluQnkPI_Okh3J0



Preliminary Engagement Activities: (ICAI Module Pg. No. 2.7 – 2.9) (Theoretical Question 1, Pg. No. 2.30)

The auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with. It includes: - (RTP M-24 Q. 3)

- Performing procedures regarding the continuance of the client relationship²
- Evaluating compliance with ethical requirements, including independence¹
- Establishing an understanding of terms of engagement²

Important Notes to above Point: (Theoretical Question 2, Pg. No. 2.30)

- The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: - (RTP S-24 Que 10)
 - Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence
 - Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and
 - Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.
- Point a) and c) are covered in Ch. 11 in detail, so no need to read them in detail here.
- Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement. (RTP M-24 Q. 3)

Click on the link/ scan the QR Code to watch video on above topic:

https://youtu.be/UAUpb_beB2g?si=aTueafV1ID9nyBE



Establishing the overall audit strategy: (ICAI Module Pg. No. 2.9 – 2.10)

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

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as: -

- | | |
|-------|---|
| (i) | The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters.
<i>(Here, 'which resources to be deployed where?' will be answered)</i> |
| (ii) | The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.
<i>(Here, 'how much resources to be deployed?' will be answered)</i> |
| (iii) | When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates.
<i>(Here, 'when resources to be deployed?' will be answered)</i> |
| (iv) | How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.
<i>(Here, 'how resources to be managed, directed and supervised?' will be answered)</i> |

Factors to be taken into consideration by auditor for establishing audit strategy: (ICAI Module Pg. No. 2.10 – 2.12)

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

- | | |
|-----|---|
| (a) | <p><u>Identify the characteristics of the engagement that define its scope:</u>
It is important for auditor to identify scope of the engagement. Only a well identified scope can lead to establishment of a sound audit strategy. There are many characteristics of engagement defining its scope. Some of characteristics are as under: -</p> <ul style="list-style-type: none"> ➤ Applicable financial reporting framework applicable to the entity ➤ Nature of business segments to be audited including the need for specialized knowledge ➤ Industry specific reporting requirements required by industry regulators ➤ Expected use of audit evidence obtained in previous audits |
| (b) | <p><u>Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required: (MTP 2 M-24 Q. 3 (c)) (MTP 1 S-24 Q. 1 (a))</u>
The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances are given under: -</p> <ul style="list-style-type: none"> ➤ The entity's timetable for reporting |

➤ Organization of meetings to discuss of nature, timing and extent of audit work with management ➤ Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report ➤ Discussion with management regarding the expected communications on the status of audit work throughout the engagement. ➤ Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
(c) <u>Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts: (MTP 2 M-24 Q. 6 (d)) (M-24 Que 2(d) – 3 Marks)</u> The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under: ➤ Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control ➤ Significant industry developments such as changes in industry regulations and new reporting requirements. ➤ Significant changes in the financial reporting framework, such as changes in accounting standards. ➤ Other significant relevant developments, such as changes in the legal environment affecting the entity.
(d) <u>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:</u> Considering results of preliminary engagement activities and knowledge gained from similar engagements goes a long way in establishing sound audit strategy. Examples are listed as under: - ➤ Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them. ➤ The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
(e) <u>Ascertain the nature, timing and extent of resources necessary to perform the engagement.</u> Selection of engagement team and assignment of audit work to team members is a significant factor in establishing overall audit strategy. Experienced team members may be assigned in areas where there is higher risk of material misstatement. Similarly, engagement budgeting and devotion of more time to areas of higher risk of material misstatement are to be kept in mind.

Click on the link/ scan the QR Code to watch video on Overall Audit Strategy:	
https://youtu.be/-HzpcP5OI0o?si=2nOMJeeb3blxPul4	

Development of Audit Plan: (ICAI Module Pg. No. 2.13)

SA-300. 'Planning an audit of financial statements' states that auditor shall develop an audit plan that shall include description of- (MTP 1 M-24 Q. 3 (c))

(i)	The nature, timing and extent of planned risk assessment procedures.
(ii)	The nature, timing and extent of planned further audit procedures at assertion level
(iii)	Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

Important points related to Overall Audit Strategy and Audit Plan: (ICAI Module Pg. No. 2.4 – 2.16)

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.
Risk assessment procedures are audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error at the financial statement and assertion levels.
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.
The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan.
The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement, however, while discussing the matters care is required in order not to compromise the effectiveness of the audit.
Understanding client's business is one of the important principles in developing an audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible. Gaining knowledge of client's business is, therefore, one of the foremost requirements to develop audit plan.
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.
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.
The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. 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.
Planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.
Example: MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Consideration

for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary. Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary.

Example:

CA Kartik is planning for audit of a company engaged in manufacturing of cosmetics. Considering nature of operations of the company, he had planned to include testing of controls of the company over purchases, sales and inventories. One fine day, he reaches the corporate office and asks for manuals and required documentation to ensure surprise element in testing. He had never shared with management his intention to carry out above procedures.

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit. Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, approach of CA Kartik is not proper.

Example:

CA Mary, while planning audit of a company, feels that she would inquire from in-house legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. These are planned risk assessment procedures to identify and assess risk of material misstatement.

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

CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company. Non-compliance of the same can have implications in form of civil and criminal liabilities.

Such an important matter concerning changes in laws and regulations is to be considered by auditor while establishing overall audit strategy.

Planning Supervision and Review of work of Engagement Team Members: (ICAI Module Pg. No. 2.17) (Theoretical Question 5, Pg. No. 2.30)

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: -

(i)	The size and complexity of the entity.
(ii)	The area of the audit.
(iii)	The assessed risks of material misstatement.
(iv)	The capabilities and competence of the individual team members performing the audit work.

Documentation: (ICAI Module Pg. No. 2.17) (MTP 2 S-24 Q. 4 (c))

The auditor shall document: -

(i)	the overall audit strategy
(ii)	the audit plan and
(iii)	any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

Click on the link/ scan the QR Code to watch video on Audit Plan:

<https://youtu.be/bGgTCbfsClk?si=zy3YdU6fMNYnsidz>



Audit Programme: (ICAI Module Pg. No. 2.18 – 2.25)

Meaning:

- Audit programme is a list of examination and verification steps to be applied and set out in such a way that the interrelationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.
- It consists of a series of verification procedures to be applied to the financial statements and accounts of a given entity for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on financial statements.
- It is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

Example of Sample audit programme pertaining to sales of an entity:

Sr. No.	Nature of Procedure	Extent of Check	Basis of sample	Done by
(a)	Vouch few sales invoices from copies available in record of the concern.			
(b)	Trace these invoices into the account books of the concern.			
(c)	Verify few invoices with e-way bills generated on the e- way bill portal.			
(d)	Trace few sales invoices into the stock records to ensure that sold quantities have been reduced from stocks.			
(e)	Trace also few sales invoices into accounts of buyers			

Evolving one audit programme- Not Practicable for All businesses (M-24 Que 1(a) – 4 Marks):

- Businesses vary in nature, size and composition, hence evolving one audit programme applicable to all business under all circumstances is not practicable.

The Assistant to keep an open mind: (MTP 2 S-24 Q. 6 (b))

- The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him.
- 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.
- Hence, assistants should inform to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

Periodic review of the audit programme:

- There should be periodic review of the audit programme to assess its adequacy, otherwise 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.

- It needs to be unfailingly followed by the assistants which may bring an element of rigidity in the audit programme. However, to remove this difficulty, periodic review is undertaken.

Constructing an audit programme (M-24 Que 1(a) – 4 Marks):

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

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

The advantages of an audit programme are: -

- (1) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- (2) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- (3) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- (4) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less and the audit can proceed systematically.
- (5) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- (6) 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.
- (7) It serves as a guide for audits to be carried out in the succeeding year.
- (8) 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.

The disadvantages of an audit programme are: - (MTP 1 S-24 Q. 6 (c))

- (1) 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) 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 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) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

- All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal. **(Theoretical Question 3, Pg. No. 2.30)**

Auditor verifies reasonably available evidences. By the word “available”, we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

Example:

Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc.

During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum.

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

Click on the link/ scan the QR Code to watch video on Audit Programme:

<https://youtu.be/AElf9pX3dlg?si=5KEt1I8RAo9PoUEH>



Click on the link/ scan the QR Code to watch other videos of Chapter 2

Case Study:

https://youtu.be/V7fGmlgH_38



Test Your Understanding Questions:

<https://youtu.be/WFtLz5P4IoQ>



Test Your Knowledge Questions:

<https://youtu.be/2LN3Huah7Js>



Chapter 3 – Risk Assessment and Internal Control

Weightage of the Chapter: 8-12 Marks

Audit Risk: (ICAI Module Pg. No. 3.4 – 3.12) (MTP 2 S-24 Q. 4 (b))

Meaning:

- Audit Risk means the risk that the auditor expresses an **inappropriate audit opinion** when the **financial statements are materially misstated**¹.
- It means that an auditor expresses an unmodified opinion when financial statements are materially misstated.
- **Example**, that profits of a company have been increased artificially by showing fake revenues of sizeable amounts in its financial statements. In such a case, financial statements are materially misstated. The probability, that auditor in such a case, expresses an inappropriate audit opinion is referred to as audit risk

Audit risk- What is not included?:

- Audit risk does not refer to the **auditor's business risks** such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.
- For purposes of the SAs, audit risk does not include the risk that the auditor might express **an opinion that the financial statements are materially misstated when they are not**. This risk is ordinarily insignificant.
- Audit risk is a function of the risks of material misstatement^{3 4} and detection risk.
- So, Audit Risk = Risk of Material Misstatement x Detection Risk
- The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk.
- Hence, Audit Risk = Inherent risk x Control risk x Detection Risk

Risk of Material Misstatement²:

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

1. Inherent Risk:

- As per SA 200, there is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.
- Few examples of inherent risks could include: -
 - An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.

- There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated.
- Wear & Tear Private Limited is a “start-up” engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements.

2. Control Risk:

- As per SA 200, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.
- It can be said that there exists an inverse relation between control risk and efficiency of internal control of an entity. When efficiency of internal control of an entity is high, the control risk is low and when efficiency of internal control of that entity is low, the control risk is high.
- Few examples of control risks could include: -
 - A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.
 - An entity has devised a control that fire extinguishers and smoke detectors are in place and are in working condition at all times to reduce the risk of damage to inventories caused by fire. There is a risk that fire extinguishers in place are expired and are not being refilled. Similarly, there is a possibility that smoke detectors are not working.
 - A company has devised a control relating to petty cash that items of expenditure of only less than Rs.10,000 should be routed through imprest system of petty cash. There is a risk that control is not being followed.
 - A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations.

Detection Risk:

- SA 200 defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- Detection risk comprises sampling and non-sampling risk:
 - **Sampling risk** is the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It

simply means that the sample was not representative of the population from which it was chosen.

- **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.
- Examples of detection risk could include: -
 - Sizeable work-in-progress inventories are expected in financial statements of a company. However, auditor of the company does not devote time to attending inventory count. Instead, he chooses to rely upon alternative audit procedures.
 - The auditor of a company has audited revenue of a company by taking a sample. However, there is a risk that sample of revenue is not representative of overall revenue.
 - Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. (RTP M-24 Q. 5)
- The auditor can only influence detection risk. Inherent risk and control risk belong to the entity and are influenced by the entity.
- Therefore, auditor must reduce detection risk in order to keep audit risk at low level.
- Detection risk may be reduced by increasing area of checking, testing larger samples and by including competent and experienced persons in the engagement team.

Important Notes to above Topic:

1. Misstatement refers to a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Few examples of misstatements could be: -

- Charging of an item of capital expenditure to revenue or vice-versa
 - Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework
 - Selection or application of inappropriate accounting policies
 - Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework
 - Intentional booking of fake expenses in statement of profit and loss
 - Overstating of receivables in financial statements by not writing off irrecoverable debts
 - Overstating or understating inventories **(MTP 2 S-24 Q. 1 (a))**
2. The risks of material misstatement may exist at two levels: -
 - (i) The overall financial statement level
 - (ii) The assertion level for classes of transactions, account balances, and disclosures.
 3. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
 4. The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms, such as High, Medium or Low.

Click on the link/ scan the QR Code to watch video on Audit Risk:

https://youtu.be/7aJcksertKE?si=Jm4r-GjbU_dYdukv



SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment": (ICAI Module Pg. No. 3.12 – 3.16)

Risk Assessment Procedures Meaning:

- The audit procedures performed
- to obtain an understanding of the entity and its environment, including the entity's internal control,
- to identify and assess the risks of material misstatement, whether due to fraud or error,
- at the financial statement and assertion level.

Objective:

- 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.
- Here, responses to the assessed risks of material misstatement refers to perform further audit procedures in accordance with SA 330 – 'The Auditor's Responses to Assessed Risks'.

For the purpose of identifying and assessing the risks of material misstatement, the auditor shall: -
(MTP 1 M-24 Q. 5 (b))

- (a) **Identify risks** throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements
- (b) **Assess the identified risks**, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions
- (c) **Relate the identified risks to what can go wrong** at the assertion level, taking account of relevant controls that the auditor intends to test and
- (d) Consider the **likelihood of misstatement**, including the possibility of multiple misstatements, and whether the potential misstatement is of a **magnitude that could result in a material misstatement**.

The risk assessment procedures shall include the following:

- (i) **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.⁵
- (ii) **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. **(MTP 1 S-24 Q. 1 (b))**
- (iii) **Observation and inspection** may support inquiries of management and others, and may also provide information about the entity and its environment.⁶

- Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Example:

- Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.
- On perusing financial statements of Jo Jo Limited put up for audit, it is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). The auditor is using “analytical procedures” as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities. It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

Important Notes to above Point:

5. Examples of Inquiry as Risk Assessment Procedures:

- Inquiries directed toward **internal audit personnel** may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity’s internal control and whether management has satisfactorily responded to findings from those procedures. **(M-24 Que 2(a) – 4 Marks)**
- Inquiries of **employees** involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward **in-house legal counsel** may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract. **(M-24 Que 2(a) – 4 Marks)**
- Inquiries directed towards **marketing or sales personnel** may provide information about changes in the entity’s marketing strategies, sales trends, or contractual arrangements with its customers. **(M-24 Que 2(a) – 4 Marks)**
- Inquiries directed to the **risk management function** (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to **information systems personnel** may provide information about system changes, system or control failures, or other information system- related risks. **(M-24 Que 2(a) – 4 Marks)**

6. Examples of Observations and Inspection as Risk Assessment Procedures:

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

Click on the link/ scan the QR Code to watch video on SA 315:

[https://youtu.be/4T7fbo -FZw?si=lu-k2RitusH_mP1X](https://youtu.be/4T7fbo-FZw?si=lu-k2RitusH_mP1X)



Understanding the Entity and Its Environment: (ICAI Module Pg. No. 3.24 – 3.29) (RTP M-24 MCQ)

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

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

- Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.
- Examples of matters the auditor may consider include market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products.
- Relevant regulatory factors include the regulatory environment, including, the applicable financial reporting framework and the legal and political environment.
- Examples of matters the auditor may consider include accounting principles and industry specific practices, regulatory framework for a regulated industry, legislation and regulation that significantly affect the entity's operations, including direct supervisory activities, taxation, government policies currently affecting the conduct of the entity's business, environmental requirements affecting the industry and the entity's business.
- Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation etc.

(b) The nature of the entity, including: -

- (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (iv) the way that the entity is structured and how it is financed;
- to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- Examples of matters that the auditor may consider while obtaining understanding of nature of entity include: -
 - Business operations such as nature of revenue sources, products or services, conduct of operations, location of production facilities, key customers and suppliers of goods and services
 - Investment and investment activities such as capital investment activities and planned or recently executed acquisitions
 - Financing and financing activities such as major subsidiaries, debt structure etc.
 - Financial reporting such as accounting principles and revenue recognition practices

(c) <u>The entity's selection and application of accounting policies, including the reasons for changes thereto</u> 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) <u>The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement:</u> Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include: - - Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry). - New products and services (a potential related business risk might be, for example, that there is increased product liability). - Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
(e) <u>The measurement and review of the entity's financial performance:</u> Examples for measuring and reviewing financial performance which may be used by an auditor may include: - - Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics. - Period-on-period financial performance analyses. - Budgets, forecasts, variance analyses, and departmental or other level performance reports. - Credit rating agency reports

Important Notes to above Point:

7. Gaining knowledge about client's business is one of the important principles in developing an overall audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible.
8. Understanding the entity - a continuous process: (MTP 2 M-24 Q. 5 (b))
 Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
 - Assessing risks of material misstatement of the financial statements.
 - Determining materiality in accordance with SA 320.
 - Considering the appropriateness of the selection and application of accounting policies
 - Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions
 - Developing expectations for use when performing analytical procedures
 - Evaluating the sufficiency and appropriateness of audit evidence obtained such as the appropriateness of assumptions and of management's oral and written representations.

Click on the link/ scan the QR Code to watch video on Understanding of Entity:

https://youtu.be/YBxFQTgT8Dw?si=CZJGmLwwcq_yVNTA



SA 330 - The auditor's responses to assessed risks (ICAI Module Pg. No. 3.65 – 3.72):

Objectives:

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

In designing the further audit procedures to be performed, the auditor shall:

- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and
 - (ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and
- (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Test of Controls

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.

Nature and Extent of Test of Controls:

- In designing and performing test of controls, the auditor shall:
 - (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit.
 - (ii) The consistency with which they were applied.
 - (iii) By whom or by what means they were applied.
 - (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.
- Inquiry alone is not sufficient to test the operating effectiveness of controls.
- Accordingly, other audit procedures are performed in combination with inquiry.
- In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

	<u>Matters the auditor may consider in determining the extent of test of controls include the following:</u> • The frequency of the performance of the control by the entity during the period. • The length of time during the audit period that the auditor is relying on the operating effectiveness of the control. • The expected rate of deviation from a control. • The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level. • The extent to which audit evidence is obtained from tests of other controls related to the assertion. <u>Using Audit Evidence obtained in Previous Audits:</u> 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. <u>Evaluating the Operating Effectiveness of Controls:</u> • 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. <u>Specific inquiries by auditor when deviations from controls are detected:</u> 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
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	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.
Substantive Procedures	<u>Meaning:</u> Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. This requirement reflects the facts that: (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement and (ii) there are inherent limitations to internal control, including management override. Substantive procedures comprise: (i) Tests of details (of classes of transactions, account balances, and disclosures): (a) Tests of Transactions i.e. Vouching (b) Tests of Balances i.e. Verification, and (ii) Substantive analytical procedures. <u>Nature and extent of Substantive procedures:</u> Depending on the circumstances, the auditor may determine that: - Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls. - Only tests of details are appropriate. - A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Click on the link/ scan the QR Code to watch video on SA 330:

https://youtu.be/jGIEfRNCQOE?si=LaH5v_RgaoXSqCsY



Materiality – SA 320 – ‘Materiality in Planning and Performing an Audit’ (ICAI Module Pg. No. 3.16 – 3.24):

- SA 320 states that misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.
- Materiality is not always a matter of relative size.** For example, a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future.

Materiality in Planning and performing an audit - Auditor's responsibility:

- Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
 - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected **to influence the economic decisions of users** taken on the basis of the financial statements;
 - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the **size or nature of a misstatement**, or a combination of both; and
 - Judgments about matters that are material to users of the financial statements are based on a consideration of **the common financial information needs of users as a group**. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
- In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
 - Determining the nature, timing and extent of risk assessment procedures;
 - Identifying and assessing the risks of material misstatement; and
 - Determining the nature, timing and extent of further audit procedures.
- If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount.
- For eg., CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of Rs. 25 crore. The company has been sanctioned a term loan of Rs. 50 lacs from a bank. However, as at end of the year, only Rs. 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act, 2013 requires disclosure in this respect. If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

Determination of materiality- a matter of professional judgment: (MTP 2 S-24 Q. 2 (c))

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

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

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.
<u>Determining Materiality and Performance Materiality when Planning the Audit:</u> - When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. - If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.
<u>Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole:</u> - A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. - Factors that may affect the identification of an appropriate benchmark include the following: - The elements of the financial statements like assets, liabilities, equity, revenue, expenses - Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused. For example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets. - The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates, the entity's ownership structure and the way it is financed. For example, If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings; - The relative volatility of the benchmark. - Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. - Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.
<u>Chosen Benchmark – Relevant financial data:</u> In relation to the chosen benchmark, relevant financial data ordinarily includes: - - Prior periods' financial results and financial positions, - The period to-date financial results and financial position, and - Budgets or forecasts for the current period, - Adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates.
<u>Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment:</u> - 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. - For Eg., that the auditor may consider 5% of profit before tax from continuing operations to be

appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider 1% of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.
<u>Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures:</u> Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following: - Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items like in case of related party transactions, and the remuneration of management and those charged with governance. - The key disclosures in relation to the industry in which the entity operates. For example, research and development costs for a pharmaceutical company. - Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements like in case of newly acquired business.
<u>Revision in Materiality level as the Audit Progresses:</u> - Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. - If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.
<u>Documenting the Materiality:</u> The audit documentation shall include the following amounts and the factors considered in their determination: - Materiality for the financial statements as a whole - If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures - Performance materiality and - Any revision of (a)-(c) as the audit progressed
<u>Materiality and Audit Risk are considered throughout the audit, in particular, when:</u> - Identifying and assessing the risks of material misstatement; - Determining the nature, timing and extent of further audit procedures; and - Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

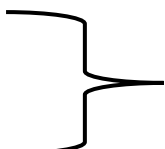
Click on the link/ scan the QR Code to watch video on SA 320:

https://youtu.be/0dLB_u8590Q?si=WwM5ebrlgGUiXmQH



Internal Control: (ICAI Module Pg. No. 3.29 – 3.32)Meaning:

- As per SA-315, “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, the internal control may be defined as –
 - the process designed, implemented and maintained
 - by those charged with governance, management and other personnel
 - to provide reasonable assurance about the achievement of an entity’s objectives with regard to
 - reliability of financial reporting,
 - effectiveness and efficiency of operations,
 - safeguarding of assets, and
 - compliance with applicable laws and regulations.
- The way in which internal control is designed, implemented and maintained varies with an entity’s size and complexity.



These 4 are purposes of Internal Controls as well.

Objectives of Internal Control are: (Test You Understanding Question 10, Pg. No. 3.81)

- (i) **transactions are executed** in accordance with managements general or specific **authorization**;
- (ii) all transactions are **promptly recorded in the correct amount in the appropriate accounts and in the accounting period** in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (iii) **assets are safeguarded** from unauthorised access, use or disposition; and
- (iv) the **recorded assets are compared with the existing assets** at reasonable intervals and appropriate action is taken with regard to any differences.

Benefits of Understanding of Internal Control:

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

Limitations of Internal Control:

- (i) Internal control can provide only reasonable assurance:
 - Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity’s financial reporting objectives.
 - The likelihood of their achievement is affected by inherent limitations of internal control.
- (ii) Human judgment in decision-making:
 - Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
 - For example, there may be an error in the design of, or in the change to, a control.
- (iii) Lack of understanding the purpose:
 - Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) Collusion among People

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

(v) Judgements by Management:

- Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) Limitations in case of Small Entities:

- Smaller entities often have fewer employees due to which segregation of duties is not practicable.
- However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity.
- This oversight may compensate for the generally more limited opportunities for segregation of duties.
- On the other hand, the owner- manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Components of Internal Control (ICAI Module Pg. No. 3.32 – 3.41):**A. Control Environment:**➤ The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

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

➤ What is included in Control Environment?

The control environment includes:

- the governance and management functions and
- the attitudes, awareness, and actions of those charged with governance and management.
- the control environment sets the tone of an organization, influencing the control consciousness of its people.

➤ Elements of the Control Environment:

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

(a) Communication and enforcement of integrity and ethical values:

- Integrity and ethical behaviour are the product of the entity's ethical and behavioural standards, how they are communicated, and how they are reinforced in practice.
- The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel

to engage in dishonest, illegal, or unethical acts.

(b) Commitment to competence :

- Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) Participation by those charged with governance:

- It includes attributes of those charged with governance such as their independence from management, their experience and stature (i.e. Level), the extent of their involvement and the information they receive and the scrutiny of activities.

(d) Management's philosophy and operating style:

- Matters such as approach of management to taking and managing business risks, management's attitude towards information processing and accounting function and personnel reflects upon management's philosophy and operating style.

(e) Organisational structure:

- The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting.

(f) Assignment of authority and responsibility:

- Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) Human resource policies and practices:

- For example, standards for recruiting the most qualified individuals with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour demonstrate an entity's commitment to competent and trustworthy people.⁹

- The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent (i.e. discouragement/ barrier/ restraint/ blockage) to fraud.
- Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud.
- The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

B. The Entity's Risk Assessment Process: (MTP 1 S-24 Q. 5 (b))

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

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

Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

C. The information system, including the related business processes, relevant to financial reporting and communication:

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

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

D. Control Activities:

- Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.
- An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.
- Control activities relevant to audit generally include policies and procedures relating to -
 - performance reviews (reviews of actual performance with budgets),
 - information processing (for example controls over checking arithmetical accuracy of records, program change controls etc.),
 - physical controls (like controls over physical security of assets) and
 - segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)¹⁰

E. Monitoring of Controls:

- Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis.
- It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

Important Notes to above Point:

9. Example:

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the

company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

10. Example:

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding “control activities”. When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements. It helps her in gaining insight into the internal control system of the company.

Other Relevant points related to Internal Control (ICAI Module Pg. No. 3.38 – 3.41):

➤ Controls relevant to Audit:

Factors relevant to the auditor’s judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

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

➤ Controls over the completeness and accuracy of information:

- 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.

➤ 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.
➤ <u>Controls relating to objectives that are not relevant to an audit:</u> - An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. - For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit.
➤ <u>Nature and Extent of the Understanding of Relevant Controls:</u> - 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. - Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include: - Inquiring of entity personnel. - Observing the application of specific controls. - Inspecting documents and reports. - Tracing transactions through the information system relevant to financial reporting.

Risks that require Special Audit Consideration (ICAI Module Pg. No. 3.41 – 3.42):

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following: - Whether the risk is a risk of fraud - Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention - The complexity of transactions - Whether the risk involves significant transactions with related parties - 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 - Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.
<u>Identifying Significant Risks:</u> - Significant risks often relate to significant non-routine transactions or judgmental matters. - Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. - Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement.

- The auditor assesses assertions affected by a significant risk as higher inherent risk.
- The following are always significant risks:
 - Risks of material misstatement due to fraud
 - Significant transactions with related parties that are outside the normal course of business for the entity.

Risks of Material Misstatement – Greater for Significant Non-Routine Transactions: (MTP 2 M-24 Q. 6 (a))

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

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

Risks of material misstatement– Greater for Significant Judgmental Matters:

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

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

Evaluation of Internal Control System (ICAI Module Pg. No. 3.43 – 3.52):

Benefits of Evaluation of Internal Control to the Auditor:

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

- whether errors and frauds are likely to be located in the ordinary course of operations of the business
- whether an adequate internal control system is in use and operating as planned by the management
- whether an effective internal auditing department is operating
- 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)
- whether the controls adequately safeguard the assets
- how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned
- how reliable the reports, records and the certificates to the management can be
- the extent and the depth of the examination that he needs to carry out in the different areas of accounting

- what would be appropriate audit technique and the audit procedure in the given circumstances
- what are the areas where control is weak and where it is excessive and
- whether some worthwhile can be given to improve the control system.

Formulate Audit Program after understanding Internal Control:

- The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation.
- If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers.
- It is also important for him to know whether the system is actually in operation.
- The extent and the nature of the audit programme is substantially influenced by the internal control system in operation.
- 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.

Evaluation of Internal Control– Methods:

- The auditor must ask the right people the right questions if he is to get the information he wants.
- It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.
- To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same:
 - (i) Narrative record
 - (ii) Check List
 - (iii) Internal Control questionnaire and
 - (iv) Flow chart

(i) Narrative Record:

- This is a complete and exhaustive description of the system as found in operation by the auditor.
- Actual testing and observation are necessary before such a record can be developed.
- It may be recommended in cases where no formal control system is in operation and would be more suited to small business.
- The basic disadvantages of narrative records are:
 - (a) To comprehend the system in operation is quite difficult.
 - (b) To identify weaknesses or gaps in the system.
 - (c) To incorporate changes arising on account of reshuffling of manpower, etc.

(ii) Check List:

- This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.
- When he completes instruction, he initials the space against the instruction.
- Answers to the check list instructions are usually Yes, No or Not Applicable.

- This is again an on-the-job requirement and instructions are framed having regard to the desirable elements of control.
- Examples:
 - (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?
- The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

(iii) Internal Control Questionnaire: (MTP 2 M-24 Q. 2 (d))

- 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 organization.
- An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method.
- With a proper questionnaire, all internal control evaluation can be completed at one time or in sections.
- The review can more easily be made on an interim basis.
- The questionnaire form also provides an orderly means of disclosing control defects.
- It is the general practice to review the internal control system annually and record the review in detail.
- In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.
- The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.
- If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture.
- The concerned auditor then prepares a report of deficiencies and recommendations for improvement.
- Few illustrative examples of Internal Control Questionnaire in different areas of an entity are given as under:
 - Purchases:
 - Are purchases centralised in the Purchase Department?
 - Are the purchase orders based on valid purchase requisitions duly signed by authorised persons in this behalf?
 - Are purchases based on competitive quotations from two or more suppliers?
 - Are purchase orders pre-numbered?
 - Are purchase orders signed only by employees authorized in this behalf?
 - Are all materials received only in the Receiving Department?

- Creditors:
 - Are all advance payments duly authorized by persons competent to authorize such payments?
 - Are duplicate invoices marked immediately on receipt to avoid payment against them?
 - Are all supplier's statements compared with ledger accounts?
 - Is there any follow-up action to investigate difference, if any, between the suppliers' statements and the ledger accounts?
 - Is a list of unpaid creditors prepared and reconciled periodically?
- Inventories:
 - Are stocks stored in assigned areas?
 - Are stocks insured comprehensively against different risks? If some risk is not insured, whether it is due to specific decision taken by a senior official?
 - Is a record maintained for the insurance policies?
 - Is the record reviewed periodically?
 - Is there an official who decides on the value for which stocks are to be insured?
- Fixed Assets:
 - Are fixed assets verified periodically?
 - Is there a written procedure for such verification?
 - Are reports prepared on such verification?
 - Do such reports indicate damaged/ obsolete items of fixed assets?
 - Are discrepancies disclosed by such reports investigated?

(iv) Flow chart:

- It is a graphic presentation of each part of the company's system of internal control.
- A flow chart is considered to be the most concise way of recording the auditor's review of the system.
- It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.
- It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

Example:

Zomba Products Private limited is a small company. The control systems in the company are rudimentary (i.e. basic/ primary).

In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.

Testing of Internal Control (ICAI Module Pg. No. 3.52 – 3.54):

- Test of controls are performed by the auditor on a selective basis.
- Test of controls are performed to obtain audit evidence about the effectiveness of the:-
 - (i) Design of the accounting and internal control system
 - (ii) Operation of the internal control throughout the period
- Test of controls may include:

(i) 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. (ii) 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. (iii) 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. (iv) Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls. - Deviations from prescribed controls may be caused by such factors as • changes in key personnel, • significant seasonal fluctuations in volume of transactions and • human error - 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.
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Click on the link/ scan the QR Code to watch video on Internal Controls:

<https://youtu.be/1U10SHpmgIs?si=HlVnjhh0BF-IZ0TS>



Automated Environment (ICAI Module Pg. No.3.54 – 3.59):

- An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. - The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. - The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.
<u>Key features of an automated environment:</u> (i) Enables faster business operation (ii) Accuracy in data processing and computation (iii) Ability to process large volume of transactions (iv) Integration amongst business operations (v) Better security and controls

(vi) Less prone to human errors (vii) Provides latest information (viii) Connectivity and networking capability
- If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. - On the other hand, if a company is using an off-the-shelf (i.e. readymade) accounting software (for eg., Tally), then it is likely to be less automated and hence less complex environment.
<u>Understanding and documenting automated environment:</u> Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment: (They should be documented as well) - 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 [Chief Information Officer (CIO), Chief Information System Officer (CISO), Administrators].
<u>Risks arising from use of IT Systems:</u> - 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.
<u>Impact of IT related risks: (RTP M-24 Q. 6)</u> - <u>Impact on substantive checking:</u> Inability to address above discussed risks may lead to non-reliance of data obtained from systems. It could lead to increased substantive checking i.e., detailed checking. - <u>Impact on controls:</u> It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work. - <u>Impact on reporting:</u> Due to regulatory requirements in respect of internal financial controls (discussed in subsequent paras) in case of companies, it may lead to modification of auditor's report in some instances.

Types of Controls in an automated environment: (MTP 1 M-24 Q. 6 (d))

- General IT controls:
 - General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls.
 - These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as “pervasive” controls or “indirect” controls.
 - General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:
 - (i) Data centre and network operations:
 - The objective of controls over Data centre and network operations is to ensure that production systems are processed to meet financial reporting objectives.
 - These include activities such as:
 - overall management of computer operation activities,
 - preparing, scheduling and executing of batch jobs,
 - monitoring, storage and retention of backups
 - performance monitoring of operating system, database and networks
 - matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.
 - (ii) Program change:
 - The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives.
 - It includes activities such as
 - change management process,
 - recording, managing and tracking change requests,
 - making and testing changes etc.
 - (iii) Access security:
 - The objective of controls over access security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.
 - It includes activities such as
 - security organization & management,
 - security policies & procedures,
 - application security,
 - data security,
 - operating system security,
 - network security,
 - physical security etc.

(iv) Application system acquisition, development, and maintenance (Business Applications):

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

● Application Controls:

- Application controls include both automated and manual controls that operate at a business process level.
- Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.
- Examples of automated applications include edit checks and validation of input data, sequence number checks, user limit checks, reasonableness checks, mandatory data fields.

● IT dependent Controls:

- IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications.
- In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.
- Due to the inherent dependency on IT, the effectiveness and reliability of automated application controls and IT dependent controls require the General IT controls to be effective.

General IT Controls vs. Application Controls:

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

Testing methods in an automated environment:

- There are basically four types of audit tests that should be used - inquiry, observation, inspection and reperformance.
- Inquiry is the most efficient audit test but it also gives the least audit evidence.
- Hence, inquiry should always be used in combination with any one of the other audit testing methods.
- Inquiry alone is not sufficient.
- Reperformance is most effective as an audit test and gives the best audit evidence.
- However, testing by reperformance could be very time consuming and least efficient most of the time.
- Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence.

- However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including-
 - risk assessment,
 - control environment,
 - desired level of evidence required,
 - history of errors/ misstatements,
 - complexity of business,
 - assertions being addressed etc.
- When testing in an automated environment, some of the more common methods are as follows:
 - (i) 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.
 - (ii) Observe how a user processes transactions under different scenarios.
 - (iii) Inspect the configuration defined in an application.
- Where the general IT controls are not existing or existing but ineffective, the auditor should assess the impact of IT risks and complexity of the automated environment in which the business operations take place and plan alternative audit procedures in order to rely on the system-based information.

Characteristics of Manual and Automated elements of Internal Control relevant to the Auditor's Risk Assessment (ICAI Module Pg. No.3.59 – 3.61):

- Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances: (M-24 Que 3(c) – 3 Marks)
 - Large, unusual or non-recurring transactions.
 - Circumstances where errors are difficult to define, anticipate or predict.
 - In changing circumstances that require a control response outside the scope of an existing automated control.
 - In monitoring the effectiveness of automated controls.
- Manual control elements may be less suitable for the following circumstances:
 - High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
 - Control activities where the specific ways to perform the control can be adequately designed and automated.
- 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.

Audit Approach in an Automated Environment (ICAI Module Pg. No. 3.61):

Risk Assessment	Understand and Evaluate	Test for operating effectiveness	Reporting
- Identify significant accounts and disclosures	- Document understanding of business processes using Flowcharts/ Narratives	- Assess Nature, Timing and Extent (NTE) of controls testing	- Evaluate control deficiencies
- Qualitative and Quantitative considerations	- Prepare Risk and Control Matrices (RCM)	- Assess reliability of source data; completeness of population	- Significant deficiencies, Material Weaknesses
- Relevant Financial Statement Assertions	- Understand design of controls by performing walkthroughs of end-to-end process	- Testing of key reports and spreadsheets	- Remediation of control weaknesses
- Identify likely sources of Misstatement	- Process wide considerations for Entity level controls, Segregation of Duties	- Sample testing	- Internal Controls Memo (ICM) or Management Letter
- Consider risk arising from use of IT Systems	- IT General Controls, Application controls	- Consider competence and independence of staff/ team performing controls testing	- Auditor's Report

Data Analytics for Audit (ICAI Module Pg. No.3.61 – 3.62)

- 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.
- The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.
- Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:
 - Check completeness of data and population that is used in either test of controls or substantive audit tests.
 - Selection of audit samples – random sampling, systematic sampling.
 - Re-computation of balances – reconstruction of trial balance from transaction data.
 - Reperformance of mathematical calculations – depreciation, bank interest calculation.
 - Analysis of journal entries
 - Fraud investigation.
 - Evaluating impact of control deficiencies.

Click on the link/ scan the QR Code to watch video on Automated Environment:	
https://youtu.be/CHetBndfbP8?si=4bGWM96TemoKRWW3	

Internal Financial Controls (IFC) as per Regulatory Requirements (ICAI Module Pg. No.3.63 – 3.64, 4.43):

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	
Relevant provision of Companies Act, 2013	Nature of Responsibility
Section 134 (5)(e) (M-24 Que 1(c) – 3 Marks)	In case of listed Companies , the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively.
Section 143(3)(i) of the Act	The auditor's report shall state whether the company has adequate Internal financial controls system in place and also on the operating effectiveness of such controls. This requirement shall not apply to a private company which – (i) is One Person Company or a small company; or (ii) has turnover less than ₹ 50 crore as per latest audited Financial Statements; and which has aggregate borrowings from banks or financial institutions or any body-corporate at any point of time during the financial Year for less than ₹ 25 crore.
Section 177(4)(vii) of the Act (M-24 Que 1(c) – 3 Marks)	Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems.
As per Section 149(8) of the Act (M-24 Que 1(c) – 3 Marks)	The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.
The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls.	

Distinction between Internal Financial Control and Internal Control over financial reporting (ICAI Module Pg. No. 4.43)

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

Click on the link/ scan the QR Code to watch video on IFC:

https://youtu.be/yKoDCBt8_ZY?si=eyTaxaRmBsP6xDUu



Documenting the Risks (ICAI Module Pg. No.3.64):

The auditor shall document:

- 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 an understanding.

Assess and Report Audit Findings (ICAI Module Pg. No.3.65):

- When certain findings or exceptions in IT environment and IT controls of the company are found, following points need 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.
- A deficiency in internal control exists if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing.

- Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures.
- Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

Example:

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it.

It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a “control deficiency”.

Click on the link/ scan the QR Code to watch other videos of Chapter 3**Case Study 1:**

<https://youtu.be/NoKchDHdAB8>

**Case Study 2:**

<https://youtu.be/MTqo5sCo5nE>

**Test Your Understanding Questions:**

<https://youtu.be/48Tof3qJXmo>

**Test Your Knowledge Questions:**

<https://youtu.be/PsIBrBoBg4o>



Chapter 4 – Audit Evidence

Weightage of the Chapter: 10-14 Marks

(Weightage of this Ch. is given with Ch. 6 – Total 12-18 Marks)

SA 500 – Audit Evidences

Meaning of Audit Evidence: (ICAI Module Pg. No. 4.5)

- the information used by the auditor ¹
- in arriving at the conclusions
- on which the auditor's opinion is based.

Important Notes to above Meaning:

1. Audit evidence includes both information contained in the accounting records² underlying the financial statements and other information³.
2. Accounting records include –
 - a. the records of initial accounting entries and supporting records, such as cheques and records of electronic fund transfers;
 - b. invoices;
 - c. contracts;
 - d. the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
 - e. records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
3. Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements. For example:
 - a. minutes of the meetings,
 - b. written confirmations from trade receivables and trade payables,
 - c. manuals containing details of internal control
 - d. Internal Audit Report etc.

Types of Audit Evidence: (ICAI Module Pg. No. 4.6 – 4.8)

(i) <u>Depending upon Nature:</u> (a) <u>Visual</u>: For e.g., observing physical verification of inventory conducted by the client's staff. (b) <u>Oral</u>: For e.g., discussion with the management and various officers of the client. (c) <u>Documentary</u>: For e.g., fixed deposit certificate, loan agreement, sales bill etc.
(ii) <u>Depending upon Source:</u> (a) <u>Internal Evidence</u>: Evidence which originates within the organisation being audited is internal evidence. For e.g.: Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc. (b) <u>External Evidence</u>: The evidence that originates outside the client's organization is external evidence. For e.g.: Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

Important Notes to above Point:

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

Relevance and Reliability of Audit Evidence (ICAI Module Pg. No.4.8 – 4.11):

The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

- Relevance:
 - It deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration.
 - For eg.: If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.
On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.
- Reliability:
 - Reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.
 - The following generalisations about the reliability of audit evidence may be useful:
 - (i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
 - (ii) 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.
 - (iii) 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).
 - (iv) 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).
 - (v) Audit evidence obtained as original documents is more reliable than audit evidence obtained as photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form because in these cases the reliability of which may depend on the controls over their preparation and maintenance.
 - **Generalisations about the reliability** of various kinds of audit evidence **are subject to important exceptions**. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For eg., External source may be not knowledgeable or related to the entity.

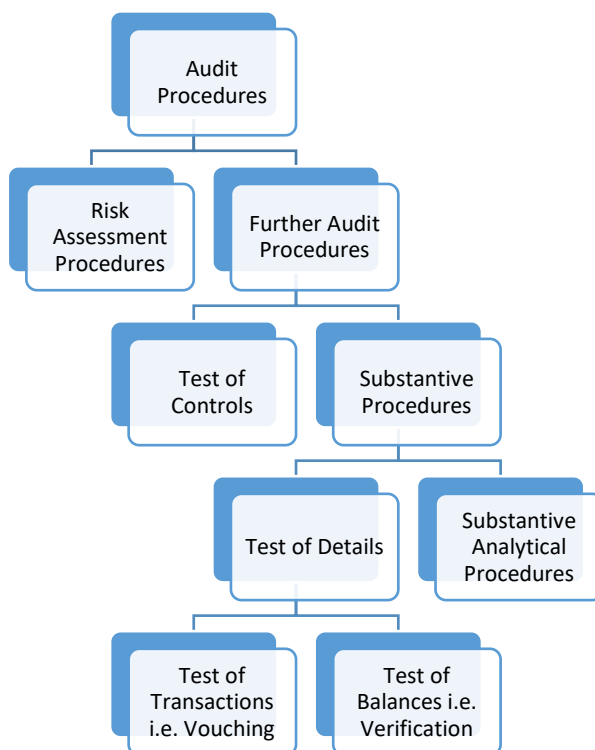
Sufficient and Appropriate Audit Evidence (ICAI Module Pg. No.4.11 – 4.14):

- Sufficiency is the measure of the quantity of Audit Evidence.
- Factors affecting auditor's judgement as to sufficiency of audit evidence:
 - (i) Materiality:
 - Less Material Assertions → Less Evidences are required
 - More Material Assertions → More Evidences are required

(ii)	<u>Risk of Material Misstatement:</u> Lower Risk of Material Misstatement → Less Evidences are required Higher Risk of Material Misstatement → More Evidences are required
(iii)	<u>Size & characteristics of the population:</u> Smaller, more homogeneous population → Less Evidences are required Larger, more heterogeneous population → More Evidences are required
- Appropriateness is the measure of the quality of Audit Evidence. - Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. - In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. (MTP 1 M-24 Q. 3 (a))	

Audit procedures for obtaining audit evidence (ICAI Module Pg. No.4.20 – 4.22):

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



(a)	Risk Assessment Procedures: - It refers 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.
(b)	Further Audit Procedures, which comprises: (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so;

It 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.

- (ii) **Substantive procedures**, including tests of details and substantive analytical procedures. Substantive procedures are designed to detect material misstatements at the assertion level.

Audit procedures to obtain audit evidence can include (ICAI Module Pg. No.4.15 – 4.19):

(i) <u>Inspection: (RTP M-24, Q. 7)</u> • 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. • An example of inspection used as a test of controls is inspection of records for evidence of authorisation. • The auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence – It is an Inspection.
(ii) <u>Observation:</u> • Observation consists of looking at a process or procedure being performed by others. • The auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. • It provides audit evidence which is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.
(iii) <u>External Confirmation:</u> • It 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. • It is relevant for assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For eg., confirmation of the terms of agreements or transactions, or to confirm modification made in the agreement. • It is also used to obtain audit evidence about the absence of certain conditions. For eg., the absence of a "side agreement" that may influence revenue recognition.
(iv) <u>Recalculation:</u> • Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically. • For eg., Recalculation of Depreciation, Recalculation of Inventory Value etc.
(v) <u>Reperformance:</u> • Repformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control. • For eg., Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable etc.
(vi) <u>Analytical Procedures:</u> • Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

(vii) Inquiry:

- Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.
- Inquiries may range from formal written inquiries to informal oral inquiries.
- Evaluating responses to inquiries is an integral part of the inquiry process.
- Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Hence, it is performed along with other procedures.

Assertions (ICAI Module Pg. No.4.23 – 4.27):**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.

Assertions are divided into the following three categories:**(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. (RTP M-24 MCQ)
- (ii) Completeness – all transactions and events that should have been recorded have been recorded.
- (iii) Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately.
- (iv) Cut-off – transactions and events have been recorded in the correct accounting period.
- (v) Classification – transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

- (i) Existence – assets, liabilities, and equity interests exist.
- (ii) Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- (iii) Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.
- (iv) Valuation and allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

- (i) Occurrence and rights and obligations – disclosed events, transactions, and other matters have occurred and pertain to the entity.
- (ii) Completeness – all disclosures that should have been included in the financial statements have been included.
- (iii) Classification and understandability – financial information is appropriately presented and described, and disclosures are clearly expressed.
- (iv) Accuracy and valuation – financial and other information are disclosed fairly and at appropriate amounts.

- Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion;
- On the other hand, if in the balance sheet there is no item as “building”, it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Audit Trail (ICAI Module Pg. No.4.27 – 4.28):

- **An audit trail** is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity.
- It is used as audit evidence to establish authentication and integrity of a transaction.
- It helps in maintaining record of system and user activity.
- Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use.
- Systems which have a feature of audit trail inspires confidence in auditors. It helps auditors in verifying whether controls devised by the management were operating effectively or not.
- It aids in verification whether a transaction was indeed performed by a person authorised to do it. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

Work of Management’s Expert as Audit Evidence (ICAI Module Pg. No.4.28 – 4.29, 4.32):Meaning of Management’s Expert:

- An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.
- For e.g., Actuarial Valuation Report on Employee Benefit Provisions by Actuary.

Relying on the work of a management’s expert: (MTP 1 S-24 Q. 1 (c))

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

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

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

- The nature and complexity of the matter to which the management’s expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management’s expert’s work.
- Whether the management’s expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management’s expert.
- Whether the management’s expert is subject to technical performance standards or other

professional or industry requirements.

- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

Selecting Items for Testing to Obtain Audit Evidence (ICAI Module Pg. No.4.29 – 4.31):

When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. The means available to the auditor for selecting items for testing are:

- (a) Selecting All Items:
- The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population).
 - 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details.
 - 100% examination may be appropriate when, for example:
 - The population constitutes a small number of large value items;
 - There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
 - The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.
- (b) Selecting Specific Items (MTP 2 M-24 Q. 1 (a) along with Non-sampling Risk) (M-24 Que 4(a) – 4 Marks)
- The auditor may decide to select specific items from a population.
 - In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested.
 - The judgmental selection of specific items is subject to non-sampling risk.
 - Specific items selected may include:
 - High value or key items:
The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.
 - All items over a certain amount:
The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
 - Items to obtain information:
The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.
- (c) Audit Sampling:
- Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it.

Click on the link/ scan the QR Code to watch video on SA 500:

https://youtu.be/lyysseTDjsE?si=Uc4S3NZDCH9_WQM1



SA 505 – External Confirmations**Definition of External Confirmation: (ICAI Module Pg. No. 4.78)**

- 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.

Other Important Points: (ICAI Module Pg. No. 4.78 and 4.85)Positive Confirmation Request Meaning:

- 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● Meaning:

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

● Negative confirmations provide less persuasive audit evidence than positive confirmations. (MTP 1 S-24 Q. 4 (a))

Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedures to address an assesses risk of material misstatement at the assertion level unless all of the following are present:

- (a) The auditor has assessed the **risk of material misstatement as low** and has obtained sufficient appropriate **audit evidence regarding the operating effectiveness of controls** relevant to the assertion;
 - (b) The **population of items** subject to negative confirmation procedures comprises **a large number of small, homogeneous**, account balances, transactions or conditions;
 - (c) A very **low exception rate is expected**; and
 - (d) The auditor is **not aware of circumstances or conditions** that would cause recipients of negative confirmation requests to **disregard such requests**.
- Here, confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

Non-response Meaning:

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

Exception Meaning:

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

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

External Confirmation Procedures adopted by the Auditor to Obtain Audit Evidence: (ICAI Module Pg. No. 4.79-4.82)

(a) <u>Determining the Information to be Confirmed or Requested:</u> - External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. - They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a “side agreement”.
(b) <u>Selecting an Appropriate Confirming Party:</u> - It should be sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed.
(c) <u>Designing Confirmation Requests:</u> • <u>Design of a confirmation request:</u> - 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. • <u>Factors to be considered by auditor when designing confirmation requests:</u> Factors to consider when designing confirmation requests include: (i) The assertions being addressed. (ii) Specific identified risks of material misstatement, including fraud risks. (iii) The layout and presentation of the confirmation request. (iv) Prior experience on the audit or similar engagements. (v) The method of communication (for example, in paper form, or by electronic or other medium) (vi) Management’s authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorisation. (vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance). • <u>Positive confirmation request:</u> - There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. - The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. - On the other hand, use of this type of “blank” confirmation request may result in lower response rates because additional effort is required of the confirming parties. • <u>Determination of properly addressed requests:</u> - Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.
(d) <u>Follow-Up on Confirmation Requests:</u> - The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. - For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Example: (RTP M-24, Q. 8)

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well - functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

Management's refusal to allow the auditor to send a confirmation request-steps taken by the Auditor: (ICAI Module Pg. No. 4.82-4.84)

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

- (a) **Inquire** as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
 - (b) **Evaluate the implications** of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
 - (c) **Perform alternative audit procedures** designed to obtain relevant and reliable audit evidence.
- If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.
 - The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

Reasonableness of Management's Refusal:

- A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation.
- A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request.
- The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.
- Example,
On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.
Implications for the Assessment of Risks of Material Misstatement: - The auditor may conclude that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures. - For e.g., if management's request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240.
Alternative Audit Procedures: Examples of alternative audit procedures the auditor may perform include: - For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end. - For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

Evaluating the Evidence Obtained (ICAI Module Pg. No. 4.86)

When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows: (a) A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception; (b) A response deemed unreliable; (c) A non-response; or (d) A response indicating an exception.

Click on the link/ scan the QR Code to watch video on SA 505: https://youtu.be/XV5AAfMejOY?si=nqEqMobWqJjpamhq	
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SA 520 – Analytical Procedure

Meaning of Analytical Procedures: (ICAI Module Pg. No. 4.97 - 4.99)

- “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.
- Examples: (i) CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to Rs. 50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. Here, CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice

an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

- (ii) The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.
i.e. Total wages = Wages per worker (Financial Data) x Total number of workers (Non-financial Data)

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships. (ICAI Module Pg. No. 4.99 - 4.101, 4.102)

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information are:

- Comparable information for **prior periods**. (Intra-firm comparison)
- **Anticipated results of the entity**, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation. (Intra-firm comparison)
- **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. (Inter-firm comparison)

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.
- Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Few more examples of Analytical Procedures (Any of these can also be asked as question):

- In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.
- On verifying the balances of sundry account receivables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him.
- Also whether in the case of account payable, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.
- In case of inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

- By reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

Scope and Objectives of SA 520 (ICAI Module Pg. No. 4.101)

Scope of SA 520:

- It deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Objectives of SA 520:

- To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- 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.

Purposes and Timing of Analytical Procedures (ICAI Module Pg. No. 4.103 – 4.104)

Purposes of Analytical Procedures:

- Similarly, it would also be possible **to compare the balances** on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
- If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.
- An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year.
- When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year.
- **Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. (In old course, once it is asked as a question, answer is as follow)**
- For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of GST paid.
- Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.
- Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.
- Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Timing of Analytical Procedures:

Experienced auditors use analytical procedures in all stages of the audit:

- (i) Planning phase
- (ii) Testing phase
- (iii) Completion phase.

Factors to be considered for Substantive Audit Procedures (ICAI Module Pg. No. 4.105 – 4.107)

(i) <u>Availability of Data:</u>	- The availability of reliable and relevant data will facilitate effective analytical procedures.
(ii) <u>Disaggregation:</u>	- The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.
(iii) <u>Account Type:</u>	- 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.
(iv) <u>Source:</u>	- Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes – Sales, Purchase etc.). - Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict. (For eg., Research and Development Expenses, Advertisement Expenses etc.)
(v) <u>Predictability:</u>	- Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). - A predictable relationship is one that may reasonably be expected to exist and continue over time.
(vi) <u>Nature of Assertion:</u>	- Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). - Predictive analytical procedures using data analytics can be used to address completeness, valuation/ measurement and occurrence.
(vii) <u>Inherent Risk or “What Can Go Wrong”:</u>	- 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. - For e.g., when side agreements with respect to revenue recognition have been identified as

a significant or fraud risk, it is unlikely that an analysis of sales compared to cash receipts or cost of sales would be appropriate to respond to that risk.

Techniques available as Substantive Audit Procedures (ICAI Module Pg. No. 4.107 – 4.109)

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.

(i) **Trend Analysis:**

- It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances.
- The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- In other words, trend analysis implies analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.
- For e.g., the auditor may compare the salary paid by the company during the year under audit with the salary paid by the company for several earlier years. There may be some percentage increase in the salary expense over the years. However, an unusual increase in such expense amount may indicate that fraudulent payments are being made to fake employees.

(ii) **Ratio Analysis:**

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

(iii) **Reasonableness tests:**

- It does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense).
- These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.
- In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.
- For e.g.,
 - Interest expense against interest bearing obligations
 - Raw Material Consumption to Production (quantity)
 - Wastage & Scrap % against production & raw material consumption (quantity)
 - Work-in-Progress based on issued of materials & Sales (quantity)
 - Sales discounts and commissions against sales volume
 - Rental revenues based on occupancy of premises

(iv) Structural modelling:

- A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Analytical Procedures used as Substantive Tests (ICAI Module Pg. No. 4.109 – 4.110)

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

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

Suitability of particular analytical procedures for given assertions (ICAI Module Pg. No. 4.110 – 4.111)

- Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
 - 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.
 - 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.
 - In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.
- Different types of analytical procedures provide different levels of assurance.
 - The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.
 - Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion.

Reliability of Data (ICAI Module Pg. No. 4.112 – 4.113)

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

- (i) Source of the information available.
For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available.
For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (iii) Nature and relevance of the information available.
For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity.
For example, controls over the preparation, review and maintenance of budgets.

Evaluation of whether the expectation is sufficiently precise (ICAI Module Pg. No. 4.113)

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- (i) The accuracy with which the expected results of substantive analytical procedures can be predicted.
For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- (ii) The degree to which information can be disaggregated.
For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- (iii) The availability of the information, both financial and non-financial.
For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

Amount of difference of recorded amounts from expected values that is acceptable (ICAI Module Pg. No. 4.113 – 4.114)

- The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance.
- The assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

Investigating results of Analytical Procedures (ICAI Module Pg. No. 4.114)

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant

amount, the auditor shall investigate such differences by:

- (i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:

Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

- (ii) Performing other audit procedures as necessary in the circumstances:

The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Click on the link/ scan the QR Code to watch video on SA 520:

<https://youtu.be/h8277XZZalo?si=riZvV4EmpXzKBYxu>



SA 501 – Audit Evidences – Specific Considerations for Selected Items:

Objectives of SA 501: (ICAI Module Pg. No. 4.68)

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

- (A) Existence and condition of inventory;
- (B) Completeness of litigation and claims involving the entity; and
- (C) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Inventory: (ICAI Module Pg. No. 4.68 – 4.72)

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

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

Attendance at Physical Inventory Counting involves:

- (a) **Inspecting** the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- (b) **Observing** compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- (c) Obtaining audit evidence as to the **reliability of management's count** procedures.
 - These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Matters relevant in planning attendance at physical inventory counting include, for example: (MTP 1 M-24 Q. 4 (b))

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

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 perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.
- Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:
 - Whether the perpetual inventory records are properly adjusted.
 - Reliability of the entity's perpetual inventory records.
 - Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.
- If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

Attendance at Physical Inventory Counting becomes impractical

- 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 like location that may pose threats to the safety of the auditor.
- The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable.
- Further, as explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

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

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: (RTP S-24 Que 12)

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

Other audit procedure may include, for example:

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

Litigation and Claim: (ICAI Module Pg. No. 4.72 – 4.75)

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

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims - Communication with the Entity's External Legal Counsel:

- If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.
- The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.
- If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

- If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes: **(M-24 Que 2(b) – 4 Marks)**
 - (a) A list of litigation and claims;
 - (b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
 - (c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.
- In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. (RTP M-24 Q. 10)
This may be the case, for example, where:
 - (a) The auditor determines that the matter is a significant risk.
 - (b) The matter is complex.
 - (c) There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.
- Further if: **(M-24 Que 2(b) – 4 Marks)**
 - (a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
 - (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,

the auditor shall modify the opinion in the auditor's report in accordance with SA 705. (Qualified Opinion or Disclaimer of Opinion)

Segment Information: (ICAI Module Pg. No. 4.76 – 4.77)

Definition of Segment Information:

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

Obtaining sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

- (a) Obtaining an understanding of the methods used by management in determining segment information, and:
 - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
 - (ii) Where appropriate, testing the application of such methods; and
- (b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

Understanding of the Methods Used by Management:

Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether

such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

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

Click on the link/ scan the QR Code to watch video on SA 501:

<https://youtu.be/Ke6U1KTflf8?si=l3qop87LroD78pvg>



SA 510 – Initial Audit Engagement – Opening Balances:

Definitions: (ICAI Module Pg. No. 4.87)

- (a) Initial audit engagement** refers to an engagement in which either:
 - (i) The financial statements for the prior period were not audited; or
 - (ii) The financial statements for the prior period were audited by a predecessor auditor.
- (b) Opening balances means** those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
- (c) Predecessor auditor** – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Scope of SA 510: (ICAI Module Pg. No. 4.87)

SA 510 deals with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement.

Objectives of Auditor as per SA 510: (ICAI Module Pg. No. 4.88)

- 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:
- (i) Opening balances contain misstatements that materially affect the current period's financial statements; and
 - (ii) 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.

Audit Procedures to obtain sufficient appropriate audit evidence about opening balances: (ICAI Module Pg. No. 4.88 – 4.90)

Audit Procedures: (RTP M-24 Q. 9)

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:

- (i) 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;
- (ii) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (iii) Performing one or more of the following:
 - (a) 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;
 - (b) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (c) Performing specific audit procedures to obtain evidence regarding the opening balances.

Nature and extent of Audit Procedures:

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

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

If the prior period's financial statements were audited by a predecessor auditor, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

Audit Procedures - for current assets and liabilities:

- For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.
- For e.g., the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.
- In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period.
- Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence: (MTP 2 M-24 Q. 2 (c))
 - Observing a current physical inventory count and reconciling it to the opening inventory quantities.

- Performing audit procedures on the valuation of the opening inventory items. - Performing audit procedures on gross profit and cut-off.
<u>Audit Procedures - for non-current assets and liabilities:</u> For non-current assets and liabilities, (i) Such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. (ii) In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties.

Consistency of Accounting Policies relating to opening balances (ICAI Module Pg. No. 4.91):

If the auditor concludes that: (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or (b) a change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework, the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.
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Reporting by the auditor with regard to opening balances (ICAI Module Pg. No. 4.91):

(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.

<u>Click on the link/ scan the QR Code to watch video on SA 510:</u> <u>https://youtu.be/XeIAjvQ03ew?si=ceNxx6lZvjeAGHET</u>	
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SA 550 – Related Parties

Definition of Related Party: (ICAI Module Pg. No. 4.92 – 4.93)

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:
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a. Common controlling ownership; b. Owners who are close family members; or c. Common key management.
However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.
<u>Meaning of control and significant influence in reference to related party:</u> Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that: (i) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and (ii) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.
The existence of the following relationships may indicate the presence of control or significant influence: (i) Direct or indirect equity holdings or other financial interests in the entity. (ii) The entity's holdings of direct or indirect equity or other financial interests in other entities. (iii) Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity). (iv) Being a close family member of any person referred to in subparagraph (iii). (v) Having a significant business relationship with any person referred to in subparagraph (iii).

Scope of SA 550 (ICAI Module Pg. No. 4.92):

- SA 550 deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. - Specifically, it applies in relation to risks of material misstatement associated with related party relationships and transactions.

Nature of Related Party Relationships and Transactions (ICAI Module Pg. No. 4.94):

- 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. - Examples: • Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions. • Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties. • Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Understanding the Entity's Related Party Relationships & Transactions (ICAI Module Pg. No. 4.94 – 4.95):

The auditor shall inquire of management regarding:

- (a) The identity of the entity's related parties, including changes from the prior period;
- (b) The nature of the relationships between the entity and these related parties; and
- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to -

- (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- (b) Authorise and approve significant transactions and arrangements with related parties; and
- (c) Authorise and approve significant transactions and arrangements outside the normal course of business.

Considerations specific to smaller entities by the auditor (ICAI Module Pg. No. 4.95 – 4.96):

- Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions.
- An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions.
- For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

How can an auditor verify the existence of related party relationships and transactions? (ICAI Module Pg. No. 4.96):

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, for example: **(MTP 1 S-24 Q. 6 (b))**

- (i) Entity income tax returns.
- (ii) Information supplied by the entity to regulatory authorities.
- (iii) Shareholder registers to identify the entity's principal shareholders.
- (iv) Statements of conflicts of interest from management and those charged with governance.
- (v) Records of the entity's investments and those of its pension plans.
- (vi) Contracts and agreements with key management or those charged with governance.
- (vii) Significant contracts and agreements not in the entity's ordinary course of business.
- (viii) Specific invoices and correspondence from the entity's professional advisors.
- (ix) Life insurance policies acquired by the entity.
- (x) Significant contracts re-negotiated by the entity during the period.
- (xi) Internal auditors' reports.
- (xii) Documents associated with the entity's filings with a securities regulator (e.g., prospectuses)

Click on the link/ scan the QR Code to watch video on SA 550:

https://youtu.be/sojaVbU5luM?si=i_NphnoGparqYF6K



SA 610 – Using the work of Internal Auditors

Definition, Objective and Scope of Internal Audit: (ICAI Module Pg. No. 4.33 – 4.34)

Definition of Internal Audit:

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.

Objective and Scope of Internal Audit:

(i) 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.

(ii) 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.

(iii) Activities Relating to Internal Control:

- Evaluation of internal control.

The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control.

- Examination of financial and operating information.

The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

- Review of operating activities.

The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.

- Review of compliance with laws and regulations.

The internal audit function may be assigned to review compliance with laws, regulations, and other external requirements, and with management policies and directives and other internal requirements.

Example:

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to

certain technical glitches.

Here, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

Ways in which the external auditor may make use of the function for purposes of the audit: (ICAI Module Pg. No. 4.34 – 4.35)

- While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements.
- The external auditor may make use of the function for purposes of the audit in one or more of the following ways:
 - (i) To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud.
 - (ii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.
 - (iii) Unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance").

Scope of SA 610: (ICAI Module Pg. No. 4.35)

SA 610 deals with the external auditor's responsibilities if using the work of internal auditors:

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

This SA doesn't mandate external auditor to use the work of Internal Auditor and to modify nature, timing and audit procedures, it is totally dependent upon external auditor's judgement/ decision.

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement.

Objectives of External Auditor as per SA 610: (ICAI Module Pg. No. 4.36)

- (i) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination.
- (ii) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
- (iii) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Examples of work of the internal audit function that can be used by the external auditor include the following: (ICAI Module Pg. No. 4.40)

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.

Evaluating the Internal Audit Function: (ICAI Module Pg. No. 4.36 – 4.39)

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

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

When external auditor determines that all of three above are not proper, the internal audit function shall not be used.

(i) Objectivity and its evaluation:

- Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments.
- Factors that may affect the external auditor's evaluation in relation to Objectivity include the following:
 - (i) Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be **free from bias, conflict of interest or undue influence** of others to override professional judgments.
For e.g., whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
 - (ii) Whether those charged with governance **oversee employment decisions** related to the internal audit function.
For e.g., determining the appropriate remuneration policy.
 - (iii) Whether there are any **constraints or restrictions** placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.
 - (iv) Whether the internal audit function is **free of any conflicting responsibilities**, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.

(ii) Competence and its evaluation:

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

include the following: (i) Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations. (ii) Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements. (iii) Whether the internal auditors have adequate technical training and proficiency in auditing. (iv) Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework.
- Objectivity and competence may be viewed as a continuum (i.e. continuation/ chain) - The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. - However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. - Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.
(iii) Application of a Systematic and Disciplined Approach: - The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity. - Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following: (i) The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity. (ii) Whether the internal audit function has appropriate quality control policies and procedures.

Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly (ICAI Module Pg. No. 4.40): (MTP 1 M-24 Q. 6 (a))

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

- (a) The more judgment is involved in:
 - (i) Planning and performing relevant audit procedures; and
 - (ii) Evaluating the audit evidence gathered;
- (b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;
- (c) The less the internal audit function's organizational status and relevant policies and procedures

adequately support the objectivity of the internal auditors; and
(d) The lower the level of competence of the internal audit function.

Example:

CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high.

In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

Using the Work of the Internal Audit Function (ICAI Module Pg. No. 4.40 – 4.41):

If the external auditor plans to use the work of the internal audit function, the external auditor shall

- discuss the planned use of its work with the function as a basis for coordinating their respective activities.
- read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.
- perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit.

Discussion and Co-ordination with the Internal Audit Function:

In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.
- Review and reporting procedures.

Coordination between the external auditor and the internal audit function is effective when, for example; **(M-24 Que 3(d) – 3 Marks)**

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

Determining Whether, in Which Areas, and to What Extent Internal Auditors can be used to provide Direct Assistance (ICAI Module Pg. No. 4.42 – 4.43):

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.
The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors.
The external auditor shall not use an internal auditor to provide direct assistance if: (a) There are significant threats to the objectivity of the internal auditor; or (b) The internal auditor lacks sufficient competence to perform the proposed work.
The external auditor shall not use internal auditors to provide direct assistance to perform procedures that: (a) Involve making significant judgments in the audit; (b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited; (c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or (d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.
Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall: (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Click on the link/ scan the QR Code to watch video on SA 610:

<https://youtu.be/bL0Wna7Utvk?si=4QVzbP2o5mvuDhjB>



SA 530 – Audit Sampling

Meaning of Audit Sampling: (ICAI Module Pg. No. 4.45 – 4.47)

Audit Sampling:

It refers to the application of audit procedures to less than 100% of items within a population relevant under the audit, such that all sampling units (i.e. all the items in the population) have an equal chance of selection.

Population:

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

Sampling Unit:

The individual items that make up the population are known as sampling units.

Objective and Scope of SA 530: (ICAI Module Pg. No. 4.45 – 4.46)

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Scope:

SA 530 becomes applicable when the auditor has decided to use audit sampling in performing audit procedures.

This standard deals with the auditor's use of -

- Statistical and
- Non-statistical sampling

when designing and selecting the-

- (i) audit sample,
- (ii) performing tests of controls and tests of details, and
- (iii) evaluating the results from the sample.

SA 500, 'Audit Evidence', lays down the means available to the auditor for selecting the items for testing. One of those is audit sampling. Hence SA 530 complements SA 500.

Population (ICAI Module Pg. No. 4.46 – 4.47)

- The auditor should select sample items in such a way that the sample can be expected to be representative of the population.
- This requires that all items in the population have an opportunity of being selected.

Characteristics of Population:**1. Appropriateness:**

- Appropriate means population from which the samples are drawn shall be relevant for the specific objective under audit.
- This is because when the samples are drawn, the audit procedures are applied on the sample and the conclusions are projected on the population.
- Example:
If the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

2. Completeness:

- The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions about whether a control activity is operated effectively during the financial reporting period, the population needs to include all relevant items i.e. all the activities that form part of that relevant internal control, throughout the entire period.
- If population is complete in all respects, the conclusions drawn on the population will be considered to be reasonable.

3. Reliable:

- Population needs to be sufficiently complete and accurate.
- Auditor should obtain evidence about the reliability of population.
- If population is not reliable with respect to accuracy and source, the sample drawn will definitely not be relevant for the specific audit objective.

Approaches to Sampling: (ICAI Module Pg. No. 4.48 – 4.50, 4.52)

<u>Approaches to Sampling:</u> (i) <u>Statistical Sampling:</u> - An approach to sampling that has the random selection of the sample units; - and the use of probability theory to evaluate sample results, - including measurement of sampling risk characteristics. (These 3 are characteristics of statistical sampling approach as well) (ii) <u>Non-statistical Sampling:</u> A sampling approach that does not have the above features is considered as non-statistical sampling.	- 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. - Sampling process is performed on Test of Controls and Test of Details.
<u>Statistical Sampling - More Scientific:</u> (i) 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. (ii) 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. (iii) There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.	In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased and the samples selected are not prejudged.
<u>Appropriateness of Sampling Approaches:</u> The advantages of statistical sampling may be summarized as follows - (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested. (ii) The sample selection is more objective and thereby more defensible. (iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision. (iv) 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. (v) 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. (vi) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.	- Under some audit circumstances, statistical sampling methods may not be appropriate. - The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance,

when exact accuracy is required or in case of legal requirements etc. - Sometimes the audit staff has no knowledge about sampling technique used, in such circumstances using statistical sampling becomes complex and inappropriate.
<u>Non-statistical Sampling:</u> - Under this approach, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. - This approach has been in common application for many years because of its simplicity in operation. - Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. - For example, March, June and September may be selected in year one and different months would be selected in the next year, On basis of value of items, top 10 highest value etc. - An attempt would be made to avoid establishing a pattern of selection year after year, i.e. the way of selecting samples, to maintain an element of surprise as to what the auditor is going to check. - It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined as they are prone to high risk of misappropriation. - <u>Criticism:</u> (i) It is neither objective nor scientific. (ii) 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. (iii) The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. - However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford. - This method is simple to operate but sometimes the sample may not be a true representative of the total population because of personal bias and no scientific method of selection.
<u>Example:</u> An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. It is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach non- statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

Factors to be considered for deciding upon the extent of checking on a sampling plan: (ICAI Module Pg. No. 4.51)

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

- (i) Size of the organisation under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.
- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

Sampling Risk: (ICAI Module Pg. No. 4.137 – 4.138) (Test Your Knowledge Question 21, Pg. No. 4.126)

As per SA 530 “Audit Sampling”, sampling risk is the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not 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 test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects **audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.**

Sample Design: (ICAI Module Pg. No. 4.53 – 4.56)

When designing an audit sample,

- (i) The auditor’s consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.
- (ii) Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.
- (iii) In fulfilling the requirement of SA 500 “Audit Evidence”, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

Stratification:

- Dividing a population into discrete sub population which have identifying characteristics is called as Stratification.
- Stratification means dividing heterogeneous (Diversified) population into Homogeneous (having similar characteristics) sub population, where samples are drawn from each sub population.
- Each Sub population is called as Stratum
- Units under those sub population are referred to as Strata.
- Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic like monetary value or characteristic that indicates a higher risk of misstatement.
- 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.

- The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum.
- To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. The auditor needs to combine the results of all the stratum to check for possible deviation or risk of material misstatement.

Value-Weighted Selection:

- When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population.
- Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.
- One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.
- This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.
- In value weighted selection, the sample size, its selection and evaluation will result in a conclusion in monetary amounts.

Sample Size: (ICAI Module Pg. No. 4.56 – 4.60)

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

- **Tolerable misstatement –**

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

- **Tolerable rate of deviation –**

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

Examples of Factors Influencing Sample Size for Tests of Controls:

- To lower the Risk of Material Misstatement through obtaining more assurance on operating effectiveness of Internal Controls → Larger the sample size needs to be.
- Increase in/ Higher the tolerable rate of deviation → sample size will decrease
Decrease in/ Lower the tolerable rate of deviation → sample size will increase.
- Higher the expected rate of deviation → larger the sample size needs to be.
Lower the expected rate of deviation → smaller the sample size needs to be.

Factors relevant to the auditor's consideration of the expected rate of deviation include:

- the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), - changes in personnel or in internal control, - the results of audit procedures applied in prior periods and - the results of other audit procedures (iv) An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population → increase the sample size. A decrease 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 → decrease the sample size. (v) In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations, however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.	<u>Examples of Factors Influencing Sample Size for Tests of Details:</u> (i) The higher the Risk of Material Misstatement → Larger the sample size needs to be. The lower the Risk of Material Misstatement → Smaller the sample size needs to be. (ii) Increase in/ Higher the tolerable misstatement → sample size will decrease Decrease in/ Lower the tolerable misstatement → sample size will increase. (iii) Higher the expected misstatement → larger the sample size needs to be. Lower the expected misstatement → smaller the sample size needs to be. <u>Factors relevant to the auditor's consideration of the expected misstatement amount:</u> - the results of risk assessment procedures, - the results of tests of control, - the results of audit procedures applied in prior periods, and - the results of other substantive procedures. (iv) An increase in the auditor's desired level of assurance that the tolerable misstatement is not exceeded by the actual misstatement in the population → increase the sample size. A decrease in the auditor's desired level of assurance that the tolerable misstatement is not exceeded by the actual misstatement in the population → decrease the sample size. (v) There will be negligible effect on sample size due to number of sampling units in the population. For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (vi) 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 → the smaller the sample size can be. (vii) When stratification of the population is appropriate → sample size will decrease.
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Sample Selection Methods: (ICAI Module Pg. No. 4.60 – 4.64)

(i) <u>Random Sampling:</u> - 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–
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(a) Simple Random Sampling:

- It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
- Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way.
- This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range.
- For e.g., The population can be considered homogeneous, if say, trade receivables balances fall within the range of Rs. 55,000 to Rs. 2,25,000 and not in the range between Rs. 525 to Rs. 10,50,000.

(b) Stratified Sampling:

- This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.
- Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum.
- The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
- In the above example, trade receivables balances may be divided into five groups as follows and auditor may pick up different percentage of items from each of the group as mentioned in the bracket:
 - i) balances in excess of Rs. 10,00,000; (100%)
 - ii) balances in the range of Rs. 7,75,001 to Rs. 10,00,000; (25%)
 - iii) balances in the range of Rs. 5,50,001 to Rs. 7,75,000; (10%)
 - iv) balances in the range of Rs. 2,25,001 to Rs. 5,50,000; (2%) and
 - v) balances Rs. 2,25,000 and below. (Immaterial – so not examined)
- 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.

(ii) Interval Sampling or Systematic Sampling: (MTP 2 S-24 Q. 1 (b))

- 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 e.g., 50 is considered as sampling interval, 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.
- Examples:

- If in a population of branch sales, particular branch sales occur only as every 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch. - If Accountant A is responsible to record all transaction in a particular month and Accountant B for next month; if this structure is same throughout the year, and the auditor determines as his sample to check every transaction of alternate months, then only one accountant's work is checked by the auditor i.e. either Accountant A or B depending upon which month the checking started from. The work of other is overlooked and there could be a possibility of material misstatement in the transactions recorded by him. - Therefore, systematic sampling when chosen as a method should be carefully applied to bring together every type of transaction within its purview. More than one starting point can be considered to minimize such risk.
(iii) <u>Monetary Unit Sampling:</u> - It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
(iv) <u>Haphazard sampling:</u> - Haphazard selection, in which the auditor selects the sample without following a structured technique. - Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. - Haphazard selection is not appropriate when using statistical sampling. - Haphazard sampling has no structured approach, does not involve judgement and does not even use the random number tables.
(v) <u>Block sampling: (MTP 2 S-24 Q. 1 (b))</u> - This method involves selection of a block(s) of contiguous (i.e. neighboring) items from within the population. - For e.g., take the first 200 sales invoices from the sales day book in the month of September, alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion. - 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. - Further, if the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily overlooked by management's practice of recording them. - There is a close similarity between this method and non-statistical sampling. Consequently, it has similar characteristics, namely, simplicity and economy. On the other hand, there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

Performing Audit Procedures: (ICAI Module Pg. No. 4.64 – 4.65)

- (i) The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
- (ii) If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a **replacement item**.

Example:

- An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined. A replacement would then mean a proper and valid cheque through which payment has been made.
 - Another example for replacement of a sample could be, if all transactions of computerized sales are being checked, for example sales recorded through a bar code scanner, and incidentally a sample of manual billing gets selected, then such item can be replaced after adequately checking the correctness of the manual bill with the supporting documents available. If replacement is not possible or reasonable, alternative audit procedure can be applied.
- (iii) If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.

Example:

- An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost. If the documentation of a sales is lost, like the sales order record, sales invoice, document for dispatch etc., then confirmation can be sought from the debtor as per SA 505. If it is a cash sale, the cash book can be cross verified for the existence of such transactions.
- An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

Nature and Cause of Deviations and Misstatements: (ICAI Module Pg. No. 4.65 – 4.66)

- (i) In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.
- (ii) In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.
- (iii) Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.
- (iv) In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an **anomaly**, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.

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

- (v) The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Projecting Misstatements: (ICAI Module Pg. No. 4.66)

- (i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.
- (ii) When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.
- (iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Evaluating Results of Audit Sampling: (ICAI Module Pg. No. 4.66)

The auditor shall evaluate-

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

Precautions to be taken while applying test check techniques are: (ICAI Module Pg. No. 4.138) (Test Your Knowledge Question 23, Pg. No. 4.127)

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

Click on the link/ scan the QR Code to watch video on SA 530:

<https://youtu.be/7Qj6xpXpFI8?si=kxgNR4PoAJ0f8YJ>



Click on the link/ scan the QR Code to watch other videos of Chapter 4:

Case Study 1:

<https://youtu.be/5u0Vlrx0joQ>



Case Study 2:

<https://youtu.be/TSgNeamcPV8>



Test Your Understanding Questions:

<https://youtu.be/PGdqHpf52Q4>



Test Your Knowledge Questions:

<https://youtu.be/yf6cW97OXi8>



Chapter 5 – Audit of Items of Financial Statements and CARO, 2020

Weightage of the Chapter: 12-20 Marks

Points to be noted:

- Assertions which are mentioned before the table or in the table, is the question which can be asked, you need to remember the point which are mentioned under there which are the answers.
- For Assertions, you may refer Ch. 4 – Audit Evidence.
- All the Disclosures part are given as per the Schedule III (Part I) to Companies Act, 2013, if nothing is mentioned specifically.
- Along with Audit of Items of Financial Statements (FS), clauses of Companies (Auditor's Report) Order, 2020 (CARO, 2020) (from Chapter – 8 – Audit Report) are covered with respective item of FS to make it understandable and help to remember.

Applicability of the CARO, 2020: (ICAI Module Pg. No. 8.73 – 8.74) (MTP 1 S-24 Q. 3 (a))

It shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013 except–

- (1) a banking company
- (2) an insurance company
- (3) Section 8 company of the Companies Act;
- (4) a One Person Company and a small company and
- (5) a private limited company, **not being a subsidiary or holding company of a public company**, having–
 - (i) a **paid-up capital and reserves** and surplus **not more than one crore rupees** as on the balance sheet date and
 - (ii) which does **not** have total **borrowings exceeding one crore rupees** from any **bank or financial institution at any point of time** during the financial year and
 - (iii) which does **not** have a **total revenue** as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) **exceeding ten crore rupees** during the financial year as per the financial statements.

Click on the link/ scan the QR Code to watch video on Applicability of CARO, 2020:

<https://youtu.be/FWZD0nNoz5c?si=OpK-qBGw2BIVLG2j>



Property, Plant and Equipment (PPE): (ICAI Module Pg. No. 5.56 – 5.65 and 5.90)

Provisions of AS 10:

- Recognition Criteria for PPE
The cost of an item of PPE should be recognised as an asset if, and only if:
 - (i) It is probable that future economic benefits associated with the item will flow to the enterprise, and
 - (ii) The cost of the item can be measured reliably.
- An enterprise evaluates under this recognition principle all its costs on PPE at the time they are incurred. These costs include costs incurred:
 - (i) initially to acquire or construct an item of PPE; and

(ii) subsequently to add to, replace part of, or service it. - <u>Elements of Cost:</u> The cost of an item of PPE comprises: (i) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates. (ii) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. (iii) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. - <u>Examples of directly attributable costs are:</u> (i) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of PPE; (ii) costs of site preparation; (iii) initial delivery and handling costs; (iv) installation and assembly costs; (v) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and (vi) professional fees - <u>Examples of costs that are not costs of an item of PPE are: (M-24 Que 5(b) – 4 Marks)</u> (i) costs of opening a new facility or business, such as, inauguration costs; (ii) costs of introducing a new product or service (including costs of advertising and promotional activities); (iii) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and (iv) administration and other general overhead costs - The expenses have to be analysed and properly classified. The revenue expense like regular repairs on assets have to be charged off to the Statement of Profit and Loss.	<u>Audit Procedures: To establish the EXISTENCE of PPE as at the period-end:</u> - Review entity's plan for performing physical verification of PPE i.e. whether performed by own staff or by a third party and the policy regarding periodicity. - Check the evidence of appropriate supervision of those performing physical verification of PPE should be examined. - Obtain PPE physical verification report backed by the working sheets from the entity and perform the following procedures: - Assess if all items of PPE are properly tagged and carry identification marks/ numbers and physical verification work papers do capture the asset identification numbers for assets physically verified. Reconciliation of items of PPE as physically verified with the fixed asset register maintained by the entity as at the date/ period of undertaking physical verification. - Verify the discrepancies noted, based on physical verification undertaken and the manner in which such discrepancies have been dealt with in the entity's books and financial statements.
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Audit Procedures: Additions to PPE during the period under audit have been recorded in the financial statements and do not include any PPE that belong to third parties but does include PPE owned and controlled by the entity although lying with a third party (COMPLETENESS):

- **Verify the movement and arithmetical accuracy of the movement** in the PPE schedule (asset class-wise) compiled by the management i.e. Opening balances + Additions during the period – Deletions during the period = Closing balances.
- **Tally the closing balance** to the entity's books of account.
- **Tally the opening balances** to the previous year audited financial statements.
- For additions during the period under audit, obtain a listing of all additions from the management and perform the following procedures:
 - For all material additions, verify if such **expenditure meets the criteria** of PPE as per AS 10.
 - These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.
 - Verify that the **cost of an item** of property, plant and equipment is **as per AS 10**.
 - Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with AS 10 when they meet the definition of PPE. Otherwise, such items are classified as inventory. Ensure that the entity is not recognizing costs of the day-to-day servicing in the carrying amount of an item of PPE.
 - **Test the purchase invoice, installation certificate or report** or other similar documentation maintained by the entity to verify the date of addition, for all additions samples of PPE during the period under audit.
 - Verify whether the PPE additions have been **approved by authorized personnel**.
 - Verify whether **proper internal processes and procedures** like inviting competitive quotations/ floating tenders etc. were followed prior to finalising the vendor for procuring items of PPE/ awarding of work contract for capital projects by checking the supporting documents of the samples selected.
- In relation to deletions to PPE:
 - Understand from the management the **reason and rationale for deletion** and the manner of disposal.
 - Obtain the **management approval** and discard note authoring disposal of the asset from its active use.
 - **Verify the process followed** for sale of discarded PPE, for example - inviting competitive quotes, tenders and the basis of calculation of sales proceeds.
 - Verify that the management has **accurately recorded the deletion of PPE** (original cost and accumulated depreciation up to the date of disposal) and the resultant gain/ loss on disposal of PPE item in the entity's books of account.

Audit Procedures: PPE have been VALUED appropriately and as per generally accepted accounting policies and practices: (MTP 1 S-24 Q. 6 (c) or) (MTP 2 S-24 Q. 6 (a))

- Verify that the entity has charged **depreciation on all items** of PPE unless any item of PPE is non-depreciable like freehold land;
- Assess that the depreciation **method used reflects the pattern** in which the asset's future economic benefits are expected to be consumed by the entity.
- Verify whether the management has done an **impairment assessment** to determine whether an item of PPE is impaired as per the requirements of **AS 28 - Impairment of Assets**.

Audit Procedures: The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements (RIGHTS AND OBLIGATION): (MTP 2 S-24 Q. 6 (a))

- Verify that all PPE **purchase invoices are in the name of the entity** that entitles legal title of

ownership to the respective entity.

- For all additions to **land and building** in particular, the auditor should check the **conveyance deed/sale deed** to verify whether the entity is the legal and valid owner or not.
- Insist and verify the **original title deeds for all immoveable properties** held as at the balance sheet date.
- In case the entity has given such **immoveable property as security for any borrowings** and the original title deeds are not available with the entity, **obtain a confirmation** from the respective lenders that they are holding the original title deeds of immoveable property as security.
- Verify the **register of charges**, available with the entity to assess that any charge has been created against the PPE.

Required DISCLOSURES for PPE have been appropriately made:

- (i) Classification shall be given in notes to accounts as:
Land, Buildings, Plant and Equipment, Furniture and Fixtures, Vehicles, Office equipment and Others (specify nature).
- (ii) Assets under lease shall be separately specified under each class of asset.
- (iii) A reconciliation of:
 - the gross and net carrying amounts of each class of assets
 - at the beginning and end of the reporting period showing
 - additions,
 - disposals,
 - acquisitions through business combinations,
 - amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of PPE) and
 - other adjustments and
 - the related depreciation and
 - impairment losses/ reversals shall be disclosed separately.
- (iv) Where sums have been **written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation** of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased **figures** as applicable and shall by way of a note also show the **amount of the reduction or increase** as applicable together with the **date thereof for the first five years subsequent to the date of such reduction or increase**.
- (v) Title deeds of Immovable Property not held in name of the Company:
The company shall provide the details of all the immovable property (other than properties where the Company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in format given below and where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

Relevant line item in the Balance sheet	Description of item of property	Gross carrying value	Title deeds held in the name of	Whether title deed holder is a promoter, director or relative of promoter /director or employee of promoter/ director	Property held since which date	Reason for not being held in the name of the company**
PPE -	Land Building	-	-	-	-	**also indicate if in dispute

	Investment property	Land Building					
	PPE retired from active use and Held for disposal-	Land Building					
	Others						

(vi) Where the Company has revalued its PPE, the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.

(vii) Capital-Work-in Progress (CWIP):

(a) For Capital-work-in progress, following ageing schedule shall be given:
CWIP ageing schedule

(Amount in Rs.)					
Amount in CWIP for a period of					Total*
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

***Total shall tally with CWIP amount in the balance sheet.**

(b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**:

(Amount in Rs.)				
	To be completed in			
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

****Details of projects where activity has been suspended shall be given separately.**

(viii) Details of Benami Property held (RTP M-24 Q. 11)

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following: -

- Details of such property, including year of acquisition,
- Amount thereof,
- Details of Beneficiaries,
- If property is in the books, then reference to the item in the Balance Sheet,
- If property is not in the books, then the fact shall be stated with reasons,
- Where there are proceedings against the company under this law as an abettor (who encourages to do wrongdoing) of the transaction or as the transferor then the details shall be provided,
- Nature of proceedings, status of same and company's view on same.

Intangible Assets: (ICAI Module Pg. No. 5.65 – 5.71)**Introduction and AS 26 – Intangible Assets:**

- An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
- To recognize any item as Intangible Assets, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise.
- As per AS 26, internally generated goodwill should not be recognized as an asset.
- Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.
- In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Audit Procedures: To establish the EXISTENCE of Intangible Assets as at the period-end:

- Verify whether such intangible asset is in **active use in the production or supply of goods or services, for rental to others or for administrative purposes** to know its existence since it does not have physical substance. Examples:
 - For verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.
 - For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.
- In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased beyond the date of deletion.

Audit Procedures: All additions to Intangible assets during the period under audit have been recorded appropriately in the financial statements (COMPLETENESS): (Similar to PPE – Completeness Process)

- **Verify the movement and arithmetical accuracy of the movement** in the Intangible Asset schedule (asset class-wise) compiled by the management i.e. Opening balances + Additions during the period – Deletions during the period = Closing balances.
- Tally the closing balance to the entity's books of account.
- Tally the opening balances to the previous year audited financial statements.
- For additions during the period under audit, obtain a listing of all additions from the management and perform the following procedures:
 - For all material additions, verify if such **expenditure meets the criteria** of an intangible asset as per **AS 26**.
 - Verify whether the additions (acquisitions) have been **approved by appropriate entity's personnel**.
 - **Verify whether proper internal processes and procedures** like inviting competitive

quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis. • Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognized, since expenditure on research should be recognised as an expense when it is incurred. • Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit. - In relation to deletions to Intangible Assets: • Understand from the management the reason and rationale for deletion and the manner of disposal. • Obtain the management approval and discard note authoring disposal of the asset from its active use. • Verify the process followed for sale of discarded asset, for example - inviting competitive quotes, tenders and the basis of calculation of sales proceeds. • Verify that the management has accurately recorded the deletion of Intangible Asset (original cost and accumulated amortisation up to the date of disposal) and the resultant gain/ loss on disposal of PPE item in the entity's books of account.
<u>Audit Procedures: Intangible assets have been VALUED appropriately and as per generally accepted accounting policies and practices: (Similar to PPE – Valuation Process)</u> - Verify that the entity has charged amortization on all items of Intangible Assets; - Assess that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. - Verify whether the management has done an impairment assessment to determine whether an item of Intangible Asset is impaired as per the requirements of AS 28 - Impairment of Assets.
<u>Audit Procedures: The entity has valid legal ownership rights over the Intangible Assets claimed to be held by the entity and recorded in the financial statements (RIGHTS AND OBLIGATION):</u> - Verify that all expense invoices/ purchase contracts are in the name of the entity that entitles legal title of ownership to the entity.
<u>Required DISCLOSURE for Intangible Assets have been appropriately made: (Similar disclosures to PPE)</u> (i) <u>Classification shall be given in notes to accounts as:</u> Goodwill, Brands/ trademarks, Computer Software, Mastheads and publishing titles, Mining rights, Copyrights, and patents and other intellectual property rights, services and operating rights, Recipes, formulae, models, designs and prototypes, Licenses and franchise and Others (specify nature). (ii) <u>A reconciliation of:</u> - the gross and net carrying amounts of each class of assets - at the beginning and end of the reporting period showing • additions, • disposals, • acquisitions through business combinations, • amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Intangible Assets) and • other adjustments and

- the related depreciation and
- impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been **written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation** of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased **figures** as applicable and shall by way of a note also show **the amount** of the reduction or increase as applicable together with the **date** thereof **for the first five years subsequent to the date of such reduction or increase**.

(iv) Intangible Assets under Development:

(a) For Intangible assets under development, following ageing schedule shall be given:

Intangible assets under development ageing schedule

(Amount in Rs.)					
	Amount in Intangible assets under development for a period of				Total*
Intangible assets under development	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

***Total shall tally with Intangible assets under development amount in the balance sheet.**

(b) For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, following Intangible assets under development completion schedule shall be given**:

(Amount in Rs.)				
	To be completed in			
Intangible assets under development	Less than 1 year	1-2 years	2-3 years	More than 3 Years
Project 1				
Project 2				

****Details of projects where activity has been suspended shall be given separately.**

Depreciation and Amortisation: (ICAI Module Pg. No. 5.107 – 5.110)

- Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life while amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Attributes:

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the **understanding of entity's accounting policy** related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is **as per the relevant provisions of Companies Act/ applicable accounting standards**.
- The accounting policy has been applied **consistently** year on year. Any **change in the accounting**

policy has been adequately disclosed.

- Whether the depreciation has been **calculated after making adjustment of residual value** from the cost of the assets.
- Whether depreciation and amortisation **charges are valid.**
- Whether depreciation and amortisation charges are **accurately calculated and recorded.**
- Whether all depreciation and amortisation charges are **recorded in the appropriate period.**
- Whether each part of an item of PPE with a cost that is significant in relation to the total cost of the item have been depreciated separately.
Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.
- Whether the **most appropriate depreciation method** for each separately depreciable component has been used.

Audit Procedures for:

- **Depreciation and amortization expenses pertaining to the period have been recorded appropriately and there is no understatement/overstatement**
- **Depreciation and amortisation expenses have been measured appropriately.**
- **Recorded depreciation and amortisation expenses were actually incurred during the period**

(All these are assertions for which following audit procedures will be performed)

- Obtain an **understanding of entity's process** of charging depreciation and amortization.
- **Obtain the fixed asset register** maintained by the entity to verify that all and only capital expenditure are covered by it. Also, to ensure that there is no fake asset is recorded, physical verification can be carried out. And also check additions/ deletion as discussed along with PPE and Intangible Assets.
- Select the sample of assets from the Fixed Assets Register **to verify the rates** of depreciation and depreciation **calculations.**
- Obtain the **list of all the components** identified by the management.
- Ensure **depreciation is charged** on the assets from the date when it is **ready to use/ available for use** and not from the date of actual usage.
- Ensure **depreciation on revalued amount** has been properly accounted from revaluation reserve.
- Depreciation computation as per **Income tax Act, 1961- Ensure that additions are tallying** with the additions as per Companies Act and the opening WDV to the Tax audit schedule for the assessment year preceding the previous year under audit.
- **Perform analytical procedures** to obtain audit evidence as to overall reasonableness of depreciation and amortisation expense - check the arithmetical accuracy of records and perform independent calculations i.e. recalculation.
- Ensure that the depreciation and amortization has been **charged as per the useful lives** of PPE and intangible assets.
- Ensure that **residual values have been properly verified** as that impacts the computation of depreciation.
- Ensure that the depreciation and amortization has been computed **prospectively whenever there is any change in useful lives** of PPE and intangible assets.

Required disclosures for depreciation and amortization have been appropriately made:

- Accounting policy for depreciation and amortization.
- Useful lives of assets as per Schedule II to the Companies Act, 2013.

- Residual value of assets.
- Depreciation method.

Example:

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October.

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

Clause (i) of Para 3 of CARO, 2020 (Related to PPE and Intangible Assets): (ICAI Module Pg. No. 8.75 – 8.76)

Sub-clause	Sub sub clause	Description
(a)	(A)	whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment
	(B)	whether the company is maintaining proper records showing full particulars of intangible assets ;
(b)		whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
(c)	whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company , if not, provide the details thereof in the format below: -	
	Description of property	Gross carrying value
	Held in name of	Whether promoter, director or their relative or employee
		Period held –indicate range, where appropriate
		Reason for not being held in name of company*
		*also indicate if in dispute
(d)		whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;
(e)		whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements;

Click on the link/ scan the QR Code to watch video on Audit of PPE, Intangible Assets, Depreciation and Amortisation and Clause (i) of CARO, 2020:

<https://youtu.be/AzCijYrti24?si=JyTzHND46ffoPNd1>



Sale of Products and Services: (ICAI Module Pg. No. 5.91 – 5.97)

Audit Procedures - Recorded sales represent goods shipped/ services performed during the period (OCCURRENCE): (MTP 1 M-24 Q. 4 (a))

- Ensure revenue is **not overstated** by performing following audit procedures:
 - Check whether a **single sales invoice is recorded twice or a cancelled sales invoice** could also be recorded.
 - Test check **few invoices** with their relevant **entries in sales journal**.
 - Obtain **confirmation** from few customers to ensure **genuineness of sales transaction**
 - Whether any **fictitious customers and sales** have been recorded.
 - Whether any **shipments were done without the consent and agreement of the customer**, especially at the year end to inflate the sales figure
 - Whether **unearned revenue recorded as earned**.
 - Whether any **substantial uncertainty** exists about **collectability**.
 - Whether **customer obligations are contingent on other actions** (financing, resale, etc.).
- Review **sequence of sales invoices**.
- Review journal entries for **unusual transactions**.
- Calculate the **ratio of sales return to sales and compare** it with previous year and enquire for the reasons for increase/ decrease.
- **Check the sales return** with sales invoice, challan, credit note, stock register, etc.

Audit Procedures - All sales made during the period were recorded and there is no understatement or overstatement (COMPLETENESS):

- Perform **sales cut-off test**. Cut-off errors will usually arise when companies recognise revenue based on the date on which the sales invoices are generated rather than the date on which the risks and rewards are transferred to the buyer.
- Auditors should also verify the **credit notes issued after the accounting period**. Sometimes sales team or sales personnel can make fictitious sales before the year- end to meet performance target and cancel out those sales with a post year end credit note.
- Trace from the **shipping documents to the sales journal**.
- Check whether **quantity is appearing in sales register** or not and check **reconciliation of total sales/ goods dispatched as per stock records and financial records and statutory records like GST**.
- **Review GST tax and GST returns** and ensure that the same are reconciled with revenue reported in the profit and loss account. **Verify reasonability** say of GST by applying the applicable rate to the gross sales value and compare the amount of GST as per statutory returns and analyze the reasons for variance, if any.

Audit Procedures - All sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted (MEASUREMENT):

- Trace a **few transactions from inception to completion**. (Examination in depth)
E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The

recognition shall be according to the revenue recognition policy of the entity.

- If the client is engaged in **export sales**, then **compliance with AS 11** shall be ensured.
- Auditor must understand **client's operations and related Generally Accepted Accounting Principles (GAAP) issues** e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- Compare the **rate of sales** affected with **related parties and review them for collectability**, as well as whether they were properly **authorized and the value** of such transactions were **reasonable and at arm's length**.

Required DISCLOSURE for sales have been appropriately made:

- In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—
 - (a) Sale of products;
 - (b) Sale of services;
 - (ba) Grants or donations received (relevant in case of section 8 companies only),
 - (c) Other operating revenues;
 Less:
 - (d) Excise duty.
- In respect of a finance company, revenue from operations shall include revenue from—
 - (a) Interest; and
 - (b) Other financial services
- Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable:
 - Whether brokerage and discount on sales other than usual trade discount has been disclosed.
 - Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Other Income: (ICAI Module Pg. No. 5.97 – 5.99)

Other Income – Recognition and Recording criteria:

- **Interest income** on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.
- **Dividends** are recognised in the statement of profit and loss only when:
 - (i) the entity's **right to receive** payment of the dividend is established;
 - (ii) it is **probable that the economic benefits** associated with the dividend will flow to the entity; and
 - (iii) the **amount** of the dividend can be **measured reliably**.
- **Gain/(loss) on sale of investment** in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Audit Procedures –

- **Recorded other income was earned during the period (OCCURRENCE)**
- **Other income earned during the period was appropriately recorded and there is no understatement or overstatement. (COMPLETENESS)**
- **Other income has been measured appropriately as per the applicable accounting standards (MEASUREMENT)**

(All these are assertions for which following audit procedures will be performed):

- For verifying interest income on fixed deposits:
 - **Obtain a listing of fixed deposits opened** during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period.
 - Verify the **arithmetical accuracy of the interest calculation** made by the entity by re-computing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
 - For **deposits still outstanding as at the period- end**, trace the same to the **direct confirmations** obtained from the respective bank/ financial institution.
 - Obtain a **confirmation of interest income from the bank and verify that the interest income as per bank reconciles** to the calculation shared by the entity.
 - Also, obtain a copy of **Form 26AS** (TDS withholding by the bank/ financial institution) and **reconcile the interest reflected** therein to the calculation shared by client.
- For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.
- Verify that Gain/(loss) on sale of investment in mutual funds:
 - It is recorded as other income only on:
 - transfer of title from the entity AND
 - is determined as the difference between the redemption price and carrying value of the investments.
 - For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.

Required DISCLOSURE for other income have been appropriately made:

Other income shall be classified as:

- (a) Interest Income (in case of a company other than a finance company);
- (b) Dividend Income;
- (c) Net gain/ loss on sale of investments
- (d) Other non-operating income (net of expenses directly attributable to such income).

Additional Disclosure related to Income (ICAI Module Pg. No. 5.99)**Undisclosed income:**

The Company shall give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

Audit Procedures of Other Specific Incomes:**Goods Sent Out on Sale or Return Basis: (Test Your Knowledge Que. 1 (a), ICAI Module Pg. No. 5.125)**

- Check whether a separate memorandum record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- Verify that price of such goods is unloaded from the sales account and the trade receivables record.

Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

- Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
- Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.

Sale of Scrap: (Test Your Knowledge Que. 4 (b), ICAI Module Pg. No. 5.130)

- Review the internal control as regards generation, storage and disposal of scrap.
- Check whether the organization is maintaining reasonable record for generation of scrap.
- Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- Check the rates at which scrap has been sold and compare the rate with previous year.
- Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- Make an overall assessment of the value of realization from scrap as to its reasonableness.

Clause (viii) of Para 3 of CARO, 2020 (Related to Income): (ICAI Module Pg. No. 8.79)

Whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year;

Click on the link/ scan the QR Code to watch video on Audit of Revenue from Operations and Other Income and Clause (viii) of CARO, 2020:

<https://youtu.be/d4TAJTeN8-E?si=maKNK5vNtPioaYts>



Purchases: (ICAI Module Pg. No. 5.99 – 5.104)

Audit Procedures - Recorded purchases represent goods actually received/ services availed during the period (OCCURRENCE):

- Ensure purchases are **not understated/ overstated** by performing following audit procedures:
 - Whether any **fictitious vendors** have been booked or purchases have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors.
 - Whether the **goods were received at the factory gate** and whether there exists an entry in the security gate inward register
 - Whether **quality inspection** of goods was done.
 - Whether a **goods receipt note was prepared and signed** by an appropriate client personnel.
 - Whether the purchase invoice was approved as per delegation of authority and whether a **3 or 2-way match** (i.e. tally between purchase order, GRN and vendor invoice) was done.
 - Whether stock record has been updated by the stores personnel.
- Special considerations during audit of purchases:
 - The purchase invoice received should be the **“Original” copy** (and not photocopy/ carbon copy)

against which the entity has recorded the purchase in its books of account. • Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B. (i.e. Free on Board – risk and rewards are transferred when goods move out from suppliers' premises), C.I.F. (i.e. Cost, Insurance and Freight – risk and rewards are transferred when goods reach to buyers' premises) etc. • Purchase invoice should be in the name of entity. • Input tax component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns. • In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify if requisite approval from Board of Directors (appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the price charged is at arm's length. - The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement. - Review journal entries for unusual transactions.	
• Audit Procedures: All purchases made during the period were recorded and there is no understatement or overstatement. (COMPLETENESS) • All purchases have been measured appropriately (MEASUREMENT): - Perform cut-off test to ensure that purchases are recognised in the correct accounting period. For that, check few year-end transactions. - Ensure correct accounting treatment of goods-in-transit as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods. - Obtain written representation from the management that all the purchases that took place during the year have been properly recorded in the books. - Perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include: (M-24 Que 4(d) – 3 Marks) • Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management, if any significant variations are found. • Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations. • Ratios: Auditor should compare the creditor turnover ratios and stock turnover ratios of the current year with previous years. • Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.	
Required DISCLOSURES for purchases have been appropriately made: - Whether purchases of stock-in-trade have been specifically disclosed. - Whether changes in inventories of finished goods, stock-in-trade and work- in-progress have been specifically disclosed. - Whether the transactions with related parties are appropriately disclosed in notes to accounts.	
Click on the link/ scan the QR Code to watch video on Audit of Purchase:	
https://youtu.be/wGxt0hmC8Y8?si=1gjbM1Sw5suMnrNZ	

Inventory: (ICAI Module Pg. No. 5.50 – 5.56) (MTP 2 M-24 Q. 3 (b))**Common Audit Procedures:**

- Inventories are assets:
 - (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.
- As per AS 2 – “Valuation of Inventories”, Inventory is valued at lower of cost and net realisable value. **(M-24 Que 1(b) – 4 Marks – Good Que)**
- The basis for valuation shall be applied consistently year on year.
- Any change in accounting policy shall have adequate disclosures in financial statements.

Audit Procedures - To establish the EXISTENCE of Inventories as at the period- end:

- **Review entity’s plan** for performing inventory count.
- Ensure that **consigned goods have been segregated**.
- Auditor should **participate in the inventory count** with the management.
- Test counts of inventory by auditor should include:
 - Observing **employees are adhering** to the agreed plan.
 - Assuring that there is appropriate **supervision on the count procedure**.
 - Assuring that all items are properly **tagged**.
 - Observing that **proper amounts are shown on tags**.
 - Determining that **tags and summary sheets are controlled and reconciled**.
 - **Reconciliation** of test counts with tags and summary sheets and discrepancies noted, if any, are summarized and agreed with client personnel.
 - **Staying alert** at all times and specifically being **cautious about empty boxes**, etc. and **obsolete items**.
 - Performing **cut-off testing** by documenting last 5-10 receiving reports and shipping documents as of the period end.
 - Ensuring **exclusion of third-party stock and damaged or obsolete stock**.
 - **Ensuring the accounting** of all stock sheets.
 - **Investigating any significant differences** between the physical stock take and the stock records as per books. Further, the auditor should ask the entity’s personnel to sign all stock count sheets and also agree the variances observed, if any, to avoid any conflicts.
- When the entity uses **periodic system for inventory count**, it should be undertaken at the end of the period. If the entity uses perpetual system with proper and adequate records, inventory may be counted at interim dates.
- **Confirm or investigate** any inventory of the entity **lying with a third party**.

Audit Procedures - Only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party (COMPLETENESS): (MTP 1 S-24 Q. 3 (b))

- **Perform analytical procedures** (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
 - Compute inventory turnover ratio (COGS/ average inventory)
 - Perform vertical analysis (inventory/ total assets)
 - Compare budgetary expectations vis-à-vis actuals
- **Examine** non-financial information related to inventory, such as **weights and other measurements**.
- Perform **purchase and sales cut-off tests**. Check few year-end transactions as discussed in Audit

of Purchase and Sales.

- With respect to tagged inventory, perform **tests for omitted transactions and tests for invalid transactions**.
- Verify the **clerical and arithmetical accuracy** of inventory listings.
- **Reconcile physical inventory amounts with perpetual records.**
- **Reconcile physical counts with general ledger control totals.**
- **Reconcile** inventories which belong to client but are **held with third parties** like transporters, warehouses, port authorities etc.
- **Goods received on consignment** basis have been properly segregated from other items of inventory.

Audit Procedures - The entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements:

- **Vouch** recorded **purchases** to underlying documentation.
- Evaluate the **consigned goods**.
- Examine client correspondence, sales and receivables records, purchase documents.
- Determine existence of **collateral agreements**.
- **Review consignment agreements.**
- **Review material purchase commitment agreements.**
- Examine **invoices for evidence of ownership** i.e. the invoices shall be in the name of the client.
- Auditor shall **obtain confirmation** for significant items of inventory which is **held by third party**.

Audit Procedures – Inventories have been VALUED appropriately and as per generally accepted accounting policies and practices:

- Depending on how the business operates, the management may value inventory using **First-in first-out (FIFO) or weighted average** basis. Consider the **reasonableness of the method adopted**.
- For Raw materials and consumables:
 - Ascertain what **elements of cost are included** e.g. carriage inward, non- refundable duties etc.
 - If **standard costs are used**, enquire into **basis of standards**; how these are **compared** with actual costs and how **variances** are analyzed and accounted for/ treated in accounting records.
 - **Test check cost prices** used with purchase invoices received in the month(s) prior to counting.
 - Follow up **valuation of all damaged or obsolete inventories** noted during observance of physical counting with a view to establishing a realistic net realizable value.
- For Work in progress:
 - Ascertain how the various **stages of production/ value additions are measured** and in case estimates are made, understand the basis for such estimates.
 - Ascertain what **elements of cost are included**. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
 - Ensure that **material costs exclude any abnormal wastage** factors.
- For Finished goods and goods for resale:
 - Enquire as to **what costs are included**, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the financial statements.
 - Ensure that inventories are **valued at net realizable value** if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.

- Follow up for items that are **obsolete, damaged, slow moving and ascertain the possible realizable value** of such items. Carefully examine the valuation of obsolete and damaged inventory. For the purpose, request the client to provide inventory ageing split and follow up for any inventories which at time of observance of physical counting were noted as being damaged or obsolete.
- **Compare recorded costs with replacement costs.**
- Examine **vendor price lists** to determine if recorded cost is less than current prices.
- **Calculate inventory turnover ratio.** Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, **test overhead** allocation rates and ensure that only **direct labor, direct material and overhead** have been included.
- Verify the correct **application of lower-of- cost or net realizable** value principles.

Required DISCLOSURES for inventories have been appropriately made:

- (i) Inventory shall be classified as:
 - Raw materials
 - Work-in-progress
 - Finished goods
 - Stock-in-trade (goods acquired for trading)
 - Stores and spares
 - Loose tools
 - Others (specify nature).
- (ii) Whether goods-in-transit have been disclosed separately under each sub-head of inventories.
- (iii) Mode of valuation shall be stated.

Example:

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills.

The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company. This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

Click on the link/ scan the QR Code to watch video on Audit of Inventory:

<https://youtu.be/-uiCvEA6eTE?si=yCCwoSRJzqbeYCAH>



Employee Benefit Expenses: (ICAI Module Pg. No. 5.104 – 5.107)

- Recorded employee benefit expenses were actually incurred during the period (**OCCURRENCE**)
- Employee benefit expenses pertaining to the period have been recorded appropriately (**COMPLETENESS**)
- Employee benefit expenses have been measured appropriately. There is no understatement or overstatement. (**MEASUREMENT**)

For all these Assertions, Audit Procedure is given below:

- Obtain an **understanding of entity's process** of capturing employee **attendance**.
- Obtain a **list of employees** as at the period-end along with a monthly movement split between **new hires, leavers and continuing employees**.
- For a sample (selected randomly) of **new hires**, obtain the **appointment letter and verify whether the salary for first month and subsequent months was processed as per the agreed terms**.
- For a sample (selected randomly) of **resigned employees**, obtain their **full and final computation** and verify whether all their dues including post-retirement benefits like gratuity, leave encashment have been paid and whether the respective employee's acknowledgement on final computation has been obtained.
- Obtain the **monthly salary registers for all 12 months**. Compile a monthly payroll reasonability by **calculating the average salary per employee per month and compare with the previous year and preceding month and analyse the reasons for variance** which could be attributable to annual increments, an employee at senior level joining/ leaving the entity, bonus pay-out etc.
- Verify if **accrual/ provision** has been made **for all employee benefits** and obligations like bonus, gratuity, leave encashment, etc.
- In case provident fund (**PF**), employee state insurance (**ESI**) are applicable to the entity, **compile a reasonability** by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any. (Analytical Procedure)
- Also, obtain **monthly deposit challans** to verify if the month-on-month liability was subsequently deposited with the authorities and within the defined timelines.
- **Perform analytical procedures** to obtain audit evidence as to **overall reasonableness of employee benefit expenses** which may include production per employee analysis. Auditor should analyse units produced per employee and compare the same with previous years and present industry trends and ask for the reasons from the management, if any significant variations are found.

Required DISCLOSURES for employee benefit expenses have been appropriately made:

Employee Benefit Expenses shall be shown separately as follow in the Notes to Accounts:

- (i) salaries and wages
- (ii) contribution to provident and other funds,
- (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP)
- (iv) staff welfare expenses

Click on the link/ scan the QR Code to watch video on Audit of Employee Benefit Expenses:

<https://youtu.be/ubbtd0ueB5I?si=D8TintEiDAr4WgN->



Other Expenses: (ICAI Module Pg. No. 5.110 – 5.113)

An auditor generally prefers to vouch for other expenses to verify following attributes:

- Whether the expenditure **pertained to current period** under audit;
- Whether the expenditure **qualified as a revenue** and not capital expenditure;
- Whether the expenditure had a **valid supporting documents** like travel tickets, insurance policy, third party invoice etc.;
- Whether the expenditure has been **classified under the correct expense head**;
- Whether the expenditure was **authorised** as per the delegation of authority matrix;

- Whether the expenditure was in relation to the entity's business and **not a personal expenditure.**

- **Audit Procedures - Recorded other expenses were actually incurred during the period**
- **Other expenses pertaining to the period have been recorded appropriately and there is no understatement or overstatement**
- **Other expenses have been measured appropriately**

(All these are assertions for which following audit procedures will be performed)

➤ **Rent Expenses:**

- Obtain a **month wise expense schedule** along with the **rent agreements**.
- Verify if expense has been **recorded for all 12 months** and whether the rent amount is as per the underlying agreement.
- Specific consideration should be given to **escalation clause in the agreement** to verify if the rent was required to be recorded on a straight-line basis during the period under audit.
- Also, verify if the **agreement is in the name of the entity and whether the expense pertains to premises used for running business operations** of the entity.

➤ **Power and fuel expense:**

- Obtain a **month wise expense schedule** along with the **power bills**.
- Verify if expense has been **recorded for all 12 months**.
- Also, **compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy** of the bill raised on monthly basis.
- In relation to the **units consumed, analyse the monthly power units consumed** by linking it to units of finished goods produced and **investigate reasons for variance** in monthly trends.

➤ **Insurance expense:**

- Obtain a **summary of insurance policies** taken along with their **validity period**.
- Verify whether the expense has been **correctly classified between prepaid and expense for the period based on number of days**.

➤ **Legal and professional expenses:**

- Obtain a **month-wise and consultant-wise summary**.
- In case of **monthly retainerhip agreements**, verify whether the **expenditure for all 12 months** has been recorded correctly.
- For **non- recurring expenses**, select a **sample and vouch** for the attributes discussed above.
- The auditor should be **cautious while vouching for legal expenses** as the same may highlight a **dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted** to the auditor for his specific consideration.

➤ **Travel, repair and maintenance, printing and stationery, miscellaneous expenses:**

- The auditor should select a sample and vouch for the attributes discussed above.
- Wherever possible, the auditor should try to prepare a summary of expenditure on monthly basis and then analytically compare the trends.
- Perform analytical procedures to obtain audit evidence as to overall reasonableness of other expense which may include expenditure per unit of production analysis.

- Auditor should analyse expense per unit produced and compare the same with previous years and present industry trends and ask for the reasons from the management, if any significant variations are found.

Foreign Travel Expenses (Test Your Knowledge Que 2 (b), ICAI Module Pg. No. 5.127)

- Examine **Travelling Allowance (T.A.) bills** submitted by the employees stating the details of tour, details of expenses, etc.
- Verify that the tour programme was properly **authorised by the competent authority**.
- Check the T.A. bills along with accompanying **supporting documents** such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- See that the **tour report** accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
- Check **Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange**.
- For a company the amount of foreign exchange spent is to be **disclosed** separately in the accounts as per requirement of **Schedule III** to the Companies Act, 2013 and **Accounting Standard 11** "The Effects of Changes in Foreign Exchange Rates".

Advertisement Expenses (Test Your Knowledge Que 4 (a), ICAI Module Pg. No. 5.129 – 5.130)

- Verify the **bills/invoices from advertising agency** to ensure that rates charged for different types of advertisement are as per the contract.
- See that the **advertisement relates to client's business**.
- **Inspect the receipt** issued by the agency.
- Ascertain the **nature of expenditure – revenue or capital expenditure** and see that it has been recorded properly.
- Ascertain the **period for which payment** is made and see that prepaid amount, if any, is carried to the balance sheet
- See that **all outstanding advertisement bills have been provided** for.

Required DISCLOSURE for other expenses have been appropriately made:

Ensure other expense have been classified under:

Rent, Insurance, Power and fuel, Repairs and maintenance- Building, Plant and machinery, others, Legal and professional, Printing and stationary, Travel expenses and Miscellaneous expenses.

Click on the link/ scan the QR Code to watch video on Audit of Other Expenses:

<https://youtu.be/RrPZCJW22vI?si=rxv7yx-5fYqj96sR>



Cash and Cash Equivalents: (ICAI Module Pg. No. 5.45 – 5.50)

- Utmost professional skepticism needs to be exercised while auditing such balances as they are prone to misappropriation.

Audit Procedures - To establish the Existence of cash and cash equivalent balances as at the period-end

Cash and cash equivalent balances that were supposed to be recorded have been recorded in the financial statements. (COMPLETENESS):

- Special care is necessary in regard to verification of cash balances, and for that Surprise Check should be performed. The cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor's visit either to the entity or to his staff. (Surprise check)
- If there are more than one cash balances, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others.
- It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared containing details of the cash balance counted along with denomination of cash. If he is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash.
- If there is any rough Cash Book or details of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book to prove that entries in the Cash Book are correct.
- If the auditor finds any slip, chit or I.O.U.s (I Owes You) in respect of temporary advances paid to the employees included as part of the cash balance, he should check whether those are approved by an authorized official and recorded in the appropriate accounts.
- The auditor should also perform a cash sensitivity analysis by compiling a summary of total cash receipts and payments each month and analyzing the trends to see if there have been variations in any specific month and request brief descriptions from the management.
- The auditor needs to obtain bank reconciliation statements (BRS) for all bank accounts maintained by the entity as at the reporting period and additionally need to understand the client's process and periodicity of making the BRS.
- The auditor should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.
- **Verification of BRS shall entail the following: (MTP 1 S-24 Q. 4 (c))**
 - Tallying the balance as per bank book to the bank confirmation/ statement.
 - Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank.
 - Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period.
 - Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same.
- **Direct Confirmation Procedure:**
 - A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in all the bank accounts as of the end of the reporting period under audit.
 - The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.

- The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
 - Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;
 - Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Audit Procedures - Cash and cash equivalent balances have been VALUED appropriately:

In addition to the procedures performed above, the auditor should ensure that all bank accounts holding foreign currency have been restated at the closing exchange rates as per applicable Financial Reporting Framework.

Required DISCLOSURES for cash and cash equivalents have been appropriately made:

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature)
- (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

Click on the link/ scan the QR Code to watch video on Audit of Cash and Cash Equivalent:

<https://youtu.be/H0s-SASdK8A?si=0zyiRExyqaldrysu>



Borrowings: (ICAI Module Pg. No. 5.27 – 5.37)

Audit Procedures - All borrowings on the balance sheet represent valid claims by banks or other third parties. (EXISTENCE) (RTP S-24 Que 13)

- Review **board minutes for approval of new lending** agreements. During review, ensure that new loan agreements or bond issuances were **authorized**. Ensure that significant debt commitments were approved by the board of directors.
- **Agree details of loans recorded** (interest rate, nature and repayment terms) to the loan agreement. Verify that **borrowing limits, if any**, imposed by agreements are not exceeded.
- Roll out and obtain independent **balance confirmations (SA 505)** in respect of all the borrowings from the lender.
- In case of **Debentures**, examine **trust deed** for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When **debt is retired**, ensure that a **discharge is received on assets securing** the debt.
- Obtain **Written Representation** that all the liabilities which have been recorded represent a valid claim by the lenders.

Audit Procedures - that all borrowings have been accounted for in the books of the company on a timely basis. (COMPLETENESS):

- Obtain a **schedule of short term and long term borrowings** showing beginning and ending balances and borrowings taken and repaid during the year, and perform the following:
 - (a) Consider any evidence of **additional debt** obtained through **examination of minutes** of the board of directors, **significant contracts, confirmations from banks/ lenders**, support for **subsequent cash disbursements** etc.
 - (b) **Trace the closing balances** as per the schedules to the general ledger.
- **Review subsequent transactions after the end of the reporting period** to determine if there are unrecorded liabilities at year- end and the transactions are recorded in the correct period.
- **Direct confirmation procedures** - Roll out and obtain independent balance confirmations in respect of all the borrowings from the lender and perform the following:
 - (i) Ascertain that the confirmation asks for **all relevant information**.
 - (ii) Send **reminders for non-replies**.
 - (iii) **Compare** the balances as per the confirmations obtained to the books of the accounts. In case of **differences**, check the **reconciliations** with supporting documents.

Audit Procedures - That liability is recorded at the correct amount. (VALUATION):

- Determine that the **accounting policies and methods of recording debt** are appropriate and applied consistently.
- **Agree loan balance and loan payables to the loan agreement.**
- **Re-compute the interest and discount or premium on redemption**, if any.
- Check **computation of the amortization of premium or discount**, if any.
- For **foreign currency loans**, check the **closing exchange rate(s)** used and verify the computations of the restatements of foreign currency balances outstanding at year end. **(As per AS 11)**
- Read the **provisions in loan and debt agreements and perform** the following:
 - (i) Test that the entity is in **compliance with loan covenants** and other significant provisions of the agreements.
 - (ii) If there are any **provisions** with which the entity is **not in compliance**, determine **whether the debt should be classified as current**. If enforcement of the provisions has been waived by the lender in case of breach of any covenant by the entity, obtain confirmation of the waiver from the lender.
- Examine the due dates on loans for proper **classification between long-term and short-term**.
- Where **instalments** of long-term loans falling due **within the next twelve months** have been **disclosed in the financial statements**, verify the correctness of the amount of such instalments.
- Examine the debt agreements for **any restrictive covenants**. Review restrictive covenant and provisions relating to **default and ensure disclosure** thereof in the financial statements.
- Examine the important terms in the loan agreements and the documents, if any, evidencing **charge** in respect of such loans and advances. Examine whether the requirements of the **applicable statute** regarding **creation and registration of charges** have been complied with including **disclosure** of the same to the extent mandated by statute and considered necessary for proper understanding of the user of financial statements.
- In case the value of the **security falls below the amount of the loan outstanding**, examine **whether the loan is classified as secured only to the extent of the market value of the security**.
- He should carefully review the **borrowings from related parties** and ensure compliance with **AS 18**.
- The auditor should also verify that the **amount borrowed is within the borrowing powers** of the company as laid down by the **AOA** (Articles of Association) and **MOA** (Memorandum of Association).
- Verify that the company has **not contravened the provisions of the Companies Act, 2013**.
- Examine the **purpose for which the amount is borrowed** and ensure that the amount is **not used**

against the interest of the company.	
Required DISCLOSURES for Borrowings have been appropriately made:	
Long-term Borrowings	Short-term Borrowings
(i) <u>Long-term borrowings shall be classified as:</u> (a) Bonds/debentures; (b) Term loans: a. from banks. b. from other parties. (c) Deferred payment liabilities; (d) Deposits; (e) Loans and advances from related parties; (f) Long term maturities of finance lease obligations; (g) Other loans and advance (specify nature).	(i) <u>Short-term borrowings shall be classified as:</u> (a) Loans repayable on demand; a. from banks. (RTP M-24 Q. 12) b. from other parties. (b) Loans and advances from related parties; (c) Deposits; (d) Other loans and advances (specify nature).
(ii) Borrowings shall further be sub- classified as secured and unsecured. Nature of security shall be specified separately in each case.	(ii) Borrowings shall further be sub- classified as secured and unsecured. Nature of security shall be specified separately in each case. (RTP M-24 Q. 12)
(iii) Where loans have been guaranteed by directors or others , the aggregate amount of such loans under each head shall be disclosed.	(iii) Where loans have been guaranteed by directors or others , the aggregate amount of such loans under each head shall be disclosed. (RTP M-24 Q. 12)
(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/ debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.	(iv) Current maturities of Long term borrowings shall be disclosed separately.
(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.	-
(vi) Terms of repayment of term loans and other loans shall be stated.	-
(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.	(v) Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.
(viii) Other Long term Liabilities: Other Long term Liabilities shall be classified	-

as: (a) Trade Payables; (b) Others	
<u>Additional Disclosures:</u> (i) Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, the company shall disclose the details of where they have been used. (ii) <u>Where the Company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:- (RTP M-24 Q. 12)</u> (a) whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts. (b) if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed. (iii) <u>Wilful Defaulter*</u> Where a company is a declared wilful defaulter by any bank or financial institution or other lender, following details shall be given: (a) Date of declaration as wilful defaulter, (b) Details of defaults (amount and nature of defaults), *wilful defaulter” here means a person or an issuer who or which is categorized as a wilful defaulter by any bank or financial institution (as defined under the Act) or consortium thereof, in accordance with the guidelines on wilful defaulters issued by the Reserve Bank of India. (iv) Where any charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed. (v) <u>Utilisation of Borrowed funds and share premium:</u> (a) Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall (i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or (ii) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries; <u>The company shall disclose the following:-</u> i. date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary. ii. date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries along with complete details of the ultimate beneficiaries. iii. date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries iv. declaration that relevant provisions of the Foreign Exchange Management Act, 1999 and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002.	

(b) Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall: (i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or (ii) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries. <u>The company shall disclose the following:-</u> i. date and amount of fund received from Funding parties with complete details of each Funding party. ii. date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries' or ultimate beneficiaries. iii. date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries iv. declaration that relevant provisions of the Foreign Exchange Management Act, 1999 and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002.
<u>Example:</u> A company has availed cash credit facility of Rs. 2 crore (O/s balance Rs. 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. It shall be shown under the head "Borrowings" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "Loans repayable on Demand" from Banks. As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

Clause (ii) of Para 3 of CARO, 2020 (Related to Inventory and Borrowings): (ICAI Module Pg. No. 8.76)

Sub-clause	Description
(a)	whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate ; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account ;
(b)	whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees , in aggregate, from banks or financial institutions on the basis of security of current assets ; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details ;
<u>Example:</u> The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2020.	

Reporting for Physical Verification of Inventory:

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under sub-clause (a) of clause (i) of Para 3 of CARO, 2020 (In actual answer, need to mention that clause, here you may refer above mentioned clause). He may consider the impact on financial statement and report accordingly.

Clause (ix) of Para 3 of CARO, 2020 (Related to Borrowings): (ICAI Module Pg. No. 8.79 – 8.80)

Sub-clause	Description					
(a)	whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-					
	Nature of borrowing, including debt securities	Name of lender	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
		Lender wise details to be provided in case of defaults to banks, financial institutions and Government.				
(b)	whether the company is a declared wilful defaulter by any bank or financial institution or other lender;					
(c)	whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;					
(d)	whether funds raised on short term basis have been utilised for long term purposes , if yes, the nature and amount to be indicated;					
(e)	whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures , if so, details thereof with nature of such transactions and the amount in each case;					
(f)	whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies , if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;					

Example: (MTP 2 M-24 Q. 6 (e))

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to Rs. 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, Rs. 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements.

Reporting for as per CARO, 2020:

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for Rs. 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, Rs. 1 crore have been used by the company for investment in effluent

treatment plant which is ostensibly (i.e. apparently) for a long-term purpose.
Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

Click on the link/ scan the QR Code to watch video on Audit of Borrowings and Clause (ii) and (iv) of CARO, 2020:

https://youtu.be/pZdOdQDQ_W0?si=LCaBvgMTji7K8Jne



Trade Receivables: (ICAI Module Pg. No. 5.37 – 5.45)

Points to be considered: (MTP 2 M-24 Q. 4 (a))

Following points need to be considered in respect of trade receivables:

- Only **bona fide sales** lead to trade receivables.
- All such sales are made to **approved customers**.
- All such sales are **properly recorded** in the books of accounts.
- Once recorded, the **debtors can be settled only by receipt of cash or on the authority of a responsible official**.
- **Segregation of duties** at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
- Debtors are **collected on time**.
- In case debtors are **not collected in time, sending reminders and taking legal actions** if required.
- **Balances are regularly reviewed**.
- A **proper system of follow up** exists and if necessary, **adequate provision for bad debt** should be made by preparing adequate ageing schedule of the debtors.

Audit Procedures - To establish the EXISTENCE of trade receivables as at the period- end:

- Check whether there are controls in place to ensure that **invoices cannot be recorded more than once** and **receivable balances are automatically recorded** in the general ledger from the original invoice.
- Ask for a period-end **accounts receivable ageing report** and trace the balance as per the report to the general ledger.
- Check whether **realization is recorded invoice-wise or not**. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first. If realization is made on account, verify whether the Company has obtained confirmations from debtors in respect of the same.
- If any **large balance is due for a long time**, auditor should **ask for reasons and justification** for the same.
- **Direct confirmation procedures: (Similar for Trade Payables as well)**
 - Here, auditor contacts **customers directly and ask them to confirm** the amounts of unpaid accounts receivable as of the end of the reporting period under audit. This should necessarily be done **for all significant account balances** as at the period- end while **certain random customers having smaller outstanding** invoices should also be selected.
 - The auditor employs direct confirmation procedure **with the consent of the entity** under audit. There may be situations where the **management** of the entity **requests the auditor not to seek confirmation** from certain trade receivables. In such cases, the auditor should **consider whether there are valid grounds for such a request**. In appropriate cases, the auditor may also need to **reconsider the nature, timing and extent of his audit procedures**

including the degree of planned reliance on management's representations.

- The trade receivables may be requested to confirm the balances either (a) **as at the date of the balance sheet**, or (b) **as at any other selected date** which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the company.
- The **form of requesting confirmation** from the trade receivables may be either (a) the form **with balance outstanding amount as per the company**, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or (b) the form **without any balance mentioned therein**, wherein the trade receivable is requested to respond with the balance outstanding as per his records. **The use of the form without any balance is preferable.**
- The method of selection of the trade receivables to be circularised should not be revealed to the Company until the trial balance of the trade receivables' ledger is handed over to the auditor. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- Any **discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor** may have a bearing on other accounts not included in the original sample. The Company should be asked to **investigate and reconcile the discrepancies**, if any.
- Where **no reply is received**, the auditor should perform **alternate procedures** regarding the balances. This could include:
 - **Agreeing the balance to cash received subsequently;**
 - **Preparing a detailed analysis of the balance**, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)
- If there are any **related party receivables**, review them for collectability as well as whether they were properly authorized and the value of such transactions were **reasonable and at arm's length**.
- Check that the receivables for **other than sales or services are not included in the list**.
- Review a **trend line of sales and accounts receivable**, or a comparison of the two over time, to check if there are any unusual trends i.e. **perform analytical procedures**. This will enable the auditor to check the reasonableness of balances. Also, **measure the average collection period**. **Make inquiries about reasons for changes** in trends with the management and document the same in audit work papers.

Audit Procedures - All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS):

- The auditor needs to satisfy himself of the **cut-offs**. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:
 - For the **invoices issued during the last few days** i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;
 - Ensure that all **goods dispatched prior to the period/ year-end have been invoiced and included in debtors** on a test check basis;
 - Ensure that **no goods dispatched after the year-end have been invoiced and included in debtors** for the period under audit.

- **Test invoices listed in receivable report.** Select few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the correct amounts, to the correct customers, and on the correct dates.
- **Match invoices to shipping/ dispatch log.** Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the **correct accounting period**. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit.
- **Assess bill and hold sales.** If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as “bill and hold”), examine supporting documentation to determine whether a sale has actually taken place or not.
- **Review the receiving log** to see if the Company has recorded an inordinately **large amount of customer returns after the audit period**, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company;
- Review the **process of giving discounts/ incentives** and check whether the same were given as **per the Company's policy/ general industry trends**.
- Review **credit memos**, on a sample basis, issued during the audit period to see if they were properly authorized and whether they were issued in the correct period. Also, review credit memos issued after the period end to see if they relate to transactions belonging to the period under audit. Where any deduction has been made against a bill, check the reason and correspondence for the same.

Audit Procedures - Trade receivable balances have been VALUED appropriately: (MTP 2 S-24 Q. 4 (a))

- **Review the process** followed by the Company to derive an **allowance for doubtful accounts**. This will include a **consistency comparison with the method used in the last year**, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the **ageing report** of accounts receivable (both Dr/Cr balance).
- Also, **obtain the list of debtors under litigation and compare with previous year**.
- **Scrutinize the analysis** and identify those **debtors which appear doubtful**; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where **any disputes exist**.
- He should check if **provisions are made at appropriate rates** considering the recoverability of amounts due.
- Prepare schedule of **movements of bad debts – Provision accounts and debts written off and compare** the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.
- Check that **write-offs of the receivable balances** have been **approved by an appropriate authority** i.e. the Board of Directors in case of a company.
- Check that the **restatement of foreign currency** trade receivables has been done properly in accordance with **AS 11**.

Required DISCLOSURE for trade receivables have been appropriately made:

- (i) Proper **disclosure of Related Party Transactions** regarding receivables have been made as per **AS 18**.

(ii) Trade Receivables ageing schedule: (MTP 2 M-24 Q. 3 (a))

(Amount in Rs.)						
Particulars	Outstanding for following periods from due date of payment#					Total
	Less than 6 months	6 months -1 year	1-2 years	2-3 years	More than 3 years	
(i) Undisputed Trade receivables–considered good						
(ii) Undisputed Trade Receivable-considered doubtful						
(iii) Disputed Trade Receivables considered good						
(iv) Disputed Trade Receivables considered doubtful						

Similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

(iii) Trade receivables shall be sub-classified as:

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iv) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(v) Debts due by:

- directors or other officers of the company or any of them either severally or jointly with any other person or
- firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Trade Payables and Other Current Liabilities: (ICAI Module Pg. No. 5.71 – 5.80)

A liability is considered to be current if it is due to be paid within twelve months and held primarily for the purpose of being traded in the entity's normal operating cycle. Otherwise, classified as non-current liabilities.

Audit Procedures - To establish the EXISTENCE of trade payables and other current liabilities as at the period-end:

- Check whether there are **controls in place to ensure that any purchase/ expense invoice does not get recorded more than once and payable balances are automatically** recorded in the general ledger at the time of recording of expense.
- Obtain the accounts **payable ageing report and trace its balances to the general ledger**. If there are any differences, investigate reconciling items. Journal entries specially for **large amounts should be carefully examined**.
- Direct confirmation procedures same as discussed in the Trade receivables.
- If there are any **related party payables**, review whether they were properly authorized and the value of such transactions were **reasonable and at arm's length**.
- Review a **trend line of purchases/ expenses and accounts payable**, or a comparison of the two over time, to see if there are **any unusual trends**. Make **inquiries about reasons for changes in trends** from the management.

Audit Procedures - Trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS): (MTP 2 S-24 Q. 5 (b))

- The auditor needs to perform the following **cut off procedures**:
 - **Last few invoices received/ recorded** at the end of the reporting date (cut-off date) and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity;
 - **All goods received prior to the period/ year-end should have been booked** in the form of purchases and included in trade creditors.
- **Test purchases/ expenses on a sample basis selecting the same from the accounts payable** ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates.
- **Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period.** This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
- **Review subsequent expense vouchers.** Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.
- For **advance received from customers/ revenue received in advance**, obtain the customer wise listing along with **its ageing and the nature**. Enquire from the entity's management if there has been **any dispute with the customer and if there is any additional liability to be recorded**. For all such advances, the auditor should verify the underlying **documentation** based on which the entity had received the advance.
- In relation to **statutory dues** liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., **prepare a reasonability with respect to sales/ purchases/ employee benefit expenses**.
 - **Example- GST liability** for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
 - Similarly, **Provident Fund liability** for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
- Further, the auditor should **obtain and verify the challans for deposits made subsequent to the period-end for all statutory liabilities** as at the balance sheet date and also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-vis the liability recorded in books of account.

Audit Procedures - Trade payables and other liability balances have been VALUED appropriately:

- Review the process followed by the Company to identify if any **old creditor balance/ liability needs to be written back**. This will include a **consistency comparison with the method used in the last year**, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the **ageing of payable balances**, and the list of vendors with whom the Company has **disputes and any claims from customers, under litigation and compare with previous year**.
- Check that **write backs in the liability** balances assessed as no longer payable have been **approved by an appropriate and authorised member** of senior management, for example – CEO/MD.

- Check that the **restatement of foreign currency trade payables** has been done properly in accordance with **AS 11**.
- Understand **management's process to identify the principal amount and the interest due thereon** (if any) remaining unpaid to any **Micro, Small and Medium Sized Enterprises** suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.

Required DISCLOSURES for trade payables and other liabilities have been appropriately made:

- (i) Whether the Company has disclosed the following details relating to **micro and small enterprises** in the notes:

- **the principal amount and the interest due** thereon (to be shown separately) remaining **unpaid to any supplier** at the end of each accounting year.
- the **amount of interest paid by** the buyer in terms of **section 16** of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year.
- the **amount of interest due and payable** for the period of delay in making payment (which have been paid but beyond the appointed day during the year) **but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006**.
- the **amount of interest accrued and remaining unpaid** at the end of each accounting year.
- the amount of **further interest remaining due and payable** even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

- (ii) **Trade payables due for payment:**

The following ageing schedule shall be given for Trade payables due for payment:-

Trade Payables ageing schedule

Trade Payables ageing schedule					
(Amount in Rs.)					
Particulars	Outstanding for following periods from due date of payment#				Total
	Less than 1 year	1-2 years	2-3 years	More than 3 years	
(i) MSME					
(ii) Others					
(iii) Disputed Dues - MSME					
(iv) Disputed Dues - Others					

similar information shall be given where no due date of payment is specified in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

- (iii) **Other Current Liabilities**

Whether the amount disclosed under other current liabilities are classified as below:

- Current maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings
- Income received in advance
- Unpaid Dividends
- Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be

disclosed. It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities";
• Unpaid matured deposits/debentures and interest accrued thereon • Unpaid matured debentures and interest accrued thereon • Others (specify nature).

Clause (vii) of Para 3 of CARO, 2020 (Related to Statutory Liabilities): (ICAI Module Pg. No. 8.78) (RTP S-24 Que 17)

Sub-clause	Description
(a)	whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
(b)	where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

Click on the link/ scan the QR Code to watch video on Audit of Trade Receivables and Trade Payables and Clause (vii) of CARO, 2020:	
https://youtu.be/Nw-ULSbF4aU?si=v4ovIZpVO1KFcFEo	

Loans and Advances and Other Current Assets: (ICAI Module Pg. No. 5.80 – 5.84)

Loans and advances include loans and advances to related parties, security deposits, capital advances, amounts recoverable in cash or in kind or for value to be received, e.g., rates, taxes and insurance paid in advance/ prepaid.

Other current assets primarily include balances with statutory/ government authorities etc.

Audit Procedures – To establish the EXISTENCE of loans and advances and other current assets at the period end:
- For establishing existence of loans and advances, direct confirmation procedures, similar to those performed for Accounts receivable balances are should be performed with the only difference that while performing circularisation of direct confirmations, in addition to the principal amount, interest receivable, if any, as per the agreed terms between the parties, may also be included as

part of the balance to be confirmed.
<u>Audit Procedures - Loans and advances and other current asset balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS):</u> - Obtain a list of all advances and other current assets and compare them with balances in the ledger. - Verify loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, is granted only if authorised by the MOA and AOA in case of company. - In addition, the auditor should confirm that the loans advanced were within the competence of persons who had advanced the same, directors in the case of a Company, partners in the case of a firm and trustees in the case of a trust. - Inspect the minutes of meeting of board of directors to confirm if all material loans and advances were approved by the board of directors. - Verify that the loan has been acknowledged by the party and in addition, inspect if any security has been deposited against due repayment of the loan. Ascertain if loans are being recovered regularly as per agreed instalments. - If there are any related party loans and advances, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length. - In relation to balances with statutory authorities like GST input credit, prepare a reasonability with respect to purchases/ expenses by applying the applicable rate to the purchases/ expenses and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity. - Further, the auditor should obtain statutory returns filed with the authorities like GST returns and verify whether the amount recorded as per books of account tallies with the claim made with the authorities. (MTP 1 M-24 Q. 5 (a))
<u>Audit Procedure - Loans and advances and other current asset balances have been VALUED appropriately:</u> - Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment. - Obtain the ageing report of loans and advances. Also, obtain the list of loans and advances under litigation and compare with previous year. - Scrutinize the analysis and identify those loans and advances that appear doubtful; discuss with management about the reasons as to why these loans/ advances are not included in the provision for doubtful balances. - Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off. - Check that write-offs or other reductions in the recoverable balances have been approved by the authorised and appropriate senior authority. - Check that the restatement of foreign currency loans and advances/ other current assets has been done properly in accordance with AS 11.
<u>Required DISCLOSURE for loans and advances and other current assets have been appropriately made:</u> (i) <u>Long Term Loans & Advances as well as Short Term Loans & Advances shall be classified as:</u> • Capital Advances; (Only in case of Long Term Loans & Advances) • Loans and advances to related parties (giving details thereof) • Other loans and advances (specify nature)

Following three disclosures shall be given for both – Long Term Loans & Advances and Short Term Loans & Advances separately:

(ii) **The above shall also be separately sub- classified as:**

- (a) Secured, considered good;
- (b) Unsecured, considered good;
- (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by:

- Directors or other officers of the company or any of them either severally or jointly with any other persons or
- Amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(v) Following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013,) either severally or jointly with any other person, that are: **(M-24 Que 4(c) – 3 Marks)**

- (a) repayable on demand or
- (b) without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

Clause (iii) of Para 3 of CARO, 2020 (Related to Loans and Advances): (ICAI Module Pg. No. 8.76 – 8.78)

whether during the year the company has made investments in, provided any guarantee or security or granted any loans or advances in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so,-

Sub-clause	Sub sub clause	Description
(a)		whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-
	(A)	the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates
	(B)	the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;
(b)		whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;

(c)	in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
(d)	if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
(e)	whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];
(f)	whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in clause (76) of section 2 of the Companies Act, 2013;

Click on the link/ scan the QR Code to watch video on Audit of Loans and Advances and Clause (iii) of CARO, 2020:

<https://youtu.be/NLwxICTYo0c?si=ubYPLhGYuL4iP9yF>



Share Capital: (ICAI Module Pg. No. 5.11 – 5.23)

- To establish the **EXISTENCE** of share capital as at the period- end
- Equity balances that were supposed to be recorded have been recognized in the financial statements. (**COMPLETENESS**)
- Equity balances have been **VALUED** appropriately

For all these Assertions, Audit Procedure is given below:

Common Audit Procedures:

- Tally the period-end share capital balance- authorised, issued and paid up, to the previous year audited financial statements.
- In case there is no change during the year, obtain a written confirmation/ representation from the Company Secretary that there were no changes to entity's capital structure during the year.
- In case there is any change, verify whether the paid-up capital as at the period-end is within the limits of authorised capital. Authorized capital should be verified by examining MOA.
- Obtain the certified copies of relevant resolutions passed at the meetings of board of directors, shareholders authorising the increase/ decrease in authorised share capital, if required, or paid up share capital.
- In case of Fresh issue made in the current year, check with compliance of Companies Act 2013 with regard to Return of Allotment, Minimum Subscription, minimum application money to be collected, maintenance of separate Bank account, payment of underwriting commission as per Sec 40 etc.
- No shares have been issued at Discount (Sec. 53 of Companies Act)
- Check if Shares are issued for cash or for Consideration other than cash. (E.g.: To promoters for their services, underwriters for commission payable to them etc.)
- Compliance with SEBI regulations and Guidelines.

Share Issued at Premium:

- Provisions of the Companies Act, 2013 (Sec. 52):
 - A Company shall transfer the amount received as premium to securities premium account and state the purpose for which the amount in the account can be applied.
 - There is no restriction or conditions prescribed in the Act for issue of shares at premium.
 - The provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.
- Application of securities premium account:

The securities premium account may be applied by the Company for the following purposes:

 - (a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
 - (b) in writing off the preliminary expenses of the Company;
 - (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 - (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
 - (e) for the purchase of its own shares or other securities under Section 68. (Buyback)
- Audit Procedures:
 - Verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and
 - Verify whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

Shares issued at Discount:

- Provisions of the Companies Act, 2013 (Sec. 53): (M-24 Que 5(a) – 4 Marks)
 - (1) a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.
 - (2) any share issued by a company at a discounted price shall be void.
 - (2A) anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.
 - (3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.
- Audit Procedures:
 - the movement in share capital during the year and wherever there is any issue,
 - he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.
 - Further, auditor should also verify that whether the company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations

specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

Issue of Sweat Equity Shares:

➤ Provisions of the Companies Act, 2013 (Sec. 54):

“Sweat Equity Shares” mean equity shares issued by the company to employees or directors at a

- i. discount or
- ii. for consideration other than cash

for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

➤ Audit Procedures:

The auditor needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with (as per Section 54):

- (a) the issue is authorized by a special resolution passed by the company;
- (b) the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (c) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

Further, the rights, limitations, restrictions and provisions as applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank *pari passu* with other equity shareholders.

Reduction of Capital:

For verifying reduction of capital, the auditor needs to examine whether the company has followed the specific requirements as required by Section 66 of the Companies Act, 2013. The auditor shall undertake the following audit procedures:

- Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;
- Verify that the Articles of Association authorises reduction of capital;
- Examine that there has been no default w.r.t. repayment of deposits accepted by company or payment of interest on such deposits. Reduction of capital shall not be affected if such default exists.
- Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;
- Check the Registrar’s Certificate as regards to reduction of capital;
- Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;
- Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;
- The company may reduce the capital by reduction in unpaid capital or cancellation of lost capital or paying off excess paid up capital. Verify the adjustment made in the members’ accounts in the Register of Members and confirm that either the paid-up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;
- Confirm that the words “and reduced”, if required by the order of the Tribunal, have been added

- to the name of the company in the Balance Sheet.
- Check if the company have complied with all the terms and conditions imposed by the tribunal while confirming reduction of share capital.
 - Verify that the Memorandum of Association of the company has been suitably altered.
- Exemption to Buy-Back: According to Section 66 (6), nothing in this section shall apply to buy- back of its own securities by a company under Section 68.

Required DISCLOSURE for equity have been appropriately made:

For each class of share capital (different classes of preference shares to be treated separately):

- (i) the number and amount of shares authorised;
- (ii) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
- (iii) par value per share;
- (iv) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
- (v) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
- (vi) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
- (vii) shares in the company held by each shareholder holding more than 5 per cent. shares specifying the number of shares held;
- (viii) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
- (ix) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
 - (a) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.
 - (b) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.
 - (c) Aggregate number and class of shares bought back.
- (x) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;
- (xi) calls unpaid (showing aggregate value of calls unpaid by Directors and officers);
- (xii) forfeited shares (amount originally paid-up).
- (xiii) A company shall disclose Shareholding of Promoters as below:

Shares held by promoters at the end of the year				% Change during the year**
Sr. No.	Promoter Name	No. of shares	% of total shares*	
Total				

*Details shall be given separately for each class of shares

**percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.

- (xiv) Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilised amounts have been used or invested.

Clause (X) of Para 3 of CARO, 2020 (Related to Share Capital): (ICAI Module Pg. No. 8.79)

Sub Clause	Description
(a)	whether moneys raised by way of initial public offer or further public offer (including debt

	instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
(b)	whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance;

Reserves and Surplus: (ICAI Module Pg. No. 5.24 – 5.27)

Basic understanding of Reserves:

- Reserves are a vital source of financing by internal means.
- The reserves can be segregated as –
 - Revenue reserves:
It represents profits that are available for distribution to shareholders or below purposes such as:
 - to supplement divisible profits in lean years,
 - to finance an extension of business,
 - to augment the working capital of the business or
 - to generally strengthen the company's financial position.
 - Capital reserves:
It represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.
Example: Securities premium, capital redemption reserve.

Audit Procedures - To establish the EXISTENCE of reserves and surplus as at the period-end

Reserves and Surplus balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS)

Reserves and Surplus balances have been VALUED appropriately (VALUATION)

- Trace and tally the opening balance of reserves and surplus to the previous year audited financial statements.
- For addition/utilization in current year, in case of:
 - Profit and Loss balance –
 - Trace the movement to surplus/ deficit as per the Statement of profit and loss for the year under audit.
 - The movement should be traced in the Statement of Changes in Equity.
 - Verify the resolution passed by the board of directors regarding the recommendation of dividend, resolution passed by shareholders declaring the dividend.
 - Considering AS-4, if dividends to holders of equity instruments are proposed or declared after the balance sheet date, an entity should not recognize those dividends as a liability as at the balance sheet date. It should, however, disclose the amount of dividends that were proposed or declared after the balance sheet date, but before the financial statements were approved for issue.
 - Securities Premium - It needs to be confirmed that the company has issued shares in excess of the nominal value of the shares and for the same, the auditor should obtain and verify the resolution passed by the board of directors.

Required DISCLOSURES for reserves and surplus have been appropriately made:

- (i) Reserves and Surplus shall be classified as:
 - (a) Capital Reserves;
 - (b) Capital Redemption Reserve;
 - (c) Securities Premium
 - (d) Debenture Redemption Reserve;
 - (e) Revaluation Reserve;
 - (f) Share Options Outstanding Account;
 - (g) Other Reserves– (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (h) Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/ from reserves, etc.; (Additions and deductions since last balance sheet to be shown under each of the specified heads);
- (ii) A reserve specifically represented by earmarked investments shall be termed as a “fund”.
- (iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head “Surplus”. Similarly, the balance of “Reserves and Surplus”, after adjusting negative balance of surplus, if any, shall be shown under the head “Reserves and Surplus” even if the resulting figure is in the negative.

Click on the link/ scan the QR Code to watch video on Audit of Share Capital and Clause (x) of CARO, 2020:

<https://youtu.be/cyPwQYqZLD0?si=vWpnqSSKSYbrUiXg>

**Provisions and Contingent Liabilities: (ICAI Module Pg. No. 5.85 – 5.89)****➤ Provisions:**

A provision is a liability which can be measured only by using a substantial degree of estimation.

A provision is recognised when:

- (i) an entity has a present obligation (legal or constructive) as a result of past event;
- (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (iii) a reliable estimate can be made of the amount of the obligation.

If the above conditions are not met, no provision is recognised.

➤ Contingent Liability:

- (i) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (ii) a present obligation that arises from past events but is not recognized because:
 - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - the amount of the obligation cannot be measured with sufficient reliability.

Audit Procedures - To establish the EXISTENCE of provisions as at the period- end

Provisions that were supposed to be recorded have been recognized in the financial statements.

(COMPLETENESS)

Provision balances have been valued appropriately. (VALUATION):

- Obtain a list of **all provisions and compare them with balances** in the ledger.
- **Inspect** the underlying **agreements** like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations.
- Obtain the underlying **working** and the basis for each of the provisions made, from the management and verify whether the same is complete and accurate.
- Wherever required, **obtain expert's report**, calculation and underlying working for the provision amount, example for warranty involving complex calculations, some entities get that valued through an actuary. In such a case, the auditor may request the management to share the actuarial valuation report and in case of any matter under legal dispute, the auditor should request for assessment made by a legal expert in relation to likelihood of a liability devolving on the entity i.e. whether probable or possible or remote as defined above. The auditor should then verify the underlying assumptions used by the expert with the data shared by the management.
- As per SA 500 – “Audit Evidence”, issued by ICAI, when using the work of a management's expert, audit evidence that the auditor should obtain include:
 - Evaluate the **competence, capabilities and objectivity** of that expert:
 - Whether the expert is employed by the entity or is an outside party.
 - Whether the expert is independent in respect of the entity.
 - Auditor's previous experience of the work of the expert.
 - Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.
 - Obtain an understanding of the work of that expert:
 - Whether the auditor has expertise to evaluate the work of the expert.
 - Evaluating the assumptions and methods used by the management.
 - Evaluating the nature of internal or external data used by the expert.
 - Evaluate the appropriateness of his work as audit evidence for the relevant assertion:
 - Relevance and reasonableness of the expert's findings or conclusions
 - Evaluating the relevance, completeness and accuracy of the source data used by the expert.
- The auditor shall obtain written representation from the management that it has made all the provisions which were required to be made as per the recognized accounting principles.

Required DISCLOSURE for provisions have been appropriately made:

- (i) Long-Term Provisions and Short-Term Provisions (shown separately) shall be classified as follow:
 - (a) Provision for employee benefits;
 - (b) Others (specify nature)
- (ii) Contingent liabilities and commitments (to the extent not provided for):

Contingent liabilities shall be classified as:

 - (a) Claims against the company not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the company is contingently liable.

Commitments shall be classified as:

 - (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
 - (b) Uncalled liability on shares and other investments partly paid;
 - (c) Other commitments (specify nature).

Considering AS 29, “Provisions, Contingent Liabilities and Contingent Assets”, ensure whether following disclosures have been made:

- For each class of provision, an enterprise shall disclose:
 - the carrying amount at the beginning and end of the period;
 - additional provisions made in the period, including increases to existing provisions;
 - amounts used (i.e. incurred and charged against the provision) during the period;
 - unused amounts reversed during the period.
- An enterprise shall disclose the following for each class of provision:
 - a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
 - an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
 - the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.
- Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
 - an estimate of its financial effect
 - an indication of the uncertainties relating to any outflow; and
 - the possibility of any reimbursement.
- Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

Click on the link/ scan the QR Code to watch video on Audit of Provisions and Contingent Liabilities:

<https://youtu.be/blG73Cor7Gs?si=-dvymKGJdtTHHYib>



Other Important Disclosures of Schedule III Part 1: (ICAI Module Pg. No. 5.90 – 5.91, 5.113 – 5.114)

➤ Relationship with Struck off Companies:

Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose the following details: -

Name of Struck off Company	Nature of transactions with struck off Company	Balance outstanding	Relationship with the Struck off company, if any, to be disclosed
	Investments in securities		
	Receivables		
	Payables		
	Shares held by struck off company		
	Other outstanding balances (to be specified)		

➤ **Following Ratios to be disclosed: -**

- (a) Current Ratio,
- (b) Debt-Equity Ratio,
- (c) Debt Service Coverage Ratio,
- (d) Return on Equity Ratio,
- (e) Inventory turnover ratio,
- (f) Trade Receivables turnover ratio,
- (g) Trade payables turnover ratio,
- (h) Net capital turnover ratio,
- (i) Net profit ratio,
- (j) Return on Capital employed,
- (k) Return on investment.

The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year. (RTP M-24 Q. 13)

➤ **Corporate Social Responsibility (CSR): (MTP 1 M-24 Q. 1 (c))**

Where the company covered under section 135 of the companies act, the following shall be disclosed with regard to CSR activities:

- (a) amount required to be spent by the company during the year,
- (b) amount of expenditure incurred,
- (c) shortfall at the end of the year,
- (d) total of previous years shortfall,
- (e) reason for shortfall,
- (f) nature of CSR activities,
- (g) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,
- (h) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

➤ **Details of Crypto Currency or Virtual Currency:**

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

- (a) profit or loss on transactions involving Crypto currency or Virtual Currency
- (b) amount of currency held as at the reporting date,
- (c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

Remaining clauses of CARO, 2020: (ICAI Module Pg. No. 5.85 – 5.89)

Clause	Sub clause	Description
(iv)		in respect of loans, investments, guarantees, and security, whether provisions of sections 185 and 186 of the Companies Act have been complied with, if not, provide the details thereof;

(v)	in respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;	
(vi)	whether maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act and whether such accounts and records have been so made and maintained;	
(xi)	(a)	whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;
	(b)	whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;
	(c)	whether the auditor has considered whistle-blower complaints, if any, received during the year by the company;
(xii) (M-24 Que 5(d) – 3 Marks)	(a)	whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability;
	(b)	whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
	(c)	whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;
(xiii)	whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;	
(xiv)	(a)	whether the company has an internal audit system commensurate with the size and nature of its business;
	(b)	whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor; (MTP 1 M-24 Q. 1(a))
(xv)	whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with;	
(xvi)	(a)	whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) and if so, whether the registration has been obtained;
	(b)	whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934;
	(c)	whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;
	(d)	whether the Group has more than one CIC as part of the Group, if yes, indicate the

		number of CICs which are part of the Group;
(xvii)		whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;
(xviii)		whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors;
(xix)		on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;
(xx)	(a)	whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act;
	(b)	whether any amount remaining unspent under subsection (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135 of the said Act;
(xxi)		whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

- Clause (i) to (xx) are applicable in case of Audit Report of Standalone Financial Statement, while only clause (xxi) is applicable in case of Audit Report of Consolidated Financial Statement.
- Paragraph 4:
 - Where, in the auditor's report, the answer to any of the questions referred to in paragraph 3 is unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.
 - Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

Audit Procedures - Other items of Financial Statements from Test Your Knowledge: (ICAI Module Pg. No. 5.121)

- **Goods sent on consignment: (Test Your Knowledge Que 2 (a) ICAI Module Pg. No. 5.126 – 5.127)**
 - Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
 - Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
 - Obtain confirmation from the consignee for the goods held on consignment on the balance

sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

- Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- See that goods in hand with the consignee have been shown separately under the head inventories.

➤ **Receipt of capital subsidy: (Test Your Knowledge Que 2 (c) ICAI Module Pg. No. 5.128)**

- Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- Check relevant entries for receipt of subsidy.
- Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

➤ **Provision for income tax (Test Your Knowledge Que 2 (d) ICAI Module Pg. No. 5.128)**

- Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- Compute tax payable as per the latest applicable rates in the Finance Act.
- Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

➤ **Payment of taxes (Test Your Knowledge Que 3 ICAI Module Pg. No. 5.129)**

- Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
- Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
- The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

- Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
- The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.
- It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

Click on the link/ scan the QR Code to watch video on Additional Disclosures of Schedule III and Remaining clauses of CARO, 2020:

<https://youtu.be/TBZxSiU1jI0?si=pPVNug3qSsDYd1kg>



Click on the link/ scan the QR Code to watch other videos of Chapter 5:

Case Study:

<https://youtu.be/lx0NAJUqUrl>



Test Your Understanding Questions:

<https://youtu.be/cY161cvvtdM>



Test Your Knowledge Questions:

<https://youtu.be/2W-sJlgZchs>



Chapter 6 – Audit Documentation

Weightage of the Chapter: 2-4 Marks

(Weightage of this Ch. is given with Ch. 4 – Total 12-18 Marks)

SA 230 – Audit Documentation: (ICAI Module Pg. No. 6.3 – 6.4) (Theoretical Question 3 – Pg. No. 6.18)

Audit Documentation refers to (MTP 1 M-24 Q. 3 (d)) -

- the record of audit procedures performed,
- relevant audit evidence obtained, and
- conclusions the auditor reached.

Important Notes to above Meaning:

1. They also known as working papers and work papers.
2. The specific documentation requirements of other SAs do not limit the application of this SA.
3. Laws or regulations may establish additional documentation requirements.
4. Examples of Audit Documentation – Audit Programmes, Analyses, Issues Memoranda, Summaries of significant matters, Letters of confirmation and representation, Checklists, Correspondence (including e-mail) concerning significant matters.

Objectives of Auditor as per SA 230: (ICAI Module Pg. No. 6.4) (MTP 1 M-24 Q. 3 (d))

The objective of the auditor is to prepare documentation that provides:

- A sufficient and appropriate record of the basis for the auditor's report; and
- Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Nature of Audit Documentation: (ICAI Module Pg. No. 6.4)

Audit documentation provides:

- evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Purpose of Audit Documentation: (ICAI Module Pg. No. 6.5) (Theoretical Question 2 – Pg. No. 6.18)

(i) Assisting the engagement team to plan and perform the audit.
(ii) Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
(iii) Enabling the engagement team to be accountable for its work.
(iv) Retaining a record of matters of continuing significance to future audits.
(v) Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
(vi) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Form, content and Extent of Audit Documentation: (ICAI Module Pg. No. 6.5 – 6.6) (Theoretical Question 1 – Pg. No. 6.18)

◆	The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (a) The nature, timing and extent of the audit procedures performed. (b) The results of the audit procedures performed and the audit evidence obtained and (c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.
◆	Further in documenting the nature, timing and extent of audit procedures performed, the auditor shall record: (a) The identifying characteristics of the specific items or matters tested. (b) Who performed the audit work and the date such work was completed; and (c) Who reviewed the audit work performed and the date and extent of such review.
◆	The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.
◆	If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.
<u>Example:</u> During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. Hence, that document mentioned in the case is necessary to document the same by including detail of the person with whom discussions took place along with date.	

The form, content and extent of audit documentation depend on factors such as: (ICAI Module Pg. No. 6.6) (MTP 2 M-24 Q. 3 (d))

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

Audit File: (ICAI Module Pg. No. 6.8)

Audit file may be defined as:

-	one or more folders or other storage media,
-	in physical or electronic form, containing the records that comprise
-	the audit documentation for a specific engagement.

Assembly of the Final Audit File: (ICAI Module Pg. No. 6.9) (M-24 Que 1(d) – 3 Marks)

-	SQC 1 “Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services”, requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
-	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. (RTP M-24 Q. 14)
-	The completion of the assembly of the final audit file after the date of the auditor’s report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
-	Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature. <u>(MTP 2 S-24 Q. 3 (c))</u>
-	Examples of such changes include: • Deleting or discarding superseded documentation. • Sorting, collating and cross-referencing working papers. • Signing off on completion checklists relating to the file assembly process. • Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor’s report.
-	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.

Example:

CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file. The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator.

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. Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor’s report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. In the given case,

even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

Completion Memorandum or Audit Documentation Summary: (ICAI Module Pg. No. 6.11) (Theoretical Question 4 – Pg. No. 6.18) (RTP M-24 Q. 15)

It describes -

- the significant matters identified during the audit and
- how they were addressed.
- Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.

Ownership of Audit Documentation: (ICAI Module Pg. No. 6.11) (MTP 2 S-24 Q. 6 (c) or)

- 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.

Click on the link/ scan the QR Code to watch video on Chapter 6 – Audit Documentation (SA 230):

<https://youtu.be/qipgJH1ruf8?si=be9pL5RjqehTCRnA>



Chapter 7 – Completion and Review

Weightage of the Chapter: 8-12 Marks

SA 580 – Written Representations (ICAI Module Pg. No. 7.28 – 7.39):

Meaning:

- A written representation is a written statement
- by management
- provided to the auditor
- to confirm certain matters or
- to support other audit evidence.

Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Written Representation as Audit Evidence:

- Similar to responses to inquiries, written representations are audit evidence.
- Although written representations provide **necessary audit evidence**, they **do not** provide **sufficient appropriate audit evidence** on their own 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 fulfilment of management's responsibilities, or about specific assertions.

Objectives of the Auditor:

(i) To obtain Written Representations:

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;

(ii) 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,
- if determined necessary by the auditor or required by other SAs; and

(iii) To respond appropriately:

- 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.

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

• An actuary responsible for actuarially determined accounting measurement. • Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements. • Internal counsel who may provide information essential to provisions for legal claims.
<u>Written representations about management's responsibilities (MTP 2 M-24 Q. 2 (a))</u> (i) <u>Preparation of the financial statements:</u> The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement. (ii) <u>Information provided and completeness of transactions:</u> The auditor shall request management to provide a written representation that: - (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and (b) All transactions have been recorded and are reflected in the financial statements.
<u>Why Written representations about management responsibilities are necessary?</u> - Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. - The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. - This is particularly appropriate when: - (i) Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities; (ii) The terms of the audit engagement were prepared in a previous year; (iii) There is any indication that management misunderstands those responsibilities; or (iv) Changes in circumstances make it appropriate to do so.
<u>Other Written representations:</u> - Other SAs require the auditor to request written representations. (SA 550 – Related Parties - full disclosures, SA 560 – all Subsequent Events are reflected in FS, SA 450 – All uncorrected misstatements are immaterial etc.) - If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. - Other written representations about the financial statements may include representations about the following: - • Whether the selection and application of accounting policies are appropriate; and • Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework: -

- Plans or intentions that may affect the carrying value or classification of assets and liabilities;
- Liabilities, both actual and contingent;
- Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
- Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.
- Additionally, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

Written representations about specific assertions:

- When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:
 - The entity's past history in carrying out its stated intentions.
 - The entity's reasons for choosing a particular course of action.
 - The entity's ability to pursue a specific course of action.
 - The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.
- In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements, in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion.

Date of and Period(s) covered by Written Representations: (M-24 Que 3(b) – 4 Marks) (RTP S-24 Que 16)

- The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.
- Written representation is necessary audit evidence and also it covers about subsequent event, hence, it needs to be as near as possible to audit report but not after the audit report date.
- The written representations shall be for all financial statements and period(s) referred to in the auditor's report.
- The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.
- It may happen that current management were not present during all periods referred to in the auditor's report, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Form of Written representations:

- The written representations shall be in the form of a representation letter addressed to the auditor.

- If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required regarding management responsibilities, the relevant matters covered by such statements need not be included in the representation letter.

Doubt as to the reliability of Written representations:

- If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.
- In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter.
- If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.
- If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, having regard to the requirement of **disclaimer of opinion**.

Requested Written representations not provided:

If management does not provide one or more of the requested written representations, the auditor shall: -

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

Disclaimer of opinion in case of non-reliability of Written Representations about management's responsibilities or failure to provide such Written Representations:

The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if:

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

Example:

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about

providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit.

The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

Click on the link/ scan the QR Code to watch video on SA 580:

<https://youtu.be/EG4t0bJvqtQ?si=Zv3x5nmrkn9FXnfP>



SA 560 - "Subsequent Events": (ICAI Module Pg. No. 7.4 – 3.13)

Meaning:

- Events occurring between
- the date of the financial statements (FS) and
- the date of the auditor's report and
- facts that become known to the auditor after the date of the auditor's report are known as subsequent events.

Example

- Company which may have planned an agreement to merge between the date of the financial statements and the date of the auditor's report.
- Or a fire claim amount of an entity receivable from insurance company as on date of financial statements may have been settled at a reduced amount before date of auditor's report.

Financial statements may be affected by certain events that occur after the date of the financial statements.

Many financial reporting frameworks specifically refer to such events.

Such financial reporting frameworks ordinarily identify two types of events: -

- (a) Those that provide evidence of conditions that existed at the date of the financial statements. (Adjusting Events) (It needs to be adjusted in the FS)

Examples:

- (i) Declaration of insolvency of a major debtor of the entity between the date of financial statements and the date of auditor's report providing evidence on the recoverability of the money due from debtor as on date of the financial statements.
- (ii) Settling a legal claim outside the court at a reduced amount between the date of financial statements and the date of auditor's report for which provision has already been made in financial statements. It provides evidence on adjustment in provision amount already made in financial statements, if any.

- (b) Those that provide evidence of conditions that arose after the date of the financial statements. (Non-adjusting Events) (Only disclosure is required in the FS)

Examples:

- (i) Issue of new share capital.
- (ii) Planned merger of the company.
- (iii) Destruction of substantial inventories due to fire between the date of the financial statements and the date of auditor's report.

Objectives of auditor in accordance with SA 560

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

Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report: (RTP M-24 Q. 15)

- 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.
- The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.
- These are required to be performed as 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 in determining the nature and extent of such audit procedures, which shall include the following:
 - (i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
 - (ii) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
 - (iii) 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.
 - (iv) Reading the entity's latest subsequent interim financial statements, if any.
- Such information may also be obtained by auditor from accounting records pertaining to period after date of financial statements, reading entity's latest available budgets etc.
- After performing these procedures, auditor shall determine that subsequent events are properly reflected in FS.

- The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Example: (MTP 2 M-24 Q. 1 (c))

CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue.

It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

Example:

CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out.

Now, she should request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The rationale of obtaining written representations is that even after performing above said procedures, she may not come to know all subsequent events. Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Date the financial statements are issued: (MTP 2 S-24 Q. 6 (c))

- It reflects the date that the auditor's report and audited financial statements are made available to third parties.
- The date the financial statements are issued generally depends on the regulatory environment of the entity.
- It would be at or after the date of issue of Audit Report.

Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued.

- When, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
 - (i) Discuss the matter with management and, where appropriate, those charged with governance.
 - (ii) Determine whether the financial statements need amendment and, if so,
 - (iii) Inquire how management intends to address the matter in the financial statements.
- If management amends the financial statements, the auditor shall:
 - (i) Carry out the audit procedures necessary in the circumstances on the amendment.
 - (ii) When FS are amended: -
 - (a) Extend the audit procedures, already referred, to the date of the new auditor's report and
 - (b) Provide a new auditor's report on the amended financial statements.
- The new auditor's report shall not be dated earlier than the date of approval of the amended FS.
- When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events to that amendment. In such cases, the auditor shall either:
 - (i) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements or
 - (ii) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.
- In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report.
- However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: -
 - (i) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report or
 - (ii) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made.

If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

Facts which become known to the auditor after the financial statements have been issued:

- When, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
 - (i) Discuss the matter with management and, where appropriate, those charged with governance.
 - (ii) Determine whether the financial statements need amendment and, if so,
 - (iii) Inquire how management intends to address the matter in the financial statements.
- If the management amends the financial statements, the auditor shall: -
 - (i) Carry out the audit procedures necessary in the circumstances on the amendment.
 - (ii) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
 - (iii) When the circumstances are such that law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, amend the auditor's report, or provide a new auditor's report as already discussed.
 - (iv) In other cases: -
 - (a) Extend the audit procedures, already referred, to the date of the new auditor's report, and the date the new auditor's report no earlier than the date of approval of the amended financial statements and
 - (b) Provide a new auditor's report on the amended financial statements.
- If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report.
- If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

Click on the link/ scan the QR Code to watch video on SA 560:

https://youtu.be/AgoXnb2C52M?si=s0gKnzH_F0Qcl8



SA 570 - "Going Concern": (ICAI Module Pg. No. 7.13 – 3.24)Introduction:

- One of the fundamental accounting assumptions.
- The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future.
- General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.
- 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.
- When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

Responsibility for assessment of the entity's ability to continue as a going concern

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

The following factors are relevant to that judgment: -

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the auditor:

- 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.

Objectives of auditor in accordance with SA 570:

- (i) 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;
- (ii) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- (iii) To report in accordance with this SA.

Risk assessment procedures and related activities:

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern and: -

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

Examples of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern:**Financial events or conditions: (MTP 1 M-24 Q. 2 (a))**

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

Operating events or conditions:

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

Other events or conditions:

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions

- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
- Changes in law or regulation or government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur

Evaluating management's assessment:

- The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of management's use of the going concern basis of accounting.
- It is not the auditor's responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management's use of the going concern basis of accounting is appropriate in the circumstances.
- Example: when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor's evaluation of the appropriateness of management's assessment may be made without performing detailed evaluation procedures if the auditor's other audit procedures are sufficient to enable the auditor to conclude whether management's use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances. (RTP M-24 MCQ)
- If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.

Additional audit procedures when events or conditions are identified:

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

- (a) Where management **has not yet performed an assessment** of the entity's ability to continue as a going concern, **requesting management to make its assessment**.
- (b) **Evaluating management's plans for future actions** in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- (c) Where the entity has **prepared a cash flow forecast**, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
 - (i) **Evaluating the reliability** of the underlying **data generated** to prepare the forecast; and
 - (ii) Determining whether there is **adequate support for the assumptions** underlying the forecast. (RTP M-24 Q. 17)
- (d) Considering whether **any additional facts or information** have become available since the date on which management made its assessment.
- (e) **Requesting written representations** from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

Examples of audit procedures when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as going concern:

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity's latest available interim financial statements
- Reading the terms of debentures and loan agreements and determining whether any have been breached
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
- Evaluating the entity's plans to deal with unfilled customer orders
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern
- Confirming the existence, terms and adequacy of borrowing facilities
- Obtaining and reviewing reports of regulatory actions
- Determining the adequacy of support for any planned disposals of assets

Auditor's Conclusions

- Based on evaluation of sufficient appropriate audit evidence, auditor needs to determine appropriateness of management's use of the going concern and shall conclude whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary.

Adequacy of disclosures when events or conditions have been identified and a material uncertainty exists: (RTP S-24 Que 16)

If the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:-

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

Implications for the auditor's report:

- (i) If use of Going concern basis of accounting is inappropriate:
If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the

preparation of the financial statements is inappropriate, the auditor shall express an **adverse opinion**.

(ii) If use of going concern basis of accounting is appropriate but a material uncertainty exists:

(a) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements:

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an **unmodified opinion** and the auditor's report shall include a **separate section under the heading "Material Uncertainty Related to Going Concern"** to: -

- I. Draw attention to the note in the financial statements that discloses such matters.
- II. State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

(b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements: (MTP 1 M-24 Q. 3 (b))

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

- I. Express a **qualified opinion or adverse opinion**, as appropriate, in accordance with SA 705.
- II. In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

(iii) Management unwilling to make or extend its assessment

- If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report.
- In such a situation, a **qualified opinion or a disclaimer of opinion** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

Example:

During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages.

Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company.

Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company 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.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company. The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

Click on the link/ scan the QR Code to watch video on SA 570:

<https://youtu.be/D3U5mEHbdiw?si=UKs3JDP9Sfz-RZXy>



SA 450 Evaluations of Misstatements identified during the Audit: (ICAI Module Pg. No. 7.23 – 7.28)

Objectives of auditor in accordance with SA 450:

- (i) The effect of identified misstatements on the audit and
- (ii) The effect of uncorrected misstatements, if any, on the financial statements.

Accumulation of misstatements identified during the audit:

- The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial (i.e. immaterial).
- A misstatement may arise from a variety of factors. For e.g., an inaccuracy in gathering or processing data from which financial statements are prepared or an omission of an amount or disclosure can result into a misstatement.

Consideration of identified misstatements as the audit progresses:

- The auditor shall determine whether the overall audit strategy and audit plan need to be revised if: -
 - (i) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or
 - (ii) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.
- The auditor may request management to -
 - (i) examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor,
 - (ii) perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and
 - (iii) make appropriate adjustments to the financial statements.
- Such a request may be made, for example, based on the auditor's projection of misstatements.
- After the examination made by the management, the auditor shall perform additional audit procedures to determine whether misstatements remain.

Communication and correction of misstatements: (MTP 1 M-24 Q. 1 (b))

- The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.
- The auditor shall request management to correct those misstatements.
- Timely communication of misstatements to the appropriate level of management is important as-
 - it enables management to evaluate whether the items are misstatements,
 - inform the auditor if it disagrees and
 - take action as necessary.
- The correction by management of all misstatements enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
- If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

Evaluating the effect of uncorrected misstatements:

The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate.

In making this determination, the auditor shall consider: -

- (i) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and
- (ii) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Communication with those charged with governance

- The auditor shall communicate with those charged with governance regarding uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.
- The auditor shall request that uncorrected misstatements be corrected.

Written Representation from management regarding effects of uncorrected misstatements

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.

Documentation regarding misstatements identified during audit: (M-24 Que 6(c) – 3 Marks)

Audit Documentation shall include

- The amount below which misstatements would be regarded as clearly trivial.
- All misstatements accumulated during the audit and whether they have been corrected; and
- The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

Example:

You are nearing completion of audit of a company. Ongoing through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs. 10 lacs paid on import of machinery was charged to statement of profit and loss.

The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

Click on the link/ scan the QR Code to watch video on SA 450:

<https://youtu.be/8Fwc12EWxjg?si=pWufm4G-p4FoertC>



SA 260 – ‘Communication with Those Charged with Governance’ (ICAI Module Pg. No. 7.39 – 7.45):

Those charged with governance (TCWG):

- The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.
- This includes overseeing the financial reporting process.
- For some entities, TCWG may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.
- Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics.
- For example, in some entities, a supervisory board exists that is separate from executive board. In other entities, both supervisory and executive functions are performed by a single board.
- Due to diversity, it is not possible to specify for all audits the persons with whom the auditor is to communicate particular matters.
- Hence, the auditor may need to discuss and agree with the engaging party the relevant persons with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant.

Communication from auditor is important with those charged with governance.

An effective two-way communication is important in assisting:

- (i) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.
- (ii) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
- (iii) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

Objectives of auditor in accordance with SA 260:

- (i) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
- (ii) To obtain from those charged with governance information relevant to the audit;
- (iii) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process and
- (iv) To promote effective two-way communication between the auditor and those charged with governance.

Matters to be communicated by auditor to TCWG:(a) The auditor's responsibilities in relation to the financial statement audit:

- (i) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance and
- (ii) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

(b) Planned scope and timing of the audit:

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.

(c) Significant findings from the audit:

- (i) The auditor's views about **significant qualitative aspects** of the entity's **accounting practices**, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity
- (ii) **Significant difficulties**, if any, encountered during the audit;
- (iii) Unless all of those charged with governance are involved in managing the entity: -
 - I. **Significant matters** arising during the audit that were discussed, or subject to correspondence, with management;
 - II. **Written representations** the auditor is requesting
- (iv) **Circumstances that affect the form and content** of the auditor's report, if any and
- (v) **Any other significant matters** arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

Communication of auditor's independence in case of listed entities: (It shall be in Writing only)

- (i) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and
- (ii) (a) All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by

the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and (b) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.
<u>The Communication process:</u> - The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. - Written communications need not include all matters that arose during the course of the audit.
<u>Adequacy of the communication process:</u> - The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. - If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action.
<u>Documentation:</u> - Where matters required by SA 260 to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. - Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

Click on the link/ scan the QR Code to watch video on SA 260:

<https://youtu.be/xeuAh3r-7YE?si=1c7qrG0e-NMQfmqs>



SA 265 - Communicating Deficiencies in Internal Control to Those Charged with Governance and Management: (ICAI Module Pg. No. 7.46 – 7.50)

<u>Scope and Objective as per SA 265:</u> The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.
<u>Meaning of "Deficiency in internal control":</u> This exists when: - (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
<u>Meaning of "Significant deficiency in internal control":</u> - A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

- The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

Few examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency: (MTP 1 S-24 Q. 5 (a))

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

Few examples of indicators of significant deficiencies in internal control:

- Evidence of ineffective aspects of the control environment, such as: -
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
 - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
 - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- Evidence of management's inability to oversee the preparation of the financial statements.

Communication of significant deficiencies in internal control to those charged with governance

- The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.
- The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: -
 - (i) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and
 - (ii) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.
- The auditor shall include in the written communication of significant deficiencies in internal control: -
 - (i) A description of the deficiencies and an explanation of their potential effects; and
 - (ii) Sufficient information to enable those charged with governance and management to understand the context of the communication.
- In particular, the auditor shall explain that: -
 - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;
 - (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
 - (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Example: (Similar que in MTP 2 M-24 Q. 6 (b))

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories.

He points it out to the management in a one-liner as under: -

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication. Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

<u>Click on the link/ scan the QR Code to watch video on SA 265:</u>	
<u>https://youtu.be/JTVJ0qPR1Wk?si=R6PYTCNExqDL3z8M</u>	

<u>Click on the link/ scan the QR Code to watch other videos of Chapter 7:</u>	
<u>Case Study:</u> <u>https://youtu.be/A4iJpFlm5w4</u>	
<u>Test Your Understanding and Test Your Knowledge Questions:</u> <u>https://youtu.be/SSzL70plq6o</u>	

Chapter 8 – Audit Report

Weightage of the Chapter: 8-12 Marks

Types/ Form of Audit Opinion: (ICAI Module Pg. No. 8.8 – 8.9, 8.36 – 8.40)

There are major two types of Audit Opinion:

(1) **Unmodified Opinion:**

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements (FS) are prepared, in all material respects, in accordance with the applicable financial reporting framework.

(2) **Modified Opinion:**

If the auditor:

- (a) concludes that, based on the audit evidence obtained, the FS as a whole are not free from Material Misstatements, or
- (b) is unable to obtain sufficient and appropriate audit evidence to conclude that the FS as a whole are free from Material Misstatements.

There are three sub-types of Modified Opinion:

- (i) Qualified Opinion
- (ii) Adverse Opinion
- (iii) Disclaimer of Opinion

Modified Opinion: (Covered by SA 705)

Definition of Pervasive:

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgement:

- (i) Are not confined to specific elements, accounts or items of the financial statements; or
- (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Sub-types of Modified Opinion:

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

SA 700 - Forming an Opinion and Reporting on Financial Statements: (ICAI Module Pg. No. 8.4 – 8.8)

Objectives of the Auditor:

- (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained
- (b) To clearly express that opinion through a written report.

Evaluations by the Auditor:

- The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
- This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.
- Qualitative Aspects of the Entity's Accounting Practices:
 - (i) **Management makes** a number of **judgements** about the **amounts and disclosures** in the financial statements.
 - (ii) **SA 260 (Revised) contains a discussion of the qualitative aspects** of accounting practices.
 - (iii) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of **possible bias in management's judgements**. The auditor may conclude that the cumulative effect of lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated.
Indicators of a lack of neutrality include the following:
 - (a) The **selective correction of misstatements** brought to management's attention during the audit.
Example: Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
 - (b) **Possible management bias** in the making of accounting estimates.
 - (iv) **SA 540 addresses possible management bias** in making accounting estimates.
- Specific Evaluations by the Auditor:
In particular, the auditor shall evaluate whether:
 - (i) The financial statements adequately **disclose the significant accounting policies** selected and applied;
 - (ii) The **accounting policies** selected and applied are **consistent with the applicable financial reporting framework and are appropriate**;
 - (iii) The **accounting estimates** made by management are **reasonable**;
 - (iv) The **information presented** in the financial statements is **relevant, reliable, comparable, and understandable**;
 - (v) The financial statements provide **adequate disclosures** to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
 - (vi) The **terminology used in the financial statements**, including the **title of each financial statement, is appropriate**.
- General purpose financial statements:
Financial statements prepared in accordance with a general purpose framework.
- General purpose framework:
 - A financial reporting framework designed to meet the common financial information needs of a wide range of users.
 - The financial reporting framework may be a fair presentation framework or a compliance framework.
 - The term **"fair presentation framework"** is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:
 - (i) Acknowledges **explicitly or implicitly** that, to achieve fair presentation of the financial statements, it may be necessary for management to **provide disclosures beyond those specifically required by the framework**; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances. • The term “compliance framework” is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.
Further, when the financial statements are prepared in accordance with a fair presentation framework, evaluations shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of: (i) The overall presentation, structure and content of the financial statements; and (ii) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

SA 705 - Modifications to the Opinion in the Independent Auditor’s Report: (ICAI Module Pg. No. 8.34 – 8.35, 8.40 – 8.43 and 8.47)

<u>Objectives of the Auditor: (MTP 2 M-24 Q. 4 (d))</u> The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements when it is necessary.
<u>Consequence of an inability to obtain sufficient appropriate audit evidence due to a management-imposed limitation after the auditor has accepted the engagement: (RTP M-24 Q. 19)</u> • If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation. • If management refuses to remove the limitation referred above, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence. • If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows: (i) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or (ii) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall: (a) Withdraw from the audit, where practicable and possible under applicable law or regulation; or (b) If withdrawal from the audit before issuing the auditor’s report is not practicable or possible, disclaim an opinion on the financial statements. • If the auditor withdraws as contemplated by point (ii) (a) above, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. When the auditor expects to modify the opinion in the auditor’s report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

Form and Content of Audit Report considering SA 700 and SA 705: (ICAI Module Pg. No. 8.9 - 8.24, 8.43 – 8.47)

Title:

- The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.
- For example, "Independent Auditor's Report" distinguishes the independent auditor's report from reports issued by others.

Addressee:

- The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement.
- Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed.
- The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited. In case of a company, the report is addressed to the shareholders of the company, partners in case of Partnership etc.

Auditor's Opinion:

1. **Unmodified Opinion:**

- Heading of Paragraph in the Report – 'Opinion'
- The Opinion section of the auditor's report shall also:
 - (i) **Identify the entity** whose financial statements have been audited
 - (ii) **State** that the financial statements **have been audited**
 - (iii) Identify the **title of each statement** comprising the financial statements
 - (iv) **Refer to the notes**, including the summary of significant accounting policies; and
 - (v) **Specify the date of, or period** covered by, each financial statement comprising the financial statements.
- Example:
We have **audited** the financial statements of **Ringston Limited** which comprise the **Balance Sheet** as at **31.03.2022** and the **statement of Profit and Loss Account** and the **notes to the financial statements, including a summary of significant accounting policies and other explanatory information**.
- When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:
 - (i) In our opinion, the accompanying financial statements **present fairly, in all material respects**, [...] in accordance with [the applicable financial reporting framework]; or
 - (ii) In our opinion, the accompanying financial statements **give a true and fair view of** [...] in accordance with [the applicable financial reporting framework].
- The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent
- When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

- Example:

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2022 and the Profit & Loss for the year ending on that date.

2. Qualified Opinion:

- Heading of Paragraph in the Report – ‘Qualified Opinion’.
- Five matters as discussed above, remain same.
- When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor’s opinion, **except for the effects of the matter(s) described in the Basis for Qualified Opinion section,**
 - (i) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
 - (ii) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].
- When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase “except for the possible effects of the matter(s) ...” for the modified opinion.

3. Adverse Opinion:

- Heading of Paragraph in the Report – ‘Adverse Opinion’.
- Five matters as discussed above, remain same.
- When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor’s opinion, **because of the significance of the matter(s) described in the Basis for Adverse Opinion section,**
 - (i) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
 - (ii) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

4. Disclaimer of Opinion:

- Heading of Paragraph in the Report – ‘Adverse Opinion’.
- Out of five matters as discussed with Unmodified Opinion - amend the statement which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.
- When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- (i) State that the auditor does not express an opinion on the accompanying financial statements;
- (ii) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, **the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements;**

Basis for Opinion:

1. Unmodified Opinion:

- The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:
 - (i) States that the audit was conducted in accordance with Standards on Auditing;
 - (ii) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
 - (iii) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
 - (iv) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
- Thus, the Basis for opinion section provides important context about the auditor's opinion.
- Example:

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the ICAI together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules there under, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

2. Modified Opinion:

- In case of Modified Opinion, following points also to be considered with discussed above with Unmodified Opinion:
 - Amend the heading "Basis for Opinion" required by SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
 - Within this section, include a description of the matter giving rise to the modification.
- When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by SA 700 (Revised) to include the word "qualified" or "adverse", as appropriate. (Which is discussed above with unmodified opinion)
- When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised), (which are discussed above with unmodified opinion)

(a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion. - If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. - If it is not practicable to quantify the financial effects, the auditor shall so state in this section. - If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated. - If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall: (a) Discuss the non-disclosure with those charged with governance; (b) Describe in the Basis for Opinion section the nature of the omitted information; and (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information. - If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability - Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.
Material Uncertainty related to Going Concern as per SA 570 As discussed in SA 570 – Chapter 7
Key Audit Matters It is discussed subsequently with SA 701.
Other Information: Where applicable, the auditor shall report in accordance with SA 720 (Revised).
Responsibilities for the Financial Statements: - The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." - It includes following matters: (i) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

(ii) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

- This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from Management. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework applicable to the entity.

Auditor's Responsibilities for the Audit of the Financial Statements:

- This section of the auditor's report shall state:
 - (i) That the objectives of the auditor are to:
 - (a) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
 - (b) Issue an auditor's report that includes the auditor's opinion.
 - (ii) That reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists; and
 - (iii) That misstatements can arise from fraud or error, and either:
 - (a) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
 - (b) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.
- The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:
 - (a) State that, as part of an audit in accordance with SAs, the auditor **exercises professional judgement and maintains professional skepticism** throughout the audit; and
 - (b) Describe an audit by stating that the **auditor's responsibilities** are:
 - (i) To **identify and assess the risks of material misstatement** of the financial statements, whether due to fraud or error; to **design and perform audit procedures** responsive to those risks; and to **obtain audit evidence that is sufficient and appropriate** to provide a basis for the auditor's opinion. The risk of **not detecting a material misstatement resulting from fraud is higher** than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
 - (ii) To obtain an **understanding of internal control** relevant to the audit in order to design audit procedures that are appropriate in the circumstances.
 - (iii) To **evaluate the appropriateness of accounting policies** used and the reasonableness of accounting estimates and related disclosures made by management.

- (iv) To conclude on the **appropriateness of management's use of the going concern** basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
 - (v) When the **financial statements are prepared** in accordance with a **fair presentation** framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- (c) When **SA 600 applies**, further describe the auditor's responsibilities in a **group audit engagement** by stating:

The division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components is audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/ branches/ subsidiaries or other components audited by other auditors.
- The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's **report also shall:**
 - (i) State that the **auditor communicates with those charged with governance** regarding, among other matters, **the planned scope and timing of the audit and significant audit findings**, including any **significant deficiencies in internal control** that the auditor identifies during the audit;
 - (ii) For audits of financial statements of **listed entities**, state that the auditor provides **those charged with governance** with a statement that the auditor has **complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters** that may reasonably be thought to bear on the **auditor's independence**, and where applicable, **related safeguards**; and (SA 260)
 - (iii) For audits of financial statements of **listed entities** and any other entities for which **key audit matters are communicated in accordance with SA 701**, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure.
- The description of the auditor's responsibilities for the audit of the financial statements shall be included:
 - (i) **Within the body** of the auditor's report
 - (ii) **Within an appendix to the auditor's report**, in which case the auditor's report shall include a reference to the location of the appendix or
 - (iii) **By a specific reference within the auditor's report to the location of such a description** on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

- When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:
 - (i) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
 - (ii) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
 - (iii) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

Other Reporting Responsibilities:

- If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs.
- For Example:
 - (i) Reporting as per CARO, 2020
 - (ii) Reporting for matters described in Section 143 (3) of the Companies Act, 2013 (Discussed subsequently)
- If other reporting responsibilities are presented in the same section as the related report elements required by the SAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the SAs.
- The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."

Signature of the Auditor:

- The auditor's report shall be signed.
- The report is signed by the auditor (i.e. the engagement partner) in his personal name.
- Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.
- The partner/ proprietor signing the audit report also needs to mention the membership number assigned by the ICAI.
- They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

Place of Signature:

- The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

Date of the Auditor's Report:

- The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:
 - (i) All the statements that comprise the financial statements, including the related notes, have been prepared; and

(ii) Those with the recognized authority have asserted that they have taken responsibility for those financial statements - The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in SA 560 – Subsequent Events.
<u>Unique Document Identification Number (UDIN)</u> - CAs having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them. - Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report. - It is not requirement of SA 700, hence, not limited to only Audit Report, but also to be mentioned in almost all the reports/ certificates which are signed by the CA in practice.

<u>Click on the link/ scan the QR Code to watch video on SA 700 & 705:</u>	
<u>https://youtu.be/rKHPEmPPcZ4?si=655DKUFJQsOTkH5g</u>	

SA 706 - Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report: (ICAI Module Pg. No. 8.47 – 8.51)

<u>Objectives of the Auditor:</u> The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgement it is necessary to do so, by way of clear additional communication in the auditor's report, to: (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
<u>Emphasis of Matter Paragraph:</u> <u>Definition:</u> Emphasis of Matter paragraph is a paragraph included in the auditor's report that - refers to a matter appropriately presented or disclosed in the financial statements that, - in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements. <u>Emphasis of Matter Paragraphs in the Auditor's Report:</u> The auditor shall include an Emphasis of Matter paragraph in the auditor's report provided: (i) The auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter; and (ii) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph: (RTP M-24 Q. 18) (MTP 2 S-24 Q. 2 (b))

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.

A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Separate section for Emphasis of Matter paragraph: (MTP 2 S-24 Q. 2 (b))

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (a) Include the paragraph within a separate section of the auditor's report with an appropriate **heading that includes the term "Emphasis of Matter"**;
- (b) Include in the paragraph a **clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements**. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (c) **Indicate that the auditor's opinion is not modified** in respect of the matter emphasized.

Example of Emphasis of Matter Paragraph in Audit Report:

Emphasis of Matter – Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion:

An Emphasis of Matter paragraph is not a substitute for:

- (a) A **modified opinion** in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;
- (b) **Disclosures in the financial statements** that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
- (c) **Reporting in accordance with SA 570** (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

Other Matter Paragraph:

Definition:

Other Matter paragraph is a paragraph **included in the auditor's report**

- that refers to a **matter other than those presented or disclosed in the financial statements** that, in the auditor's judgement,
- is relevant to **users' understanding of the audit, the auditor's responsibilities or the auditor's report**.

Other Matter Paragraphs in the Auditor's Report:

The auditor shall include an Other Matter paragraph in the auditor's report, provided:

- (i) This is not prohibited by law or regulation; and

- (ii) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

Separate section for Other Matter paragraph:

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter" or other appropriate heading.

Example:

We did not audit the financial statements/ information of ____ (number) branches included in the stand alone financial statements of the Company whose financial statements/financial information reflect total assets of Rs. ____ as at 31st March 20XX and the total revenue of Rs. ____ for the year ended on that date, as considered in the standalone financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of these matters.

Communication with Those Charged with Governance:

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

Click on the link/ scan the QR Code to watch video on SA 706:

https://youtu.be/2hukbGpSOGc?si=NLAs_4yeXpcn38lu



SA 701 - Communicating Key Audit Matters in the Auditor's Report: (ICAI Module Pg. No. 8.51 – 8.54)

Definition of Key Audit Matter:

- Key Audit Matters are those matters that, in the auditor's professional judgement were of most significance in the audit of the financial statements of the current period.
- Key audit matters are selected from matters communicated with those charged with governance.
- For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report.
- When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.
- The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business.

Purpose of Communicating Key Audit Matters:

- As per SA 701, the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.
- Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgement in the audited financial statements.

Objectives of the Auditor:

The objectives of the auditor are to-

- determine key audit matters and,
- having formed an opinion on the financial statements,
- communicate those matters by describing them in the auditor's report.

Determining Key Audit Matters:

In making this determination, the auditor shall take into account the following:

- (i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- (ii) Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
- (iii) The effect on the audit of significant events or transactions that occurred during the period.

Communicating Key Audit Matters:

- The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters".
- The introductory language in this section of the auditor's report shall state that:
 - (i) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and
 - (ii) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

Communicating Key Audit Matters- not a substitute for disclosure in the Financial Statements etc.:

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- (i) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- (iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- (iv) A separate opinion on individual matters.

- As per SA 705, unless required by law or regulation, when the auditor **disclaims an opinion** on the financial statements, the auditor's report shall **not include a Key Audit Matters** section in accordance with SA 701.

Communication with Those Charged with Governance:

The auditor shall communicate with those charged with governance:

- (i) Those matters the auditor has determined to be the key audit matters; or
- (ii) If applicable, depending on the facts and circumstances of the entity and the audit, the auditor's determination that there are no key audit matters to communicate in the auditor's report.

Click on the link/ scan the QR Code to watch video on SA 701:

<https://youtu.be/p4rpqIh7AFI?si=zuWRCpalS0wA7DPI>



SA 710 – Comparative Information – Corresponding Figures and Comparative Financial Statements:
(ICAI Module Pg. No. 8.57 – 8.62)

The Nature of the Comparative Information:

- The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework.
- The essential audit reporting differences between the approaches are:
 - (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
 - (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Objectives of the Auditor:

As per SA 710, the objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
- (b) To report in accordance with the auditor's reporting responsibilities.

Comparative Information:

Definition:

- The amounts and disclosures included in the financial statements
- in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Audit Procedures regarding comparative information:

- The auditor shall determine whether the **financial statements include the comparative information required by the applicable financial reporting framework** and whether such information is **appropriately classified**. For this purpose, the auditor shall evaluate whether:
 - (a) The **comparative information agrees** with the amounts and other disclosures presented in the **prior period**; and
 - (b) The **accounting policies** reflected in the **comparative information are consistent** with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed
- If the auditor becomes aware of a **possible material misstatement in the comparative information** while performing the current period audit, the auditor shall **perform such additional audit procedures** as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560.
- As required **by SA 580**, the auditor shall **request written representations for all periods** referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

Corresponding Figures:

Definition:

- Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements
- and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures").

- The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Audit Reporting regarding Corresponding Figures:

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

1. If the auditor's **report on the prior period**, as previously issued, included a **qualified opinion**, a disclaimer of opinion, **or an adverse opinion** and the **matter** which gave rise to the modification **is unresolved**, the auditor shall **modify the auditor's opinion on the current period's financial statements**. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
 - (a) **Refer to both the current period's figures and the corresponding figures** in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
 - (b) In other cases, **explain** that the audit opinion has been modified because of the **effects or possible effects of the unresolved matter on the comparability** of the current period's figures and the corresponding figures.
2. If the auditor obtains audit evidence that a **material misstatement exists** in the **prior period** financial statements on which an **unmodified opinion** has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall **express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements**, modified with respect to the corresponding figures included therein.
3. **Prior Period Financial Statements Not Audited**- If the prior period financial statements were not audited, the auditor shall **state in an Other Matter paragraph** in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor:

If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an **Other Matter paragraph** in the auditor's report:

- (a) That the financial statements of the **prior period were audited by the predecessor auditor**;
- (b) The **type of opinion expressed** by the predecessor auditor and, if the opinion was **modified**, the **reasons therefore**; and
- (c) The **date of that report**.

Comparative Financial Statements:

Definition:

- Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion.

- The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.
- When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.
- When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.

Prior Period Financial Statements Audited by a Predecessor Auditor:

If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an **Other Matter paragraph** in the auditor's report:

- (a) That the financial statements of the **prior period were audited by the predecessor auditor**;
- (b) The **type of opinion expressed** by the predecessor auditor and, if the opinion was **modified**, the **reasons therefore**; and
- (c) The **date of that report**.

unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

- If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.
- If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Click on the link/ scan the QR Code to watch video on SA 710:

<https://youtu.be/ENaPpX-dTPs?si=58vbnaj6Hq1LVUkq>



Audit of Branch Office Accounts including 'SA 600 - Using the Work of another Auditor': (ICAI Module Pg. No. 8.62 – 8.65)

- Every company shall maintain books of accounts and other relevant books for registered office as well as for branch offices on accrual basis and according to the double entry system of accounting.
- As per section 143 (8) of the Companies Act, 2013,
 - (i) where a company has a branch office, the accounts of that office shall be audited either by the company auditor branch auditor
 - (ii) where the branch office is situated in a country outside India, the accounts of the branch office

shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

- The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.
- The branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

SA 600:

- Definitions:
 - Principal auditor means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
 - Other auditor means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.
 - Component means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.
- When the accounts of the branch are audited by a person other than the company's auditor (or principal auditor), there is need for a clear understanding of the role of such other auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole;
- Also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit.
- The statutes grant right to visit component/ branches to company/ principal auditor, wherever necessary.
- Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.
- When using the work of another auditor, the principal auditor should ordinarily perform the following procedures: **(M-24 Que 4(b) – 4 Marks)**
 - (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
 - (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.
- The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.
- The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor.
- This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

SA 299 – Joint Audit of Financial Statements: (ICAI Module Pg. No. 8.65 – 8.68)Meaning:

- Joint audit basically implies pooling together the resources and expertise
- of more than one firm of auditors
- to render an expert job
- in a given time period
- which may be difficult to accomplish acting individually.

Advantages of Joint Audit:

- Sharing of expertise.
- Advantage of mutual consultation.
- Lower workload.
- Better quality of performance.
- Improved service to the client.
- In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- Lower staff development costs.
- Lower costs to carry out the work.
- A sense of healthy competition towards a better performance.

Disadvantages of Joint Audit:

- The fees being shared.
- Psychological problem where firms of different standing are associated in the joint audit.
- General superiority complex of some auditors.
- Problems of co-ordination of the work.
- Areas of work of common concern being neglected.
- Uncertainty about the liability for the work done.

Requirements as per SA 299:

It requires that–

- (i) the engagement partner and other key members of the **engagement team from each of the joint auditors should be involved in planning the audit.**
- (ii) the joint auditors should **jointly establish an overall audit strategy** which sets the scope, timing and direction of the audit, and also guides the development of the audit plan.
- (iii) before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should: **(MTP 1 S-24 Q. 2 (b))**
 - (a) **identify division of audit areas and common audit areas;**
 - (b) ascertain the **reporting objectives** of the engagement;
 - (c) **consider and communicate** among all joint auditors the **factors that are significant in directing the engagement team's efforts;**
 - (d) consider the **results of preliminary engagement activities**, or similar engagements performed earlier.
 - (e) **ascertain the nature, timing and extent of resources** necessary to accomplish the engagement.
- (iv) each of the joint auditors should **consider and assess the risks of material misstatement and communicate to other joint auditors.**
- (v) the joint auditors should **discuss and document the nature, timing, and the extent of the audit procedures for (I) common and (II) specific allotted areas** of audit to be performed.
- (vi) the joint auditors should **obtain common engagement letter and common management**

representation letter. (vii) the work allocation document should be signed by all the joint auditors and communicated to those charged with governance.
<u>Responsibilities of Joint Auditors:</u> It further states that, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for: (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors; (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas; (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters; (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes; (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework; (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.
<u>Reporting:</u> - It may be noted that the joint auditors are required to issue common audit report. - However, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. - In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

Click on the link/ scan the QR Code to watch video on Branch Audit (along with SA 600) and Joint Audit (SA 299):

<https://youtu.be/coUEr9AL0Yc?si=FZwGO4Mnf7- I5EA>



Section 143 (1) – Reporting requirements: (ICAI Module Pg. No. 8.68 – 8.69) (MTP 2 S-24 Q. 5 (a))

As per section 143(1), auditor shall inquire into following matters given as under:

- (a) whether **loans and advances made by the company** on the basis of **security** have been properly secured and whether the **terms** on which they have been made are **prejudicial to the interests of the company or its members;**
- (b) whether **transactions** of the company which are **represented merely by book entries** are **prejudicial to the interests of the company;**
- (c) where **the company** not being an investment company or a banking company, whether so much of the **assets of the company as consist of shares, debentures and other securities** have been **sold at a price less than that at which they were purchased** by the company;
- (d) whether **loans and advances made by the company have been shown as deposits;**
- (e) whether **personal expenses have been charged to revenue account;**

- (f) where it is stated in the books and documents of the company that any **shares have been allotted for cash**, whether **cash has actually been received** in respect of such allotment, and if **no cash has actually been so received**, whether the **position as stated in the account books and the balance sheet is correct**, regular and not misleading.
- However, the auditor is not required to report on the matters specified above unless he has any special comments to make on any of the items referred to therein.
 - If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied.
 - Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

Section 143 (3) – Reporting requirements: (ICAI Module Pg. No. 8.69 – 8.72)

As per section 143 (3), auditor's report shall also state:

- (a) whether he has **sought and obtained all the information and explanations** which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, **proper books of account** as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the **report on the accounts of any branch office of the company audited** under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's **balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns**;
- (e) whether, in his opinion, the **financial statements comply with the accounting standards**;
- (f) the **observations or comments of the auditors on financial transactions or matters** which have **any adverse effect** on the functioning of the company;
- (g) whether any **director is disqualified** from being appointed as a director under sub-section (2) of the section 164;
- (h) any **qualification, reservation or adverse remark relating to the maintenance of accounts** and other matters connected therewith;
- (i) whether the company has adequate **internal financial controls (IFC)** with reference to financial statements in place and the operating effectiveness of such controls;
However, it may be noted that the reporting requirement on adequacy of IFC with reference to financial statements shall not be applicable to a private company which is a–
 - (i) One person company; or
 - (ii) Small company; or
 - (iii) Company having turnover less than Rs. 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than Rs. 25 crore.
- (j) such other matters as are prescribed in **Rule 11 of the Companies (Audit and Auditors) Rules, 2014** which are as under:-
 - (i) whether the company has **disclosed the impact**, if any, of **pending litigations** on its financial position in its financial statement;

- (ii) whether the company has **made provision**, as required under any law or accounting standards, for **material foreseeable losses**, if any, on long term contracts including derivative contracts;
- (iii) whether there has been **any delay in transferring amounts**, required to be transferred, to **the Investor Education and Protection Fund by the company**.
- (iv) (a) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;
- (b) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties") with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and
- (c) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub- clause (1) and (2) contain any material misstatement.
- (v) Whether the **dividend declared or paid** during the year by the company **is in compliance with section 123** of the Companies Act, 2013.
- (vi) Whether the company has used **such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility** and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

Section 143 (12) – Reporting on frauds: (ICAI Module Pg. No. 8.72 – 8.73)

(a) Reporting to the Central Government-

- As per section 143(12) of the Companies Act, 2013 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of Rs. 1 crore or above, is being or has been committed in

the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.

(b) Reporting to the Audit Committee or Board-

- In case of a fraud involving lesser than the specified amount [i.e. less than Rs. 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.
- Besides, auditor has also to report matters pertaining to fraud at point (xi) of paragraph 3 of CARO, 2020 which is discussed with Chapter 5.

Click on the link/ scan the QR Code to watch video on Sec. 143 (1), 143 (3) and 143 (12):

<https://youtu.be/tzcrbNN0mhA?si=cp3x2I44baqowbTL>



Click on the link/ scan the QR Code to watch other videos of Chapter 8:

Case Study:

<https://youtu.be/KUNtCm9cmpY>



Test Your Understanding Questions:

<https://youtu.be/dBj7zcXsd8Q>



Test Your Knowledge Questions:

<https://youtu.be/yy4zPwapKGI>



Chapter 9 – Special Features of Audit of Different Types of Entities

Weightage of the Chapter: 8-12 Marks

(Weightage of this Ch. is given with Ch. 10 – total weight 12-18 marks)

Audit of Sole Trader: (ICAI Module Pg. No. 9.32 – 9.33)

- Even in case of change of auditor of sole trader, it would be duty of incoming auditor to communicate with the previous auditor.
- Otherwise audit points are similar to as discussed in the Audit Partnership and LLP subsequently.

Audit of Firm: (ICAI Module Pg. No. 9.33 – 9.36)

Appointment of Auditors:

- The auditor of a firm is usually appointed by the partners either on the basis of a decision taken by them or to comply with a condition of the partnership agreement.
- His remuneration is also fixed by the partners.
- In case the firm is required to get its accounts audited under the requirements of any statute (i.e. Mandatory Audit), the auditor will have to qualify the report in case of non-compliance with the accounting standards. Alternatively (i.e. Voluntary Audit), only disclosure of non-compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

Matters to be considered before starting audit:

Examine the **partnership agreement** and note the provisions therein as regards the following matters:

- The **name and style** under which the business shall be conducted.
- The **duration** of the partnership, **if any**, that has been agreed upon.
- The **amount of capital** that shall be contributed by each partner—whether it will be **fixed or could be varied** from year to year.
- The **period at the end of which the accounts of the partnership will be closed periodically** and the **profit-loss sharing ratio**; whether the **losses shall be borne by the partners** or whether any of the partners will **not be required** to do so.
- The provisions as regards **maintenance of books of account** and the matters which must be taken into account for determining the profits of the firm available for division among the partners e.g., creation of reserves, provision for depreciation, etc. also the period within which accounts can be reopened for correcting a manifest error.
- **Borrowing capacity of the partnership.**
- The **rate at which interest** will be allowed on the **capitals and loans** provided by partners and the rate at which it will be **charged on their drawings and current accounts**.
- Whether any **salaries are payable to the partners or withdrawals** are permitted against shares of profits and, if so, to what extent?
- **Duties of the partners** as regards the management of business of the firm; also, the partners **who shall act as managing partners**.
- Who shall operate the bank account of the firm? How will the surplus funds of the partnership be invested?
- Limitations and restrictions that have been agreed upon, the rights and powers of partners and on their implied authority to pledge the firm's credit or to render it liable.

Advantages of Audit of a Partnership Firm:

- Disputes: Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated.

- Dissolution: On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
- Reliable: Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.
- Admission: Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.
- Control: An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Matters which should be specially considered in the audit of accounts of a partnership:

- Confirming that the letter of appointment, signed by a partner, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- Review Minute Books of meetings of Partners.
- Examine that firm is engaged in the objects/ operations specified/ extended/ modified as per the partnership deed.
- Examine Books of Accounts whether it is as per the nature of business or not.
- Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
- Confirm the provision of tax before arriving at the figure of divisible profit.
- Verify profit and losses have been divided among the partners in their agreed profit-sharing ratio.

Example:

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day.

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

Audit of Limited Liability Partnership (LLP): (ICAI Module Pg. No. 9.37 – 9.39)

Introduction:

- LLP is governed by LLP Act, 2008
- Minimum of 2 Partners can form an LLP and at least two partners would be Designated Partners who would be required to take DPIN (Designated Partner Identification Number).
- Definition of Small LLP:
Any LLP:
 - (a) the **Contribution** of which, does not exceed **twenty-five lakh rupees** or such higher amount, **not exceeding five crore rupees**, as may be prescribed; and
 - (b) the **Turnover** of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed **forty lakh rupees** or such higher amount, **not exceeding fifty crore rupees**, as may be prescribed;

LLP's are required to maintain books of accounts which shall contain:

1. Particulars of all sums of **money received and expended** by the LLP and the matters in respect of

which the receipt and expenditure takes place, 2. A record of the assets and liabilities of the LLP, 3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold, 4. Any other particulars which the partners may decide.
<u>Audit of the Accounts of an LLP:</u> - Every LLP shall be audited: (i) whose turnover exceeds, in any financial year, forty lakh rupees, or (ii) whose contribution exceeds twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule. - Where audit is not mandatory, however, the partners of such LLP decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule.
<u>Advantages / Purpose / Need of Audit:</u> - <u>Detection of Errors:</u> Auditing the accounts of a LLP helps in detecting errors & frauds & verification of financial statements. - <u>Disputes:</u> Disputes, if any between any partners in the matter of accounts can be settled with the help of audited accounts. - <u>Reliability:</u> Banks & financial institutions lend money to the firms only on the basis of audited accounts. - <u>Better Compliance and Management:</u> Periodical visits & suggestions by the auditor will be helpful in improving the management of the LLP. - <u>Reconstitution:</u> For settling accounts between partners at the time of admission, death, retirement, insolvency, insanity, etc. audited accounts are accepted by those concerned who have dealings with the LLP.
<u>Returns to be maintained and filed by an LLP:</u> - Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. - Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.
<u>Appointment of Auditor:</u> - The auditor may be appointed by the designated partners of the LLP – • At any time for the first financial year but before the end of first financial year, • At least thirty days prior to the end of each financial year (other than the first financial year), • To fill the casual vacancy in the office of auditor, • To fill the casual vacancy caused by removal of auditor. - The partners may appoint the auditors if the designated partners have failed to appoint them.
<u>Auditor's Duty regarding Audit of LLP:</u> - There should be defined nature and scope of audit in writing. It can be sent by the LLP to auditor through Appointment Letter and/ or through Engagement Letter to be sent by the Auditor to LLP. - Consider Minutes book and LLP Agreement in Audit as discussed in the Audit of Partnership. (MTP 2 S-24 Q. 3 (b)) - Reporting :- The auditor should mention: (MTP 2 S-24 Q. 3 (b)) (a) Whether the records of the firm appear to be correct & reliable. (b) Whether he was able to obtain all information & explanation necessary for his work.

(c) Whether any restriction was imposed upon him.	
Click on the link/ scan the QR Code to watch video on Audit of Sole Trader, Partnership Firm and LLP:	
https://youtu.be/P9qEtcMBVsE?si=gOaOePrkBOsbVEJ	

Audit of Local Bodies: (ICAI Module Pg. No. 9.22 – 9.27)

<u>Meaning of Municipality:</u> - A Municipality can be defined as a unit of local self-government in an urban area. - By the term 'local self-government' is ordinarily understood • the administration of a locality – a village, a town, a city or any other area smaller than a state • by a body representing the local inhabitants, • possessing fairly large autonomy, • raising at least a part of its revenue through local taxation and • spending its income on services which are regarded as local and, therefore, distinct from state and central services.
<u>Municipal government in India covers five distinct types of urban local authorities-</u> - the municipal corporations, - the municipal councils, - the notified area committees, - the town area committees and - the cantonment committees.
<u>Municipal authorities are endowed with specific local functions covering:</u> - regulatory, - maintenance and - development activities.
<u>Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:</u> - general administration and revenue collection, - public health, - public safety, - education, - public works, and - others such as interest payments, etc.
- Property taxes and octroi are the major sources of revenue of the municipal authorities; other municipal taxes are professional tax, non-mechanised vehicles tax, taxes on advertisements, taxes on animals and boats, tolls, show-tax, etc. - The taxation powers of the corporations are confined to a few items and are of a generally compulsive nature; on the other hand, the tax powers of other types of urban local authorities cover a wider range, optional in nature and subject to a procedure for their imposition requiring the final sanction of the state governments.
<u>Local bodies may receive different types of grants from the state administration as well.</u> <u>Broadly, the revenue grants are of three categories:</u> <u>General purpose grants:</u> These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies. <u>Specific purpose grants:</u> These grants which are tied to the provision of certain services or performance of certain tasks.

- (c) Statutory and compensatory grants: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

Financial Administration:

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit.

(a) Budgetary Procedures:

- It serves the twin considerations of financial accountability and control of expenditure.
- The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council.
- One important feature of the municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called extraordinary items which cover most of the capital transactions.
- There are number of special funds (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)

(b) Expenditure Control:

- The integration of legislation and executive powers in the municipal council makes it difficult for its executive to function as its inquisitorial (i.e. inquiring/ investigating) body as well.
- Moreover the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee.
- This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

(c) Accounting System:

- Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit (i.e. excessive amount) of information.
- Both these situations are not conducive to a proper system of management information.

Objectives of Audit of Local Bodies/ Auditor's concern i.e. the auditor should report on:

- (a) reporting on the fairness of the content and presentation of financial statements;
- (b) reporting upon the strengths and weaknesses of systems of financial control;
- (c) reporting on the adherence to legal and/or administrative requirements;
- (d) reporting upon whether value is being fully received on money spent; and
- (e) detection and prevention of error, fraud and misuse of resources.

Appointment:

- The Local Fund Audit Wing of the State Govt. is generally in-charge of the audit of municipal accounts which appoints the Auditor.
- Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc. have power to appoint their own auditors for regular external audit.

Audit Programme:

(a) Rules and Regulations:

The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(b) Authorisations:

He should ensure that all types of sanctions, either special or general, accorded by the competent

authority.

(c) Provisioning:

He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(d) Performance:

The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Click on the link/ scan the QR Code to watch video on Audit of Local Bodies:

<https://youtu.be/7DX1uj0Z-U8?si=3noGrgDgO83ewoht>



Audit of Non-Governmental Organisations (NGOs): (ICAI Module Pg. No. 9.27 – 9.32)

Sources and Application of Funds:

Sources of Funds:

(i) Promoter's Contribution/ Corpus Contribution: (M-24 Que 6(a) or – 4 Marks)

- Donations and grants received in the nature of promoter's contribution are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO.
- The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO.
- Such contributions are generally given with reference to the total funds required by an NGO.

(ii) Voluntary Contribution:

- As per the Income Tax Act, 1961 states that income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the computation of total income.

(iii) Revolving Fund: (M-24 Que 6(a) or – 4 Marks)

- The objective of a contribution or grant towards a Revolving Fund is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on.
- However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.

(iv) Specific Grant/ Fund:

- Donations and grants received for acquisition of specific fixed assets are those grants whose primary condition is that an NGO accepting them should purchase, construct or otherwise acquire the assets for which the grant is given.

(v) Contribution in Kind:

- These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., wool, reeds, cloth, etc.

Application of Funds:

The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

While planning the audit, the auditor may concentrate on the following:

- (i) **Knowledge of the NGO's work**, its mission and vision, areas of operations and environment in which it operate.
- (ii) Updating **knowledge of relevant statutes** especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
- (iii) Reviewing the **legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations**.
- (iv) Reviewing the NGO's **Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies** if any.
- (v) Examination of **minutes** of the Board/ Managing Committee/ Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the **accounting system, procedures, internal controls and internal checks** existing for the NGO and verify their applicability.
- (vii) Setting of **materiality levels** for audit purposes.
- (viii) The **nature and timing of reports or other communications**.
- (ix) The **involvement of experts and their reports**.
- (x) Review the **previous year's Audit Report**.

Audit Programme:(i) Corpus Fund:

- The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s).
- The interest income be checked with Investment Register and Physical Investments in hand.

(ii) Reserves:

- Vouch transfers from projects / programmes with donors' letters and board resolutions of NGO.
- Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.

(iii) Ear-marked Funds:

- Earmarking refers to a fund allocation practice in which an entity, a government, or an individual sets aside a determined amount of funds to use for a specific goal.
- Check requirements of donors' institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

(iv) Project / Agency Balances:

- Vouch disbursements and expenditure as per agreements with donors for each of the balances.

(v) Loans:

- Vouch loans with loan agreements, counterfoil of receipt issued.

(vi) Fixed Assets:

- Vouch all acquisitions / sale or disposal of assets including depreciation and the

authorisations for the same.

- Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.

(vii) Investments:

- Check Investment Register and the investments physically ensuring that investments are in the name of the NGO.
- Verify further investments and dis-investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) Cash in Hand:

- Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.

(ix) Bank Balance:

- Check the BRS and ascertain details for old outstanding and unadjusted amounts.

(x) Inventory:

- Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) Programme and Project Expenses:

- Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/ project and accordingly, in the case of programmes/ projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) Establishment Expenses:

- Verify that PF, life insurance premium, ESI and their administrative charges are deducted, contributed and deposited within the prescribed time.
- Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(i) Contributions and Grants for projects and programmes:

- Check agreements with donors and grants letters to ensure that funds received have been accounted for.
- Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 2010

(ii) Receipts from fund raising programmes:

- Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt.
- Ensure that collections are counted and deposited in the bank daily.

(iii) Membership Fees:

- Check fees received with Membership Register.
- Ensure proper classification is made between entrance and annual fees and life membership fees.
- Reconcile fees received with fees to be received during the year.

(iv) Subscriptions:

- Check with subscription register and receipts issued.

- Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. - Check the receipts with subscription rate schedule.
(v) <u>Interest and Dividends:</u> - Check the interest and dividends received and receivable with investments held during the year.

Audit of Charitable Institution: (ICAI Module Pg. No. 9.40 – 9.42)

<u>General:</u> - Studying the constitution under which the charitable institution has been set up. - Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up. - Examining the system of internal check, especially as regards accounting of amounts collected. - Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly. - Examine the Trust Deed or the Regulations as laid down.
<u>Subscriptions and donations:</u> - Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year. - Whether official receipts are issued: • confirming that adequate control is imposed over unused receipt books; • obtaining all receipt books covering the period under review; • test checking the counterfoils with the cash book; any cancelled receipts being specially looked into; • obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts; • examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and • verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.
<u>Legacies:</u> - Verifying the amounts received by reference to correspondence with any figures and other available information.
<u>Grants:</u> - Vouching the amount received with the relevant correspondence, receipts and minute books. - Obtaining a certificate from a responsible official showing the amount of grants received.
<u>Investments Income:</u> - Vouching the amounts received with the dividend and interest counterfoils. - Checking the calculations of interest received on securities bearing fixed rates of interest. - Checking that the appropriate dividend has been received where any investment has been sold

ex-dividend or purchased cum-dividend. - Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.
<u>Rent:</u> - Examining the rent roll and inspecting tenancy agreements, noting in each case: • the amounts of the rent, and • the due dates. - Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.
<u>Special function, etc. –</u> - Vouching gross receipts and outgoings in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. - In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.
<u>Income Tax Refunds –</u> - Where income-tax has been deducted at source (TDS) from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income- tax. - This involves: • vouching the Income-tax refund with the correspondence with the Income-tax Department; and • checking the calculation of the repayment of claims.
<u>Expenditure:</u> - Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited there from either directly or indirectly. - Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test- basis. - Verifying the cash and bank payments. - Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

Audit of Trusts and Societies: (ICAI Module Pg. No. 9.75 – 9.80)

<u>Books of Account:</u> Charitable and religious trusts should maintain regular books of account. The Auditor is required to report whether the Trust has maintained proper books of accounts, including the following, namely: - - Cash Book - ledger; - journal; - copies/ counterfoils of bills and receipts issued by the trust, whether machine numbered or otherwise serially numbered

- (v) any other book that may be required to be maintained in order to give a true and fair view of the state of the affairs of the person and explain the transactions effected;

Financial Statements:

- Every year the trust has to prepare financial statements like the Balance sheet and Income and expenditure statements based on its books of accounts.
- The format for preparation and presentation of financial statements is prescribed under respective applicable laws.

Auditor's Responsibility:

- Verify maintenance of Books of Accounts as required
- Verify records for the purpose of Audit
- Ensure compliance with AS and SA
- Maintain professional skill and expertise to apply audit tests
- Conduct the audit by applying the generally accepted auditing procedures
- Evaluation of internal control on test check basis considering the materiality concept
- Prepare documentation/ working papers as necessary

Such working papers should include his notes on the following, amongst other matters:

- work done while conducting the audit and by whom;
- explanation and information given to him during the course of the audit and by whom;
- decision on the various points taken;
- the judicial pronouncements relied upon by him while drafting the audit report; and
- certificates issued by the client / management letters.

It is important that the audit working papers prepared and/or obtained by the auditor provide evidence that:

- the opinion expressed by the auditor is based on the examination made by him;
- in arriving at his opinion, the auditor has given due cognizance to the information and explanations given by the assessee and that his opinion is not arbitrary;
- the information and explanations obtained were full and complete that is, the auditor has called for all the information and explanations which were necessary to be considered before arriving at his opinion; and
- the auditor did not merely rely upon the information or explanations given by the assessee but that he subjected such information and explanations to reasonable tests to verify their accuracy and completeness

In case of Audit of Trusts, the auditor has to ascertain:

(There are total 18 points are given in the Module, here 8 point are covered which one may remember)

- whether **accounts are maintained regularly** and in accordance with the **provisions of the applicable Act and the rules**;
- whether **receipts and disbursements are properly and correctly shown in the accounts** and money received in the form of **donations is being applied as per the objects of the trust** and as per the **specific direction** by the donor, if any.
- whether **all books, deeds, accounts, vouchers or other documents or records** required by the auditor **were produced** before him;
- whether a **register of movable and immovable properties is maintained**, the changes therein are communicated from time to time to the regional office, and the defects and inaccuracies mentioned in the previous audit report have been duly complied with and rectified.

- whether the **manager or trustee or any other person** required by the auditor **to appear before him did so and furnished the necessary information** required by him;
- whether any **property or funds of the Trust** were applied for any object or purpose other than the object or purpose of the Trust;
- the amounts of **outstanding for more than one year and the amounts written off**, if any;
- whether the **minute books of the proceedings of the meeting** is maintained

In case of Audit of Societies, the auditor's considerations:

(There are total 10 points are given in the Module, here 6 point are covered which one may remember)

- The auditor should **ascertain governing legislation of society** i.e. Societies Registration act, 1860 or any applicable state law under which it has been registered.
- **Object of society needs to be ascertained** from its memorandum of association/ bye laws. Its activities may include charitable, social, cultural or educational activities.
- Ascertain whether society has obtained **registration under Foreign Contribution (Regulation) Act, 2010** in case foreign contributions are received.
- Ascertain whether it is also **registered** under relevant provisions of **Income Tax Act** which may **make it eligible for tax exemption on its income**.
- Obtain an **understanding of internal control to design audit procedures** with special reference to donations and various expenditures incurred in relation to achievements of objects of society.
- Evaluate **appropriateness of accounting policies** with special reference to donations and grants. Also evaluate accounting policies in relation to specific grants.

Click on the link/ scan the QR Code to watch video on Audit of NGO, Charitable Institutions, Trust and Society:

<https://youtu.be/STSumz9sSi4?si=LxVJ9d53-p-0Tsyp>



Government Audit: (ICAI Module Pg. No. 9.5 – 9.22)

Consolidated Fund of India or of the State:

- As per Article 266, the Consolidated Fund of India consists of
 - all the revenue received from direct and indirect taxes,
 - all the loans taken by the Govt. of India and
 - all the amount of repayment of loans received by the Govt. of India.
- Its importance lies in the fact that all government expenditure is incurred from this fund.
- No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

Meaning of Government Auditing:

Government Auditing is:

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions

- by the responsible officials - and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.
<u>Objectives of Government Auditing:</u> (a) <u>Accounting for Public Funds:</u> Government audit serves as a mechanism or process for public accounting of government funds. (b) <u>Appraisal of Government policies:</u> It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them. (c) <u>Base for Corrective actions:</u> Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
- Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. - The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.
<u>Comptroller & Auditor General (C & AG):</u> - In India, the function of Government Audit is discharged by the independent statutory authority of the C & AG through the agency of the Indian Audit and Accounts Department. - He shall be appointed by the President of India and shall not be removed from office except on the ground of proven misbehavior or incapacity. - He shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.
<u>Duties of C & AG:</u> (i) <u>Compile and submit Accounts of Union and States:</u> - C & AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. - C & AG shall, from the accounts compiled by him or by the Government or any other person responsible in that behalf prepare in each accounts showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine. - C & AG shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for. (ii) <u>General Provisions Relating to Audit:</u> It shall be the duty of the C & AG— (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether

the expenditure conforms to the authority which governs it;

- (b) **to audit and report all transactions** of the Union and of the States relating to **Contingency Funds and Public Accounts**;
- (c) **to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts** kept in any department of the Union or of a State.

(iii) Audit of Receipts and Expenditure:

- Where anybody or authority is **substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory** having a Legislative Assembly, the C & AG shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, **audit all receipts and expenditure of that body or authority and to report** on the receipts and expenditure audited by him.
- Meaning of Substantially financed:
Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year:
 - is not less Rs. 25 lakhs and
 - the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority,
 such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

(iv) Audit of Grants or Loans:

- Where any **grant or loan is given for any specific purpose** from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the C & AG shall scrutinise the procedures by which the **sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access**, after giving reasonable previous notice, **to the books and accounts** of that authority or body.

(v) Audit of Receipts of Union or States:

- It shall be the duty of the C & AG to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly.
- Such an audit provides for checking:
 - whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities.
 - whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;
 - whether such regulations and procedures are actually being carried out;
 - whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds; and
 - review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though

individual cases of assessment, demand, collection, refund, etc. are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

- The extent and quantum of audit required to be done under each category of audit are determined by the C & AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period.

(vi) Audit of Accounts of Stores and Inventory:

- The C & AG shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.
- Audit is conducted:
 - to ascertain whether the **Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores** are well devised and properly carried out.
 - to bring to the notice of the government **any deficiencies in quantities** of stores held or **any defects in the system of control**.
 - to verify that the **purchases** are **properly sanctioned, made economical and in accordance with the Rules for purchase** laid down by the competent authority.
 - to ensure that the **prices paid are reasonable and are in agreement with those shown in the contract** for the supply of stores, and that the **certificates of quality and quantity** are furnished by the inspecting and receiving units. Cases of **uneconomical purchase of stores and losses attributable to defective or inferior quality** of stores are specifically brought by the audit.
 - to check the **accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances** in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any **excess or idle inventory is specifically mentioned in the report** and **periodical verification of inventory** is also conducted to ensure their existence. The **valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts** and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

(vii) Audit of Government Companies and Corporations:

- Public enterprises are required to maintain commercial accounts and are generally classified under three categories—
 - (a) Departmental enterprises engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;
 - (b) Statutory bodies, corporations, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and
 - (c) Government companies set up under the Companies Act, 2013.
- Role of C & AG as per the provisions of the Companies Act, 2013:
 - in the case of a **Government company** or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State

Governments, the **C & AG shall appoint the auditor and direct such auditor** the manner in which the accounts of the Government company are required to be audited and there upon the **auditor** so appointed **shall submit a copy of the audit report** to the C & AG which, among other things, include the directions, if any, issued by the C & AG, **the action taken thereon and its impact on the accounts and financial statement** of the company. (MTP 1 M-24 Q. 2 (d))

- The Comptroller and Auditor-General of India shall **within 60 days from the date of receipt of the audit report** have a right to –
 - **conduct a supplementary audit** under section 143(6)(a), of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the C & AG may direct; and (RTP S-24 MCQ 8)
 - **comment upon or supplement such audit report** under section 143(6)(b). Any comments given by the C & AG upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.
- Further, without prejudice to the provisions relating to audit and auditor, the C & AG may cause test audit to be conducted of the accounts of such company and shall apply to the report of such test audit.

Powers of C & AG

The C & AG Act gives the following powers to the C & AG in connection with the performance of his duties-

- (a) To **inspect any office of accounts** under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
- (b) To **require that any accounts, books, papers and other documents** which deal with or are otherwise relevant to the transactions under audit, **be sent to specified places**.
- (c) To **put such questions or make such observations** as he may consider necessary to the person in charge of the office and to **call for such information** as he may require for the preparation of any account or report which is his duty to prepare.
- (d) In carrying out the audit, the C & AG has the power to **dispense with any part of detailed audit** of any accounts or class of transactions **and to apply such limited checks** in relation to such accounts or transactions as he may determine.

Expenditure Audit: (MTP 1 M-24 Q. 6 (b) – all 5 in brief)

(i) Audit against Rules & Orders:

- It aims to ensure that the expenditure incurred conforms to the relevant provisions of the statutory enactment i.e. Constitution and of the laws and rules made thereunder and in accordance with the Financial Rules and Regulations framed by the competent authority.
- It is of a quasi-judicial type of work performed by the audit authorities.
- It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.
- These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- (a) Rules and orders regulating the **powers to incur and sanction expenditure from the Consolidated Fund of India or of a State** (and the Contingency Fund of India or of a State);
 - (b) Rules and orders dealing with the **mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts** of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
 - (c) Rules and orders regulating the **conditions of service, pay and allowances, and pensions of government servants.**
- It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities and not to prescribe what such rules, regulations and orders shall be.
 - But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:
 - (a) they are **not inconsistent with any provisions of the Constitution or any laws** made thereunder;
 - (b) they are **consistent with the essential requirements of audit and accounts** as determined by the C&AG;
 - (c) they **do not come in conflict with the orders of, or rules made** by, any higher authority; and
 - (d) in case they have **not been separately approved by competent authority**, the issuing authority possesses the necessary rule-making power.

(ii) **Audit of sanctions:**

- The auditor has to ensure that each item of expenditure is covered by a sanction, either special or general, accorded by competent authority authorizing the expenditure.

(iii) **Audit against provision of funds:**

- Audit against provision of funds aims at ascertaining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.

(iv) **Propriety audit:**

- This audit aims that the expenditure is incurred with due regard to broad and general principles of financial propriety.
- The auditors try to bring out cases of improper, avoidable, or ineffective expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.
- A transaction may satisfy all the requirements of regularity audit in so far as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. For e.g.:- a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.
- Here, it is difficult to frame any precise rules, hence, it is dependable for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit.
- However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows: (MTP 2 M-

24 Q. 6 (c)

- (a) The expenditure **should not be** prima facie **more than the occasion demands**. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public **moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money**.
- (b) **No authority should exercise** its powers of sanctioning expenditure to pass an order which will be **directly or indirectly to its own advantage**.
- (c) **Public moneys should not be utilised** for the benefit of a **particular person or section of the community unless**:
 - (i) the amount of expenditure involved is insignificant; or
 - (ii) a claim for the amount could be enforced in a Court of law; or
 - (iii) the expenditure is in pursuance of a recognised policy or custom; and
 - (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

(v) Performance audit:

- This audit ensures that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them.
- The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit:-
 - **Efficiency audit** looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.
 - **Economy audit** looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.
 - **Effectiveness audit** is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.
 - **Efficiency-cum-performance audit**, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.
- The procedure for conducting performance audit covers:
 - identification of topic,
 - preliminary study,
 - planning ,
 - execution of audit, and
 - reporting.

Reporting Procedures:

- Article 151 of the Indian Constitution enjoins that the C&AG shall report on the accounts of the Union and of each of the States to the President or the Governor concern and the latter shall cause the report to be laid before the legislatures and thereafter also publicised adequately in order to create a proper climate of public opinion for taking remedial action where necessary, on the findings of the Auditor General.

- In India, the reporting is factual and the conclusions are left to be drawn by the reader. This is presumably to ensure total objectivity. Nothing debars C&AG from making recommendations in the audit report but traditionally this has been left to be done by the Public Accounts Committee.

Click on the link/ scan the QR Code to watch video on Government Audit:

<https://youtu.be/zEG2YYcBIPQ?si=itKnDiZt3CpyZkwj>



Audit of Educational Institution (School, College or University): (ICAI Module Pg. No. 9.43 – 9.46)

General:

- Examine the **Trust Deed or Regulations**, in the case of **school or college** and note all the provisions affecting accounts. In the case of a **university**, refer to the **Act of Legislature** and the Regulation framed there under.
- **Read through the minutes** of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

Fee from Students: (MTP 2 M-24 Q. 5 (c))

- Check **names entered in the Students Fee Register** for each month or term, with the respective Class Registers, showing names of students on rolls and **test amount of fees charged**; and verify that there **operates a system of internal check** which ensures that demands against the students are properly raised.
- Check **fees received by comparing counterfoils** of receipts granted with **entries in the Cash Book** and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- **Total up the various columns of the Fees Register** for each month or term to ascertain that fees **paid in advance** have been carried forward and that the arrears that are **irrecoverable** have been written off under the sanction of an appropriate authority.
- Check **admission fees with admission slips** signed by the head of the institution and confirm that the amount has been **credited to a Capital fund**, unless the Managing Committee has taken a decision to the contrary.
- See that **free studentship and concessions** have been **granted by a person authorised** to do so, having regard to the Rules prepared by the Managing Committee.
- Confirm that **finer for late payment or absence**, etc. have been either collected or remitted under proper authority.
- Confirm that **hostel dues were recovered before student's accounts were closed** and their **deposits of caution money refunded**.

Other Receipts/ Grants & Donations:

- Verify **rental income from landed property** with the rent rolls, etc.
- Vouch **income from endowments and legacies**, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- Verify **any Government or local authority grant** with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

Expenditure:

- Verify that the **Provident Fund money of the staff has been invested** in appropriate securities.
- Vouch **donations**, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
- Vouch, all **capital expenditure in the usual way** and verify the same with the **sanction** for the Committee as contained in the minute book.
- Vouch, in the usual manner, **all establishment expenses and enquire into any unduly heavy expenditure under any head**. If there was any annual budget prepared, see that any excess under any head over the budgeted amount was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.
- See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

Assets & Liabilities:

- Report any **old heavy arrears on account of fees**, dormitory rents, etc. to the Managing Committee.
- Confirm that **caution money and other deposits** paid by students on admission, have been **shown as liability in the balance sheet not transferred to revenue**, unless they are not refundable.
- See that the investments representing **endowment funds** for prizes are kept separate and **any income in excess of the prizes has been accumulated and invested** along with the corpus.
- Ascertain that the **system ordering inspection on receipt and issue of provisions**, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
- Verify the **inventories of furniture, stationery, clothing, provision and all equipment** etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Compliances:

- Confirm that the **refund of taxes deducted from the income from investment** (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
- Finally, verify the **annual statements of account and**, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

Audit of Hospital: (ICAI Module Pg. No. 9.46 – 9.48)Register of Patients:

- Vouch the **Register of patients with copies of bills** issued to them.
- Verify bills for a selected period with the **patients' attendance record** to see that the bills have been correctly prepared.
- Also see that **bills have been issued to all patients** from whom an amount was recoverable according to the rules of the hospital.

Collection of Cash:

- Check **cash collections as entered in the Cash Book** with the **receipts, counterfoils and other evidence** for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

Income from Investments, Rent etc.:

- See with reference to the **property and Investment Register** that **all income that should have been received** by way of rent on properties, dividends, and interest on securities have been collected.

<u>Legacies and Donations:</u> ➤ Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
<u>Reconciliation of Subscriptions:</u> ➤ Trace all collections of subscription and donations from the Cash Book to the respective Registers. ➤ Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
<u>Authorisation and Sanctions:</u> ➤ Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
<u>Grants and TDS:</u> ➤ Verify that grants, if any, received from Government or local authority has been duly accounted for. ➤ Also, that refund in respect of taxes deducted at source has been claimed.
<u>Budgets:</u> ➤ Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
<u>Internal Check:</u> ➤ Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
<u>Depreciation:</u> ➤ See that depreciation has been written off against all the assets at the appropriate rates.
<u>Registers:</u> ➤ Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
<u>Inventories:</u> ➤ Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
<u>Management Representation and Certificate:</u> ➤ Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Audit of Club: (ICAI Module Pg. No. 9.48 – 9.49)

<u>Entrance Fee:</u> ➤ Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
<u>Subscriptions:</u> ➤ Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
<u>Arrears of Subscriptions:</u> ➤ Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly

adjusted.
<u>Arithmetical accuracy:</u> ➤ Check totals of various columns of the Register of members and tally them across.
<u>Irrecoverable Member Dues:</u> ➤ See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
<u>Pricing:</u> ➤ Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
<u>Member Accounts:</u> ➤ Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
<u>Purchases:</u> ➤ Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
<u>Margins earned:</u> ➤ Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. ➤ The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
<u>Inventories:</u> ➤ Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.
<u>Investments:</u> ➤ Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.
<u>Management Powers:</u> ➤ Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

Audit of Cinema: (ICAI Module Pg. No. 9.49 – 9.51) (MTP 1 M-24 Q. 6 (c) – Receipt of Ticket till 5th point)

➤ Verify the internal control mechanism: • that entrance to the cinema-hall during show is only through printed tickets; • that they are serially numbered and bound into books; • that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially; • that for advance booking a separate series of tickets is issued; and • that the inventory of tickets is kept in the custody of a responsible official.
➤ Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
➤ Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

➤	Reconcile the amount of Tax collected with the total number of tickets issued for each class and vouch and verify the tax returns filed each month.
➤	Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.
➤	Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.
➤	Vouch the expenditure incurred on advertisement, repairs and maintenance . No part of such expenditure should be capitalized.
➤	Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.
➤	Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.
➤	Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
➤	The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

Audit of Hotels: (ICAI Module Pg. No. 9.56 – 9.58)

<u>Internal Controls – (RTP M-24 Q. 20)</u>	
➤	Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined.
➤	It is the responsibility of management to introduce controls which will minimise the leakage as far as possible.
➤	Evidence of their success is provided by the preparation of regular, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated.
➤	The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.
➤	The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.
➤	The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.
➤	If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor.
➤	As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.
<u>Room Sales & Hall Bookings –</u>	
➤	The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.

- The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
- Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.
- In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.
- The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.
- The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

Inventories – (MTP 1 M-24 Q. 5 (c))

- The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores areas and sales point.
- The auditor should carry out tests to ensure that all such documentation is accurately processed.
- Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision.
- In particular, any movement of goods in or out of the stores should be checked.
- Many hotels use specialised professional valuers to take and value the inventories on a continuous basis throughout the year.
- Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year end.
- Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the amounts included for such inventories are reasonable.
- In order to satisfy himself of this, the auditor should consider attending the physical inventory taking and carrying out certain pricing and calculation tests.
- The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

Fixed Assets –

- Many hotels account for certain quasi-fixed assets such as silver and cutlery on inventory basis.
- This can lead to confusion between each inventory items and similar assets which are accounted for on a more normal form on assets basis.
- In such cases, it is important that very detailed definitions of inventory items exist and the auditor should carry out tests to ensure that the definitions have been closely followed.
- The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, whereas costs of major alterations and additions to the hotel building and facilities capitalised.

Casual Labour –

- The hotel trade operates to very large extent on casual labour. The records maintained of such wage payments are frequently inadequate.

- The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

Travel Agents & Shops –

- For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies.
- The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.
- Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

Audit of Hire Purchase and Leasing Companies: (ICAI Module Pg. No. 9.51 – 9.56)

Hire Purchase:

- **Meaning:**
A Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer, who obtains possession, has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-
 - possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,
 - the property in the goods is to pass to such person on the payment of the last of such instalments, and
 - such person has a right to terminate the agreement at any time before the property so passes.
- **While checking the hire- purchase transaction, the auditor may examine the following:**
 - (i) Hire purchase **agreement is in writing and is signed** by all parties.
 - (ii) Hire purchase agreement **specifies** clearly-
 - (a) The hire-purchase **price of the goods** to which the agreement relates;
 - (b) The **cash price of the goods**, that is to say, the price at which the goods may be **purchased by the hirer for cash**;
 - (c) The **date on which the agreement** shall be deemed to have commenced;
 - (d) The **number of instalments** by which the hire- purchase price is to be paid, the **amount of each of those instalments**, and the **date**, or the mode of determining the date, upon which it is payable, and the person **to whom and the place** where it is payable; and
 - (e) The **goods to which the agreement relates**, in a manner sufficient to identify them.
 - (iii) Ensure that **instalment payments are being received regularly** as per the agreement.

Leases:

- There are two types of leases – Operating Lease and Financing Lease.
- Difference between Operating Lease and Finance Lease:

	Operating Lease	Finance Lease
Common examples	Lease of Projector, Computers, Laptops, Coffee Dispensers etc.	Lease of Plant and Machinery, Land, Office Building etc.
Ownership	Ownership of the asset remains with the lessor for the entire period of lease.	Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred. (M-24 Que 6(d) – 3 Marks)

Accounting treatment (RTP M-24 Q. 21)	Operating lease is generally treated like a renting arrangement. That means, the lease payments are treated as operating expenses and the asset does not appear as an asset on lessee's balance sheet.	Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee. (M-24 Que 6(d) – 3 Marks)
Purchase Option	Under operating lease, the lessee does not have any option to buy the asset during the lease period.	Finance lease allows the lessee to have a purchase option at less than the fair market value of the asset.
Lease Term	Lease term generally extends to less than 75% of the projected useful life of the leased asset.	Lease term is generally more than or equal to estimated economic life of the asset under the lease arrangement.
Operating/running expenses	Lessee pays only the monthly lease payments. No running or administration costs are to be borne for example: registration, repairs etc. since it gives only right to use the asset.	Lessee generally bears insurance, maintenance and taxes.
Tax benefit (RTP M-24 Q. 21)	Since operating lease is as good as renting, lease payment is considered as expense. No depreciation can be claimed by the lessee.	Lessee can claim both interest and depreciation expense as financial lease is treated like a loan. (M-24 Que 6(d) – 3 Marks)

- A normal finance lease transaction usually goes through the following modality:

- The lessee will select the equipment, and satisfy himself about its functional fitness and specifications, the lessor has no participation at this stage.
- Having chosen the equipment, the lessee approaches a lessor, either directly or through a lease-broking agency.
- The lease agreement is broadly negotiated and the rates are finalised. The lessor places an order on the manufacturer as chosen by the lessee.
- The manufacturer delivers the equipment at the site of the lessee, and the latter gives notice of acceptance to the lessor.
- The lease agreement giving detailed terms of contract is signed between the parties. Leases will normally be full pay-out, with term varying as per requirements.
- During the lease period, the lessee:
 - Will pay rentals regularly at periods agreed-upon, which are usually each calendar month;
 - Will keep the equipment in good repair and working condition, etc.
 - Will be entitled to any manufacturer's warranties or after-sales services.
- At the end of the lease period, the equipment shall retreat to the lessor. The lessee may, however, be given a renewal right, or may be allowed to participate in purchase of the equipment when the lessor intends to sell it. No purchase option shall be given to the lessee in the lease agreement itself.

- Auditor's Procedures:

- The **object clause** of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.

- Whether **there exists a procedure to ascertain the credit analysis of lessee** like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.
- The **lease agreement should be examined** and the following points may be noted:
 - the **description of the lessor, the lessee, the equipment and the location** where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
 - the amount of **tenure of lease, dates of payment, late charges, deposits or advances** etc. should be noted.
 - whether the equipment **shall be returned to the lessor on termination of the agreement** and the cost shall be borne by the lessee.
 - whether the agreement **prohibits the lessee from assigning the subletting** the equipment and authorises the lessor to do so.
- Examine the **lease proposal form submitted** by the lessee requesting the lessor to provide him the equipment on lease.
- Ensure that the **invoice is retained safely** as the lease is a long-term contract.
- Examine the **acceptance letter obtained from the lessee** indicating that the equipment has been received in order and is acceptable to the lessee.
- See the **Board resolution authorising** a particular director to execute the lease agreement has been passed by the lessee.
- See that the **copies of the insurance policies** have been obtained by the lessor for his records.

Click on the link/ scan the QR Code to watch video on Audit of Educational Institutions, Hospitals, Club, Cinema, Hotel, Hire Purchase and Leasing Companies:

https://youtu.be/QUtR_Rpv2Ac?si=GU0mBeCEs_J5KgfX



Audit of Co-operative Society: (ICAI Module Pg. No. 9.59 – 9.67)

- Meaning:
A Cooperative (also known as co-operative, co-op, or coop) is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise".
- The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments

Audit as per the Co-Operative Societies Act, 1912:

- (1) The Registrar shall **audit** or cause to be audited by some person authorised by him by general or special order in writing in this behalf the accounts of **every registered society once at least in every year**.
- (2) The audit under sub-section (1) shall include an **examination of overdue debts, if any, and a valuation of the assets and liabilities of the society**.
- (3) The **Registrar, the Collector or any person** authorised by general or special order in writing in this behalf by the Registrar shall at all times **have access to all the books, accounts, papers and securities of a society, and every officer of the society shall furnish such information** in regard to

the transactions and working of the society as the person making such inspection may require.

The following points should be kept in mind in connection with the audit of a co-operative society:

- Qualifications of Auditors:
Apart from a CA, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.
- Appointment of the Auditor:
 - An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society.
 - The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.
- Books, Accounts and other records of Co-operative Societies:
Depending upon the nature and object of the society, different kinds of books and registers will be maintained, so as to disclose a proper and fair picture of financial transactions. In case of large scale co-operative organisation, different subsidiary books and registers shall be maintained and the daily summary totals will be transferred to main Cash Book. For example:
 - Daily cash sales summary register.
 - A register of collection from debtors if credit sales are allowed by bye-laws of society.
 - A register of recovery of loans from salaries and directly by receipts from members in case of credit society.
 - Loan disbursement register in case of credit society.
 - Any other columnar subsidiaries depending upon the nature and functions of society.
- Restrictions on share holdings:
 - In the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of 20% of the total number of shares or of the value of shareholding to Rs. 1,000/-.
 - One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.
- Restrictions on loans:
 - A registered society shall not make a loan to any person other than a member.
 - However, with the special sanction of the Registrar, a registered society may make a loan to another registered society.
 - The State Government may further put such restrictions as it thinks fit on the loaning powers of the society to its members or to other societies in the interest of the society concerned and its members.
- Restrictions on borrowings:
 - A registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society.
 - The auditor will have to examine the bye-laws in this respect.

- Investment of funds:
A society may invest its funds in any one or more of the following:
 - (a) In the Central or State Co-operative Bank.
 - (b) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
 - (c) In the shares, securities, bonds or debentures of any other society with limited liability.
 - (d) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
 - (e) In any other moneys permitted by the Central or State Government.
 In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts does not mention anything about the investment of reserve fund outside the business specifically.
- Appropriation of profits:
A prescribed percentage of the profits should be transferred to Reserve Fund, before distribution as dividends or bonus to members.
- Contributions to Charitable Purposes:
A registered society may, with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose.
- Investment of Reserve Fund outside the business or utilisation as working capital:
Some of the State Acts provide that a society may use the Reserve Fund:
 - (a) in the business of a society, as working capital (subject to the rules made in this behalf).
 - (b) may invest as per provisions of the Act.
 - (c) may be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.
- Contribution to Education Fund:
 - Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society.
 - Contribution to Education Fund is a charge on profits and not an appropriation.
- Apart from statutory provisions relating to Reserve Fund, the auditor may have regard to the provisions in bye-laws and Rules and Regulations of the society regarding the appropriation of profits. Transfers to other reserves, dividends to members etc. are the other appropriations.
- Appropriations of profits must be approved by the General Body of the society, which is the supreme authority in the co-operative management.
- Further, it may be noted that necessary accounting entries for the appropriation of profits must be passed after the date of approval by the General Body.
- Here there is a departure from corporate accounting practice, where entries are passed for proposed appropriations, subject to approval of Annual General Meeting.

Special Features of Co-Operative Audit:

- Examination of overdue debts:
 - Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor.
 - A further analysis of these overdue debts from the viewpoint of chances of recovery will have

	to be made, and they will have to be classified as good or bad. ● The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.
-	<u>Overdue Interest:</u> ● Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. ● Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. ● In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.
-	<u>Certification of Bad Debts:</u> ● Bad debts and irrecoverable losses before being written off against Bad Debts Funds, Reserve Fund etc. should be certified as bad debts or irrecoverable losses by the auditor where the law so requires. ● Where no such requirement exists, the managing committee of the society must authorise the write-off.
-	<u>Valuation of Assets and Liabilities:</u> ● The auditor will have to ascertain existence, ownership and valuation of assets. ● Regarding the liabilities, the auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.
-	<u>Adherence to Co-operative Principles:</u> ● The auditor will have to ascertain in general, how far the objects have been achieved in the course of its working. ● The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society. ● For the same, cost accounting methods may be adopted to reduce the cost, reduction in wastage of funds, avoidance of middlemen commission etc. are considered.
-	<u>Observations of the Provisions of the Act and Rules:</u> ● An auditor of a co-operative society is required to point out the infringement with the provisions of Co-operative Societies Act and Rules and bye-laws. ● The financial implications of such infringements should be properly assessed by the auditor and they should be reported.
-	<u>Verification of Members' Register and examination of their pass books:</u> ● Examination of entries in members pass books, on test check basis, regarding the loan given and its repayments, and confirmation of loan balances in person is very much important in a co-operative organisation to assure that the entries in the books of accounts are free from manipulation. ● Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part.

- Special report to the Registrar:
 - During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points.
 - The Registrar on receipt of such a special report may take necessary action against the society.
 - In the following cases, for instance, a special report may become necessary:
 - (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
 - (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
 - (iii) Specific examples of mismanagement. Decisions of management against co-operative principles.
 - (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.
- Audit classification of society:
 - After a judgement of an overall performance of the society, the auditor has to award a class to the society.
 - This judgement is to be based on the criteria specified by the Registrar.
 - It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification.
 - The auditor should be very careful, while making a decision about the class of society.
- Discussion of draft audit report with managing committee:
 - On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report.
 - The audit report should never be finalised without discussion with the managing committee.
 - Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

Audit, Inquiry and Inspection of Multi State Co-operative Society: (ICAI Module Pg. No. 9.67 – 9.74)

Meaning of Multi-state Co-operative Society:

- The Multi-State Co-operative Societies Act, 2002, which applies to co-operative societies whose objects are not confined to one State.
- The funds of a Multi-State co-operative society cannot be utilised for any political purpose.

Books of Accounts:

Every Multi- State Co-operative society shall keep books of account with respect to-

- (i) all sum of money received and expended and matters in respect of which the receipt and expenditure take place;
- (ii) all sale and purchase of goods;
- (iii) the assets and liabilities;
- (iv) in the case of a Multi-State Co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-law of such a society.

Audit of Multi-State Co-operative Society- Qualification of Auditors:

- A person who is a CA can only be appointed as auditor of Multi-State co-operative society.
- However the following persons are not eligible for appointment as auditors of a Multi- State co-operative society- **(MTP 1 S-24 Q. 5 (c))**
 - (a) A body corporate.
 - (b) An officer or employee of the Multi-State co-operative society.
 - (c) A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.
 - (d) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.
- If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

- Appointment of Auditors:

- The **first auditor** or auditors of a Multi-State co- operative society shall be appointed by the **board within one month** of the date of registration of such society and the auditor or auditors so appointed shall **hold office until the conclusion of the first annual general meeting**.
- If the **board fails** to exercise its powers under this sub-section, the Multi-State co-operative society in **the general meeting may appoint the first auditor** or auditors.
- The **subsequent auditor** or auditors are appointed by Multi-State co-operative society, at **each annual general meeting**.
- The auditor or auditors so appointed shall **hold office from the conclusion of that meeting until the conclusion of the next annual general meeting**.

- Power and duties of Auditors:

- Every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.
- As per the provisions of the Act, the auditor shall make following inquiries:
 - (a) Whether **loans and advances made** by the Multi-State co-operative society on the basis **of security have been properly secured** and whether the terms on which they have been made are **not prejudicial to the interests of the Multi-State co-operative society** or its members,
 - (b) Whether **transactions** of the Multi-State co-operative society which are represented **merely by book entries are not prejudicial to** the interests of the Multi-State co-operative society,
 - (c) Whether **personal expenses have been charged to revenue account**, and
 - (d) Where it is Stated in the books and papers of the Multi-State co-operative society that any **shares have been allotted for cash**, whether cash has actually, **been received** in respect of such allotment, and if **no cash has actually been so received**, whether the position as stated in the **account books and the balance sheet as correct regular and not misleading**.

- Content of Auditor's Report:

The auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:
 - (i) Whether he has **obtained all the information and explanation which to the best of his knowledge and belief were necessary** for the purpose of his audit.
 - (ii) Whether, in his opinion, **proper books of account have been kept** by the Multi-State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.
 - (iii) Whether the **report on the accounts of any branch office** audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
 - (iv) Whether the Multi-State co-operative society's **balance sheet and profit and loss account dealt with by the report are in agreement with the books of account** and return.

Where any of the matters referred above is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

Power of Central Government to direct special audit in certain cases –

- Where the Central Government is of the opinion: (RTP S-24 Que 18)

- (a) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or
- (b) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- (c) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

- Central Government's Order:

The Central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order shall be conducted.

- Appointment of the Auditor:

It may appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit.

- Shareholding Restriction:
However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society.
 - Special Auditor's Powers, Duties & Report:
 - The special auditor shall have the same powers and duties and need to report matters in relation to the special audit as an auditor/ audit of a Multi- State co-operative society as discussed.
 - However the special auditor shall instead of making his report to the members of the Multi-State co-operative society make the report to the Central Government.
 - Action by the Central Government:
 - On receipts of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force.
 - However, if the Central Government does not take any action on the report within four months from the date of its receipt, that Government shall send to the Multi- State Co-operative society either a copy of, or relevant extract from, the report with its comments thereon and require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.
 - Expenses pertaining to the Special Audit:
The expenses of, and incidental to, any special audit (including the remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society and in default of such payment, shall be recoverable from the Multi-State Co-operative society as an arrear of land revenue.
- Inquiry by Central Registrar:
- When:
The Central Registrar may, on a request from :-
 - a federal co-operative to which a Multi- State Co-operative society is affiliated or
 - a creditor or not less than one-third of the members of the board or
 - not less than one-fifth of the total number of members of a Multi-state co-operative society,
 - How:
Hold an inquiry or direct some person authorized by him by order in writing in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society.
 - Opportunity of being Heard:
However, before holding such inquiry fifteen days' notice must be given to the Multi-State co-operative society.
 - Powers given:
The Central Registrar or the person authorized by him shall have the following powers, namely:
 - (a) he shall at **all reasonable times have free access to the books, accounts, documents, securities, cash and other properties** belonging to or in the custody of the Multi-State co-

operative society and **may summon any person** in possession or responsible for the custody of any such books, accounts, documents securities, cash or other properties to produce the same at any place specified by him.

- (b) he may, notwithstanding any bye-law specifying the period of notice for a general meeting of the Multi-State co-operative society, **require the officers of the society to call a general meeting of the society by giving notice of not less than seven days** at such time and place at the headquarters of the society to consider such matters as may be directed to him, and where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.
- (c) he may **summon any person who is reasonably believed by him to have any knowledge of the affairs** of the Multi-State co-operative society to appear before him at any place at the headquarters of the society or any branch thereof and may examine such person on oath.

- Follow up:

The Central Registrar shall, within a period of **three months of the date of receipt of the report**, communicate the report of inquiry to the Multi-State co-operative society, the financial institutions, if any, to which the society is affiliated, and to the person or authority, if any at whose instance the inquiry is needed.

Inspection by Central Registrar:

- When:

The Central Registrar may, on a request from :-

- a federal co-operative to which a Multi- State Co-operative society is affiliated or
- a creditor or not less than one-third of the members of the board or
- not less than one-fifth of the total number of members of a Multi-state co-operative society,

- How:

By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi- State co-operative society.

- Opportunity of being Heard:

No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.

- Powers given:

The Central Registrar or the person authorized by him shall have the following powers, namely:

- (a) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
- (b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

- Inspection Report:

A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

Example:

A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary.

The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It shall keep books of account with respect to: -

- (i) all sum of money received and expended and matters in respect of which the receipt and expenditure take place
- (ii) the assets and liabilities

Click on the link/ scan the QR Code to watch video on Audit of Co-operative Society and Multi-State Co-operative Society:

<https://youtu.be/nTZvgXYg5lo?si=gx19013RnxPwf8ly>



Click on the link/ scan the QR Code to watch other videos of Chapter 9:

Case Study:

<https://youtu.be/6T1moE4Z1D4>

**Test Your Understanding Questions:**

<https://youtu.be/w1ObEkgj2ak>



Chapter 10 – Audit of Banks

Weightage of the Chapter: 4-6 Marks

(Weightage is given with Ch. 9 – total weight 12-18 marks)

Bank Audit Approach: (ICAI Module Pg. No. 10.9 – 10.11)

Drawing an Audit Plan:

- the nature and level of operations,
- nature of adverse features,
- level of compliance based on previous reports and
- audit risks based on inadequacy in or breach of internal controls and the familiarization exercise carried out.

Control Environment at the Bank:

- A bank should have appropriate controls to mitigate its risks including-
 - effective segregation of duties (particularly, between front and back offices),
 - accurate measurement and reporting of positions,
 - verification and approval of transactions,
 - reconciliation of positions and results,
 - setting up limits,
 - reporting and approval of exceptions,
 - physical security and
 - contingency planning.
- The following are certain common questions /steps, which have to be kept in mind while undertaking/ performing control activities:

Nature of Que.	Questions to be considered / answered
Who	- Who performs the control? - Does the above person have requisite knowledge and authority to perform the control?
What	- What evidence is available to demonstrate /prove that the control is performed?
When	- When and with what frequency is the control performed? - Is the frequency enough to prevent, detect and correct risk of material misstatements?
Where	- Where is the evidence of performance of the control retained? - For how long is the evidence retained? - Is the evidence accessible/ available for audit?
Why	- Why is the control being performed? - What type of errors are prevented or detected through the performance of the control?
How	- How is the control performed? What are the control activities? Can these activities be bypassed? - Can the bypass, if any, be detected? - How are exceptions / deviations resolved on identification? - What is the time frame for resolving the exceptions / deviations?

Engagement team Discussion:

- These discussions are ordinarily done at the planning stage of an audit.
- The engagement team discussion ordinarily includes a discussion of the following matters:
 - **Errors** that may be more **likely to occur**;
 - **Errors** which have been **identified in prior years**;
 - **Method by which fraud might be perpetrated** by bank personnel or others within particular account balances and/or disclosures;
 - Audit **responses to Engagement Risk, Pervasive Risks, and Specific Risks**;
 - Need to **maintain professional skepticism** throughout the audit engagement;
 - Need to **alert for information or other conditions that indicates that a material misstatement may have occurred** (e.g., the bank's application of accounting policies in the given facts and circumstances).
- **Advantages** of such a discussion:
 - **Specific emphasis** should be provided to the **susceptibility of the bank's financial statements** to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
 - It further enables the audit engagement partner to **delegate the work to the experienced engagement team members**, and to **determine the procedures to be followed** when fraud is identified.
 - Further, audit engagement partner **may review the need to involve specialists** to address the issues relating to fraud.

Form and Content of FS: (ICAI Module Pg. No. 10.11 – 10.12)

- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Banking Regulations Act, 1949 or as near thereto as the circumstances admit.
- Form A of the Third Schedule to the Act, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Few points related to Bank Audit (ICAI Module Pg. No. 10.12– 10.13):

- Provisions of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies i.e. considering eligibility, qualifications and disqualifications of company auditor.

Appointment of Auditor:

- The auditor of a banking company is to be appointed at the annual general meeting of the shareholders,
- The auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors.
(In either case, approval of the Reserve Bank of India is required before the appointment is made.)
- The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

Remuneration of Auditor:

- The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of Section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine).
- The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.
- The auditor of a banking company, nationalised bank, State Bank of India, or regional rural bank has the same powers as those of a company's auditor in the matter of access to the books, accounts, documents and vouchers.

Types of Bank Audit Reports to be issued: (ICAI Module Pg. No. 10.7 – 10.8, 10.13 – 10.15)

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

- Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
- Long Form Audit Report. (LFAR)
- Report on compliance with SLR requirements.
- Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
- Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/ credit system.
- Report on instances of adverse credit-deposit ratio in the rural areas.

Auditor's Report:

- In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:
 - (a) whether, in his opinion, the financial statements present a true and fair view of the affairs of the bank and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
 - (b) whether or not the transactions of the bank, which have come to his notice, have been made within the powers of that bank;
 - (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit; and
 - (d) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

Format of Report

- The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of series of SA 700 discussed in Chapter 8 on Audit Report.
- The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report.
- It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report the matters covered by Section 143 of the Companies Act, 2013.
- However, it is pertinent to mention that the reporting requirements relating to the CARO, 2020 is not applicable to Banking Companies.

Long Form Audit Report (LFAR)

- Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a LFAR.
- The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.
- The Statutory Central Auditors are required to submit the LFAR to the banks latest by 30th June every year.
- While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

Reporting to RBI

- The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:
 "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".
- Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". The said Standard explains that the duty of confidentiality is over-ridden by statute, law or courts.
- SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

Click on the link/ scan the QR Code to watch video on basics of Bank Audit:

https://youtu.be/ozr_MYXuvsw?si=jANu_M99JO1m2DHo



Conducting an Audit (ICAI Module Pg. No. 10.15 – 10.21): (Only Bank Audit specific/ new points are covered here)

Initial consideration by the statutory auditor (Only Bank Audit specific points are covered here)

- Declaration of Indebtedness:
The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness. Indebtedness refers to the situation of owing money to the bank in any case, whatsoever.
- Internal Assignments in Banks by Statutory Auditors:
The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year, like Concurrent audits.
- Assessment of Engagement Risk:
The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

Understanding the Risk Management Process:

Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- (a) Oversight and involvement in the control process by those charged with governance:
Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
- (b) Identification, measurement and monitoring of risks:
Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
- (c) Control activities:
A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.
- (d) Monitoring activities:
Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
- (e) Reliable information systems:
Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Audit Planning Memorandum:

The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:

- Describe the expected scope and extent of the audit procedures to be performed by the auditor.
- Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.

- Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

Assess the Risk of Fraud including Money Laundering:

- As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.
- The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.
- The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms.
- The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

Assess Specific Risks:

The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Stress Testing:

- Stress testing is a software testing activity that determines the robustness of software by testing beyond the limits of normal operation.
- Stress testing is particularly important for "mission critical" software, but is used for all types of software.
- RBI has required that all commercial banks shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

BASEL III framework:

- Basel norms or accords are the International Banking regulations issued by the Basel Committee on Banking Supervision (BCBS).
- BCBS and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis.
- In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital.
- The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord.

Reliance on / review of other reports: (MTP 2 S-24 Q. 3 (a))

The auditor should take into account the adverse comments, if any, on advances appearing in the following-

- Previous year's audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank's latest inspection report.
- Concurrent/ Internal audit report.
- Report on verification of security.

- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

Click on the link/ scan the QR Code to watch video on Conducting Bank Audit:

<https://youtu.be/yHaUs-MbndQ?si=DXi5pEU-ZHfD44pY>



Advances: (ICAI Module Pg. No. 10.21 – 10.31)

Introduction:

- Advances are amount of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.
- All Bank Loans are made at interest which is a compensation for borrowing.
- Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

Types of Advances:

- Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower. Examples of funded loans are Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted and Purchased, Participation on Risk Sharing basis, Interest-bearing Staff Loans.
- Non-funded facilities are those which do not involve such transfer. Examples of non-funded loans are Letters of credit, Bank guarantees, etc.

Classification of Advances:

(i) Sector wise:

- RBI issues common guidelines for lending to Priority Sector which banks are required to follow.
- Examples of Priority Sectors are Agriculture, MSME, Education, Housing, etc.

(ii) Security wise:

- Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.
 - (a) Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.
 - (b) Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Mode of Creation of Security:

Depending on the nature of the item concerned, creation of security may take the form of:

(i) Mortgage:

Mortgage are of several kinds but the most important are as follow:

- (a) Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
- (b) Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) Pledge:

- A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance.
- The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods.
- The pledge of goods constitutes a specific (or fixed) charge.

(iii) Hypothecation:

- The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.
- Neither ownership nor possession is transferred to the bank.
- However, the borrower holds the physical possession of the goods as an agent/ trustee of the bank.
- The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

(iv) Assignment:

- Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person.
- Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

(v) Set-off:

- Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor.
- The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).
- For the purpose of set-off, all the branches of a bank are treated as one single entity.
- The right of set-off can be exercised in respect of time-barred debts also.

(vi) Lien:

Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances:

- An asset becomes Non-performing Assets (NPA) when it ceases to generate income for the Bank.
- A NPA is a loan or an advance where :-
 - (i) interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan;
 - (ii) the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/ CC);
 - (iii) the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- **Out of Order:** An account should be treated as 'out of order' if: **(MTP 1 S-24 Q. 6 (a))**
 - (i) the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
 - (ii) In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet ; or
 - (iii) credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.
- **Example of Out of Order:**
A Ltd. has been sanctioned a Cash Credit Facility by ADB Bank Ltd. for INR 50 lacs but as per the Stock Statements furnished for the last quarter, the Bank has calculated the Drawing power to be INR 42 Lakhs. In this case, the account would be termed as OUT OF ORDER if :-
 - (i) the outstanding balance remains continuously in excess of the INR 50 lacs/42 lacs whatever the case may be; or
 - (ii) The outstanding balance in the account is less than INR 42 lacs but there are no credits or any payments deposited into this account continuously for 90 days as on the date of Balance Sheet; or
 - (iii) credits are there up to say INR 2 lakhs but are not enough to cover the interest debited during the same period which is around INR 5 lakhs.
- **Overdue:** Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.
- Income from NPA is not recognized on accrual basis but is booked as income only when it is actually received.
- **Classification and Provisioning of Advances: (RTP M-24 Q. 23)**

Classification of Advances	Provision required (of Advance)
1. Standard Assets (i) Standard Regular (ii) SMA – Special Mention Accounts (a) SMA 0 – Accounts showing stress signals (b) SMA 1 – Overdue between 31 to 60 days (c) SMA 2 – Overdue between 61 to 90 days	No Provision
2. Non-performing Assets: (i) Sub-standard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%

(ii) <u>Doubtful Assets:</u> Would be one, which has remained in the sub-standard category for a period of 12 months. (a) Doubtful up to 1 Year (D1) (b) Doubtful 1 to 3 Years (D2) (c) Doubtful more than 3 Years (D3) (iii) <u>Loss Assets:</u> Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	(Secured + Unsecured) 25% + 100% 40% + 100% 100% + 100% 100%
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- Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise.
- Asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA. (RTP S-24 MCQ 7)
- Accounts regularized near the Balance Sheet Date:
 - The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity.
 - Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA.
 - The auditor should check for sample transactions immediately before the closing of the Financial Year and immediately after the closing of the financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the Borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.
- Government Guaranteed advances: (M-24 Que 6(b) – 4 Marks)
 - Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
 - The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.
- Advances under Consortium:
 - Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium.
 - Joint appraisal, control and monitoring will facilitate for exchange of valuable information among the Banks.
 - Usually, a Bank with a higher share will lead the consortium.
 - Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances.
 - Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of

other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

- The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.
- The Lead Bank would be responsible for computing the drawing power (DP) of the borrower and allocate the same to member banks.
- In certain special circumstances, at the request of the Borrower, the Lead Bank may allot a higher or lower share of drawing power to the member bank, as against their share of advances.

Accounts where there is erosion in the value of security / frauds committed by borrowers:

- Erosion means the gradual destruction or diminution of something not prudent to follow stages of asset classification.
- It should be straight-away classified as doubtful or loss asset as appropriate as follows:
 - (i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straight-away classified under doubtful category and provisioning should be made as applicable to doubtful assets.
 - (ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straight-away classified as loss asset. It may be either written off or fully provided for by the bank.

Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.:

Advances against Term Deposits, National Savings Certificates (NSCs) eligible for surrender, Kisan Vikas Patras (KVP)/ Indira Vikas Patra (IVP) and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

Agricultural Advances affected by Natural Calamities:

- Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities.
- Banks may decide on their own relief measures, viz., conversion of the short-term production loan into a term loan or reschedulement of the repayment period and the sanctioning of fresh short-term loan, subject to the guidelines contained in RBI's latest Master Circular.
- In such cases, the NPA classification would be governed by such rescheduled terms.

Advances to Staff:

- Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank.
- In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.
- Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates.
- The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

Agricultural Advances:

- As per the guidelines, Agricultural Advances are of two types:
 - Agricultural Advances for “long duration” crops;
 - Agricultural Advances for “short duration” crops.
- The “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops would be treated as “short duration” crops.
- The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers’ Committee in each State.
- The following NPA norms would apply to agricultural advances (including Crop Term Loans):
 - A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
 - A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Computation of Drawing Power (DP): (ICAI Module Pg. No. 10.34 – 10.35)**Meaning:**

- Drawing Power generally addressed as “DP” is an important concept for Cash Credit (CC) facility availed from banks and financial institutions.
- Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

Different from Sanctioned Limit:

- The Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc.
- On the other hand, Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.

Considerations:

- All accounts should be kept within both the drawing power and the sanctioned limit at all times.
- The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/ Head Office regularly.

Bank’s Duties:

- Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets.
- Drawing power is required to be arrived at based on current stock statement.
- However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.
- The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

Auditor’s Concern:

- The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.
- The audited Annual Report submitted by the borrower should be scrutinized properly.

- The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

Computation of DP:

- It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors.
- Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

Stock Audit:

- The stock audit should be carried out by the bank for all accounts having funded exposure of more than 5 crores.
- Auditors can also advise for stock audit in other cases if the situation warrants the same.
- Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital.
- The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

Example: (Similar Que in RTP S-24 Que 19)

CA P is conducting stock audit of a borrower availing cash credit facility of Rs. 100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22:

Value of stocks	Rs. 125 lacs
Value of stocks (fully damaged) included in above	Rs. 5 lacs
Value of debtors	Rs. 50 lacs
Value of debtors exceeding 90 days included in above	Rs. 10 lacs
Value of creditors for goods	50 lacs

Calculation of DP:

Particulars	Rs. In Lacs
Value of stocks as on 31.12.22	125.0
Less: value of damaged stocks	5.0
	120.0
Less: creditors for goods as on 31.12.22	50.0
Value of Paid stocks	70.0
Less: Margin @ 25%	17.5
Drawing Power (A)	52.5
Value of debtors as on 31.12.22	50.0
Less: debtors exceeding 90 days	10.0
	40.0

Less: Margin @ 40%	16.0
Drawing Power (B)	24.0
Drawing Power (A + B)	76.5

Click on the link/ scan the QR Code to watch video on Advances and Drawing Power:

<https://youtu.be/Yj4f-gGS-iM?si=WXf9Z82sYB3Fanog>



Audit of Advances: (ICAI Module Pg. No. 10.35 – 10.38)

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following: (MTP 2 M-24 Q. 1 (b))

- (a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- (b) Advances represent amount due to the bank.
- (c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
- (d) There are no unrecorded advances.
- (e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
- (f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- (g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- Examining the validity of the recorded amounts;
 - Examining loan documentation;
 - Reviewing the operation of the accounts;
 - Examining the existence, enforceability and valuation of the security;
 - Checking compliance with RBI norms including appropriate classification and provisioning; and
 - Carrying out appropriate analytical procedures.
- In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis.
 - The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant.
 - Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Evaluation of Internal Controls over Advances:

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an **advance only** after satisfying itself as to **the credit worthiness** of the borrower and after **obtaining sanction from the appropriate authorities** of the bank.
- All the **necessary documents** (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) **should be executed** by the parties before advances are made.
- The **compliance with the terms of sanction** and **end use of funds** should be ensured.
- **Sufficient margin as specified** in the sanction letter should be kept **against securities** taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be **ensured at regular intervals**.
- All **securities requiring registration** should be registered in the name of the bank or otherwise accompanied by documents sufficient **to give title to the bank**.
- **Drawing Power Register** should be **updated every month** to record the value of securities hypothecated. These entries should be checked by an officer.
- The **accounts should be kept within** both the **drawing power and the sanctioned limit**.
- All the accounts which **exceed the sanctioned limit or drawing power** or are **otherwise irregular** should be brought **to the notice of the controlling authority regularly**.
- The **operation of each advance** account should be reviewed **at least once a year** and at more frequent intervals in the case of large advances.

Click on the link/ scan the QR Code to watch video on Audit of Advances:

<https://youtu.be/9TrGcsLIYJo?si=AWoZXOmLSgbruXHQ>

**Audit of Income: (ICAI Module Pg. No. 10.38 – 10.45)**

Interest Income is major portion of income of Bank.

Audit approach and procedures:Auditor's Concern:

- The auditor is primarily concerned with obtaining reasonable assurance that-
 - the recorded income arose from transactions, (Occurrence)
 - which took place during the relevant period and (Cut-off)
 - pertained to the bank, (Occurrence)
 - there is no unrecorded income and (Completeness)
 - the income is recorded at appropriate amount. (Accuracy/ Measurement)

RBI's Directions:

- RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.

Materiality:

- If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.

Revenue Certainty:

- Bank recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned.
- It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection.

Revenue Uncertainty:

- In view of the significant uncertainty regarding ultimate collection of income arising in respect of NPA, the guidelines require that banks should not recognize income on NPA until it is actually realised.
- When a credit facility is classified as NPA for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for.
- This will apply to Government guaranteed accounts also.

Advances against Securities:

- Interest on advances against Term Deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

Bills Purchased:

- In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.
- The Unexpired discount/ rebate on bills discounted i.e., where part of receipt comprising discount charges on bills purchased relate to the period beyond the year-end, should be recorded as "Other Liabilities".
- Interest (discount) component paid by Bank/ Branch on rediscount of bills from other financial institutions, is not to be netted off from the discount earned on bills discounted.

Bills for Collection:

- In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected.
- The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc.
- The commission of the branch becomes due only when the bill has been collected.

Renegotiations:

- Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognized on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.
- Test check the interest earned by the banks for the sample selected.
- Test check the fees and commissions earned by the banks made for commission on bills for collection, letters of credit and bank guarantees.

Reversal of Income:

- (i) If any **advance, including bills purchased and discounted, becomes NPA as at the close of any year**, the entire **interest accrued and credited to income** account in the past periods, should be **reversed or provided** for if the same is not realized. This will **apply to Government guaranteed accounts also**. (RTP M-24 Q. 22)
- (ii) In respect of **NPAs, fees, commission and similar income** that have **accrued should cease to accrue in the current period** and should be **reversed or provided** for with respect to past periods, if uncollected. (RTP M-24 Q. 22)
- (iii) Further, in case of banks which have **wrongly recognised income in the past** should **reverse** the interest if it was **recognised as income during the current year** or **make a provision** for an equivalent amount if it was **recognized as income in the previous year(s)**.
- (iv) Furthermore, the auditor **should enquire** if there are any **large debits in the Interest Income account that have not been explained**. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

On Leased Asset:

The component of finance income (as defined in AS 19 – Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out Finance:**Meaning:**

- A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan.
- More specifically, a takeout loan, or takeout financing, is long-term financing that the lender promises to provide at a particular date or when particular criteria for completion of a project are met.
- Takeout loans are commonly used in property development.

Objectives:

- To expand sources of Finance for infrastructure projects by facilitating participation of new entities
- To address sectoral/ group/ entity exposure issues and asset liability in mismatch concerns of tenders.
- To boost the availability of longer tenor debt finance for projects.

Recognition of Income:

In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/ taking-over institution (if the arrangement so provides).

On Partial Recoveries in NPAs:

- In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.

- The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/ derecognised or not recognised in the past should be accounted.
- Interest partly/ fully realised in NPAs can be taken to income.
- However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/ additional credit facilities sanctioned to the borrowers concerned.

Memorandum Account:

- On an account turning NPA, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.
- For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Income from Investment:**Interest Income on Investments:**

- This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/ in India.
- Broken period interest paid on securities purchased and amortisation of premium on Statutory Liquidity Ratio (SLR) investments is net off from the interest income on investments.

Profit on Sale of Investments:

- Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.

Profit/ Loss on Revaluation of Investments:

- In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

Click on the link/ scan the QR Code to watch video on Audit of Income:

<https://youtu.be/ag-cBg6cZBY?si=ULWwz3gRUkMrDJS1>

**Audit of Expenses: (ICAI Module Pg. No. 10.45 – 10.50)****Expenditure is to be shown under three broad heads:**

- Interest expense
- Operating expense
- Provisions and contingencies.

Audit approach and procedures:

- In carrying out an audit of **interest expense**, the auditor is primarily concerned with assessing the **overall reasonableness of the amount** of interest expense by **analysing ratios of interest** paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year.
- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest

rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

- The auditor should also **compare the average rate of interest** paid on the relevant deposits with **the corresponding figures for the previous years** and analyse any material differences.
- The auditor should, on a **test check basis, verify the calculation of interest and ensure** that:
 - (i) Interest has been **provided on all deposits** up to the date of the balance sheet;
 - (ii) **Interest rates** are in accordance with the **bank's internal regulations**, the RBI directives and agreements with the respective deposit holder;
 - (iii) **Interest on savings accounts** are in accordance with the **rules framed by the bank/RBI** in this behalf.
 - (iv) **Interest on inter-branch balances** has been provided at the rates prescribed by the head office/ RBI.
- The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period.
- The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers.
- The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

For audit of Operating expenses, the auditor should:

- **Study and evaluate the system of internal control** relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- Examine whether there are any **divergent trends** in respect of major items of expenses.
- Perform **substantive analytical procedures** in respect of these expenses.
E.g. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.
- Verify expenses with reference to **supporting documents and check the calculations** wherever required.

For audit of Provisions and contingencies the auditor should:

- Ensure that the **compliances for various regulatory requirements** for **provisioning** as contained in the various circulars have been fulfilled.
- Obtain an understanding as to how the bank **computes provision on standard assets and NPAs**. It will primarily include checking the basis of **classification of loans and receivables** into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a **sample basis**.
- Obtain the **detailed break up** of standard loans, non-performing loans and **agree the outstanding balances** with the general ledger.
- Obtain the **tax provision computation** from the bank's management and **verify the nature of items debited and credited to profit and loss** account to ascertain that the same are appropriately considered in the tax provision computation.
- Examine the **other provisions for expenses vis-a-vis the circumstances warranting** the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Since the format of the profit and loss accounts of banks does not specifically provide for disclosure of the impact of **prior period items** on the current year's profit and loss, such disclosures, **wherever warranted, may be given.**

Click on the link/ scan the QR Code to watch video on Audit of Expenses:

<https://youtu.be/puXpk8GgWFQ?si=O0rJ-hoCFzHeTqEt>



Click on the link/ scan the QR Code to watch other videos of Chapter 10:

Case Study:

<https://youtu.be/P2SYgCYIcCc>



Test Your Understanding Questions:

<https://youtu.be/SKGvkduYY9A>



Test Your Knowledge Questions:

<https://youtu.be/9NkCOezVtOI>



Chapter 11 – Ethics and Terms of Audit Engagements

Weightage of the Chapter: 8-10 Marks

Basics of Ethics: (ICAI Module Pg. No. 11.4 - 11.5)

“Ethics” means moral principles which govern a person’s behaviour or his conducting of an activity.

- Ethical guidance may follow principles-based approach or rules-based approach.
- Principles-based approach to ethics is that it requires compliance with spirit of ethics which requires accountants to exercise professional judgment to evaluate every situation to arrive at conclusions.
- While rules-based approach to ethics strictly follows clearly established rules, it is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules. (Theoretical Question 1, pg. no. 11.41)

Fundamental Principles of Professional Ethics: (ICAI Module Pg. No. 11.5) (M-24 Que 5(c) – 3 Marks)

1. Integrity:

- It requires an accountant to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.
- A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures (i.e., doubtful) required information where such omission or obscurity would be misleading.
- E.g. A CA in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs. 15 crore as per records of client. Here, Integrity is violated.

2. Objectivity:

- The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.
- E.g. If auditor does not report few misstatements as he/ she gets some monetary benefits or client is his/ her relative. Here, objectivity is compromised.

3. Professional competence and due care: (MTP 1 S-24 Q. 4 (b))

- A professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.
- Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

- Eg. If it is required to prepare and present FS of the client in accordance with Ind AS instead of AS and auditor is unaware of the applicability of it to client and expresses unmodified opinion in the case, it is the violation of professional competence and due care.
4. <u>Confidentiality:</u> - Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party. - However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law. - E.g. If an auditor discloses some confidential information to the competitor of the client for some monetary benefits or discloses some confidential information to obtain gain from share market for himself/ herself or for his/ her relative (i.e. Insider Trading). It is the violation of confidentiality.
5. <u>Professional Behaviour: (MTP 1 M-24 Q. 5(d) with example)</u> - It requires an accountant to comply with relevant laws and regulations and avoid any conduct that the accountant knows or should know might discredit the profession. - A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles. - E.g. CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. It is the violation of professional behaviour.

Click on the link/ scan the QR Code to watch video on Fundamental Principles of Ethics:

https://youtu.be/KtOCfjOv_z4?si=eussYAFUX8uhCbFG



Independence of Auditors: (ICAI Module Pg. No. 11.8)

Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest.

Independence is:

- (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, 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 reasonable and informed third party, having knowledge of all relevant information,

including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Click on the link/ scan the QR Code to watch video on Independence of Auditors:	
https://youtu.be/ocd7nOUQkHU?si=WdlcEjtFkKhcmieJ	

Threats to Independence: (ICAI Module Pg. No. 11.9)

1. <u>Self-interest threats:</u> Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (a) direct financial interest or materially significant indirect financial interest in a client (b) loan or guarantee to or from the concerned client (RTP M-24 MCQ) (c) undue dependence on a client's fees and, hence, concerns about losing the engagement (d) close business relationship with an audit client (e) potential employment with the client and (f) contingent fees for the audit engagement
2. <u>Self-review threats: (RTP S-24 MCQ 6)</u> Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (E.g. of Non audit engagement are management services, internal audit, investment advisory service 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: - (a) when an auditor having recently been a director or senior officer of the company. (b) when auditors perform services that are themselves subject matters of audit.
3. <u>Advocacy threats:</u> - Advocacy threats 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. - In such situations, auditor can be perceived as backing and championing causes of auditee client and it may lead to belief that auditor is not acting and working objectively. - Advocacy threats are threat to Independence of appearance.
4. <u>Familiarity threats: (MTP 1 M-24 Q. 1 (d))</u> - 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 including: (a) close relative of the audit team working in a senior position in the client company

(b) former partner of the audit firm being a director or senior employee of the client (c) long association between specific auditors and their specific client counterparts and (d) acceptance of significant gifts or hospitality from the client company, its directors or employees. - Provisions in Companies Act, 2013 regarding rotation of auditors mainly address these very familiarity threats. Such provisions prescribe that auditor is rotated after a certain number of years so that auditors do not become too familiar with their clients.
5. <u>Intimidation threats:</u> - Intimidation threats occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. - Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation. - Such threats attempt to intimidate auditors to deter them from acting objectively.
<u>Example:</u> A CA receives about 40% of his total audit fees from a single client. It is an example of self-interest threat.
<u>Example:</u> CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. It constitutes self-review threat.

Safeguards to Independence: (ICAI Module Pg. No. 11.11)

To address the issue, the following guiding principles are to be applied: -

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing. - Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence. - When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguards measures need to be recorded in a form that can serve as evidence of compliance with due process. - If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.
<u>Example:</u> CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It is the case of self-interest threat to

Independence. Here, he should take steps to eliminate the threat by selling shares immediately before accepting appointment as safeguard to such threat.

Click on the link/ scan the QR Code to watch video on Threats to Independence of Auditors and their safeguards:

<https://youtu.be/WclSgllujOY?si=OdDGDVeREPcedevo>



Professional Skepticism: (ICAI Module Pg. No. 11.12) (Theoretical Question 2, pg. no. 11.41) (MTP 2 S-24 Q. 1 (c))

Meaning:

It 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. (RTP M-24 MCQ)

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.

Example:

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. Here, auditor lacks Professional Skepticism.

Click on the link/ scan the QR Code to watch video on Professional Skepticism:

<https://youtu.be/Bycdm0mx8nc?si=hy1NOBmEQSrjEyw8>



SA 210 – Agreeing the Terms of Audit Engagements: (ICAI Module Pg. No. 11.14)

(i) Preconditions for an audit: (RTP M-24 Q. 24)

- 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 (TCWG) to the premise on which an audit is conducted.
- In order to establish whether the preconditions for an audit are present, the auditor shall:
 - (a) Determine whether the financial reporting framework is acceptable and
 - (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair representation;
 - (ii) For such internal control as management considers necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - (iii) To provide the auditor with:
 - Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - Additional information that the auditor may request from management for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

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

(ii) Agreement on audit engagement terms: (MTP 2 M-24 Q. 5 (d))

- The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. It shall be recorded in an audit engagement letter which is sent by the auditor to his client.
- Engagement Letter includes:
 - (a) The objective and scope of the audit of the financial statements
 - (b) The responsibilities of the auditor
 - (c) The responsibilities of management
 - (d) Identification of the applicable financial reporting framework for the preparation of the financial statements and
 - (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
- 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.

(iii) Limitation on scope prior to audit engagement acceptance:

If management or TCWG impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor

disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

(iv) Request from Entity to change the Terms of Audit Engagement:

- A request from the entity for the auditor to change the terms of the audit 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 as originally requested or
 - (c) a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.
- The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so.
- A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.
- The auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.
- If 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 TCWG, owners or regulators.

(v) Terms of engagement in recurring Audits: (Theoretical Question 3, pg. no. 11.41)

- Recurring audit is an audit which is performed by an auditor over years.
- In following situations auditor shall revise the terms of the audit engagement or to remind the entity of existing terms:
 - (i) Any indication that the entity misunderstands the objective and scope of the audit.
 - (ii) Any revised or special terms of the audit engagement.
 - (iii) A recent change of senior management.
 - (iv) A significant change in ownership.
 - (v) A significant change in nature or size of the entity's business.
 - (vi) A change in legal or regulatory requirements.
 - (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
 - (viii) A change in other reporting requirements.

Example:

Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement

that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

Example:

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

Click on the link/ scan the QR Code to watch video on SA 210:

<https://youtu.be/Yj26tkTmNFU?si=F0LXAn9zc-fDpq6g>



Standards on Quality Control 1 (SQC 1) “Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements”, the firm’s system of quality control should include policies and procedures addressing each of the following elements: - **(ICAI Module Pg. No. 11.25)**

1. **Leadership responsibilities for quality within the firm: (MTP 1 S-24 Q. 3 (c))**
 - SQC 1 requires the firm to establish quality control policies which needs to be led by chief executive officer or managing partner of the firm.
2. **Ethical Requirements:**
 - There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence. All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied.

At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.
3. **Acceptance and Continuance of Client Relationships and Specific Engagements:**
 - A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -
 - Integrity of client
 - Competence (including capabilities, time and resources) to perform engagement
 - Compliance with ethical requirements
 - With regard to the integrity of a client, matters that the firm considers include, for example: **(RTP S-24 Que 20)**
 - The identity and business reputation of the client’s principal owners, key management, related parties and those charged with its governance.
 - The nature of the client’s operations, including its business practices.

- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment. - Whether the client is aggressively concerned with maintaining the firm's fees as low as possible. - Indications of an inappropriate limitation in the scope of work. - Indications that the client might be involved in money laundering or other criminal activities. - The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.
4. <u>Human Resources:</u> 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.
5. <u>Engagement Performance:</u> Consistency in quality of engagement performance is achieved through briefing of engagement teams of their objectives, processes for complying with engagement standards, processes of engagement supervision and training, methods of reviewing performance of work, appropriate documentation of work performed.
6. <u>Monitoring:</u> The firm should ensure that policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice.

Click on the link/ scan the QR Code to watch video on SQC 1:

<https://youtu.be/8EvLccJp0yU?si=iPYPZS8ajBoZ3RKP>



SA 220 – “Quality Control for an Audit of Financial Statements”: (ICAI Module Pg. No. 11.31)

- Engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220.
- SA 220 is premised on the basis that the firm is subject to SQC 1. (RTP M-24 Q. 25)
- SA 220 is modelled on lines of SQC 1. It describes responsibilities of engagement partner in relation to following matters: -

1. <u>Leadership responsibilities for quality on audits: (Theoretical Question 5, pg. no. 11.41) (MTP 1 M-24 Q. 6 (e))</u> 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. (b) The fact that quality is essential in performing audit engagements.
2. <u>Relevant Ethical Requirements:</u> The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: - - Identifying a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. - Reporting by engagement partner to the relevant persons within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.
3. <u>Acceptance and Continuance of Client Relationships and Audit Engagements:</u> Engagement partner needs to comply with SQC 1 requirement in relation to this matter.
4. <u>Assignment of Engagement:</u> Engagement team should have appropriate competence and capabilities to perform the engagement in accordance with professional standards and regulatory and legal requirements.
5. <u>Engagement Performance:</u> Engagement partner has the responsibility for direction, supervision and performance of audit engagement in accordance with professional standards and regulatory and legal requirements. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall: (M-24 Que 6(a) – 4 Marks) (a) Determine that an engagement quality control reviewer (EQCR) has been appointed. (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer. (c) Not date the auditor's report until the completion of the engagement quality control review.
6. <u>Monitoring:</u> The engagement partner should document following matters pertaining to an audit engagement: (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved. (b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions. (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements. (d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

Click on the link/ scan the QR Code to watch video on SA 220:	
https://youtu.be/jj_H9_S4ItI?si=nlgS2bWh3BSyAj_J	

Summarised Points of MCQs, Correct Incorrect, Test Your Understanding and Theoretical Questions:

- (1) CA is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Since this is a criminal activity and also there is point towards money laundering. Therefore, proposed offer should not be accepted.
- (2) CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging “fin-tech” sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered. Since the firm does not have trained personnel to carry out these audits, offer for these audits should not be accepted.

Click on the link/ scan the QR Code to watch other videos of Chapter 11:			
Case Study: https://youtu.be/0-pNvvcJmtA			
Test Your Understanding Questions: https://youtu.be/0Wocf45FkLo		Test Your Knowledge Questions: https://youtu.be/59B9Rj7AmvY	