Compendium of Implementation Guides to Engagement and Quality Control Standards

(As on July 1, 2013)

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Foreword

The Standards on Auditing issued by the Institute of Chartered Accountants of India are important in ensuring quality in audit engagements and are performance benchmarks for the auditors. It is therefore essential that these Standards are properly understood and implemented by the members. The Implementation Guides to auditing standards are an important tool for the members to understand and implement these Standards in an appropriate manner in real life audit situations.

I am happy that the Auditing and Assurance Standards Board of the Institute has been bringing out Implementation Guides to various auditing standards for the guidance of the members. Till date, the Board has issued Implementation Guides for Standards dealing with Quality Control, Risk-based Audit of Financial Statements, Audit Materiality, Audit Sampling, Reporting Standards, Going Concern, Audit Documentation, The Auditor's Responsibilities in Relation to Other Information and Audit Evidence – Specific Considerations for Selected Items. I am confident that this Compendium of Implementation Guides containing all the Implementation Guides issued by the Board over the years will prove a very useful one stop source of reference for the members.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiative in bringing out this compendium for easy reference of the members.

June 18, 2013 **CA. Subodh K. Agrawal**
New Delhi President, ICAI

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Preface

The various Standards on Auditing issued by the Institute of Chartered Accountants of India enshrine the fundamental concepts of auditing. It is difficult for a Standard to envisage all types of real life situations that might arise in an audit. Therefore, these Standards are principle based rather than rule based, providing guiding posts rather than strait jacketed solutions for every real life scenario that might arise. This means that the auditors have the space as well as necessity for applying their professional judgment and scepticism in the warranting situations.

An appropriate understanding of the objectives and requirements of these Standards is necessary to apply them to suit the needs of the varying circumstances of each audit engagement. To help the members in this task, the Auditing and Assurance Standards Board has been bringing out guidance in the form of Implementation Guides to various Engagement and Quality Control Standards issued by the Institute.

Till date, the Board has brought out Implementation Guides on quality control at firm level (SQC) 1, the new audit reporting Standards (SA 700, SA 705 and SA 706), audit materiality (SA 320), audit sampling (SA 530), risk based audit of financial statements (SA 315 and SA 240), going concern (SA 570), audit documentation (SA 230), audit evidence - specific considerations for selected items (SA 501) and the auditor's responsibility in relation to other information in documents containing audited financial statements (SA 720). These Implementation Guides have been developed by senior members from the Profession having years of hands on experience in the field of statutory audits across industries and services sector. They contain help in the form of commentary on various requirements of the Standards in a simpler language, FAQs, templates, checklists, model policies, etc. This Compendium of Implementation Guides has been brought out to serve as a one stop source of reference of Implementation Guides brought out by the Board till date.

At this juncture, I wish to place on record my gratitude to all those members who, despite their pressing professional and personal commitments, took on themselves to develop such useful literature for the benefit of the entire Profession. As a small token of this gratitude for their services, their names have been duly acknowledged in the Preface to the respective Implementation Guides.

I am also thankful to CA. Subodh Kumar Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their support to the activities of the Auditing and Assurance Standards Board.

I also wish to place on record my gratitude for my colleagues on the Board *viz*., CA. Naveen N.D. Gupta, Vice Chairman, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shriniwas Y Joshi, CA. Sanjeev K Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary, CA. Vijay K Gupta, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Niraj Kumar Jhunjhunwala, CA. Sanjay Vasudeva, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra, CA. Harinderjit Singh and CA. Saunak Ray for their support and guidance to the Board. I also wish to place on record my thanks to the special invitees to the Board, *viz*., Dr. Manoj Anand, CA. Vijay Sachdeva, Shri Sunil Kadam, CA. Nilesh S Vikamsey, CA. Aniruddh Sankaran, CA. Jitendra Kumar Agarwal and CA. Amit Roy for their support to the Board.

I am sure that the members and other interested readers would find this Compendium of Implementation Guides quite useful. I look forward to the feedback of readers on the publication.

June 18, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

Contents

Foreword

Preface

1. Implementation Guide to SQC 1 1-142

2. Implementation Guide to Risk-based Audit of Financial Statements 143-384

3. Implementation Guide to Materiality in Planning and Performing An Audit.......................... 385-474

4. Implementation Guide to Standard on Auditing (SA) 530, 'Audit Sampling'........................ 475-530

5. Implementation Guide on Reporting Standards (SA 700, SA 705 & SA 706) 531-634

6. Implementation Guide to Standard on Auditing (SA) 230, 'Audit Documentation'............... 635-700

7. Implementation Guide to Standard on Auditing (SA) 501, 'Audit Evidence - Specific Considerations for Selected Items' 701-778

8. Implementation Guide to Standard on Auditing (SA) 570, 'Going Concern'........................ 779-834

9. Implementation Guide to Standard on Auditing (SA) 720, 'The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements' 835-868

Note : Detailed contents of each of these Implementation Guides is given at the beginning of the respective Guides.

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Implementation Guide to SQC 1

Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information and Other Assurance & Related Services Engagements

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Foreword

With the desire to be reckoned among the best in the world and be accepted globally, the auditing profession in India too is ready to undergo the painstaking processes of learning, unlearning and re-learning all through. To assume the critical responsibility of equipping the members with the internationally benchmarked technical knowledge and skills in the area of auditing and related services, essential to discharge their professional responsibilities, the Auditing and Assurance Standards Board (AASB), as a top priority, has undertaken its ambitious project of convergence with the International Standards issued by the International Auditing and Assurance Standards Board. Pursuant to the convergence process, the Institute had issued in 2007, a mother Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information, and Other Assurance & Related Services Engagements". The standard is a pre-requisite for the convergence process.

Though the standard reiterates albeit in details the fundamental principles of controlling quality of work in audit firms, this Implementation Guide, I am sure would enhance the acceptability of SQC 1 and help easier implementation of the same even at grass roots level.

With more and more internationally benchmarked auditing standards in the pipeline, I eagerly look forward to such Implementation Guides from the Board.

New Delhi
April 10, 2008

Ved Kumar Jain
President, ICAI

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Preface

The Council of the Institute of Chartered Accountants of India (ICAI) issued the Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information, and Other Assurance & Related Services Engagements", which is a mother Standard for all other Standards and is an all pervasive Standard in respect of quality control. The Standard is recommendatory from April 1, 2008 and mandatory from April 1, 2009. As the name suggests, the SQC 1 contains extensive requirements in relation to establishment and maintenance of a system of quality control (QC) in the audit firms as well as even for sole practitioners. The important elements of a system of quality control discussed by the Standard include Elements of a System of Quality Control, Leadership Responsibilities for Quality Within the Firm, Ethical Requirements - Independence, Acceptance and Continuation of Client Relationships and Specific Engagements, Human Resources - Assignment of Engagement Team, Engagement Performance - Consultation, Differences of Opinion, Engagement Quality Control Review and Documentation of the Engagement Quality Control Review - Engagement Documentation.

As a measure to cement the technical knowledge enshrined in the Standard and also to pave way for its easier implementation and greater acceptance among the membership at large, the Board has brought out this implementation guidance. This Guide provides a set of illustrative policies that an audit firm may adopt, with or without modification. This Guide also encourages the firms to tailor their QC policies to make them relevant according to their size, composition, number and nature of employed or contracted professionals, services rendered, kind of clientele, etc. The Annexures to this Implementation Guide provide the illustrative forms, checklists and templates that a firm may adopt, with or without modification, such as, annual firm personnel independence confirmation, model independence policies, client/engagement acceptance and continuance form, engagement planning memorandum template, engagement summary memorandum template, engagement QC review report template, Firm QC inspection checklist.

At this juncture, I wish to place my gratitude to CA. Khurshed Pastakia, FCA, who prepared the basic draft of the Implementation Guide. I am also grateful to all my colleagues at the Auditing and Assurance Standards Board for providing insights from their rich knowledge and experience for improving upon the draft Implementation Guide.

I also wish to place on record my appreciation for Shri Vijay Kapur, Secretary, Auditing and Assurance Standards Board and his team of officers, CA. Puja Wadhera, Senior Assistant Director and CA. Savita Singhal, Executive Officer, for their efforts and valuable inputs in finalizing this Implementation Guide.

I am sure that this Implementation Guide will help the Chartered Accountant firms in implementing SQC 1 more effectively and also in ensuring the quality of the service provided by the Chartered Accountant Firms to its clients.

New Delhi
April 10, 2008

Harinderjit Singh
Chairman
Auditing and Assurance Standards Board

Contents

Foreword

Preface

Introduction.......... 9-15

Element 1
Leadership Responsibilities for Quality within the Firm.......... 16-18

Element 2
Ethical Requirements.......... 19-24

Element 3
Acceptance and Continuance of Client Relationships and
Specific Engagements.......... 25-31

Element 4
Human Resources.......... 32-37

Element 5
Engagement Performance.......... 38-48

Element 6
Monitoring.......... 49-54

ANNEXURES.......... 55-106

Annexure I
Illustrative Annual Firm Personnel Independence
Confirmation.......... 57-59

Annexure II
Illustrative Independence Policies.......... 60-68

Annexure III
Illustrative Client/Engagement Acceptance and
Continuance Form.......... 69-72

Annexure IV
Illustrative Engagement Planning Memorandum.................... 73-83

Annexure V
Illustrative Engagement Summary Memorandum 84-88

Annexure VI
Illustrative Firm Quality Control Inspection Checklist 89-106

APPENDIX 107-142

SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance & Related Services Engagements

Introduction

The Standard on Quality Control (SQC) 1, *Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information and Other Assurance & Related Services Engagements,* issued by the Institute of Chartered Accountants of India (ICAI), establishes standards for the process of quality control that encompasses a organisational structure of a Firm of professional accountants and the policies and procedures it establishes. The principles set out in SQC 1 apply in respect of the audits and reviews of historical financial information and other assurance and other related services engagements undertaken by the firm (hereinafter referred to as “the Firm”). The text of SQC 1 is given as Appendix to this Implementation Guide. The nature, extent and formality of a firm's quality control (QC) policies and procedures should be sufficiently comprehensive and suitably designed in relation to the firm's size, the nature and complexity of the Firm's practice and appropriate cost-benefit considerations.

The objective of a system of QC is to provide the firm with reasonable assurance that its personnel comply with applicable professional standards as well as the regulatory and legal requirements in addition to the firm's policies in respect of quality and ethics.

SQC 1 is to be read in conjunction with the requirements of the Chartered Accountants Act, 1949, the Code of Ethics and any other relevant pronouncement of the Institute and relevant legal or regulatory requirement (together referred to as “the Code”). Accordingly, the Standard requires a firm to establish a system of quality control that includes policies and procedures addressing each of the following six elements:

i) Leadership responsibilities for quality within the Firm;
ii) Ethical requirements;
iii) Acceptance and continuance of client relationships and specific engagements;

iv) Human resources;
v) Engagement performance; and
vi) Monitoring.

The six elements of QC as mentioned in the preceding paragraph are interrelated. For example, for a firm to maintain ethical requirements that include independence, integrity, and objectivity, it must continually assess client relationships that affect policies and procedures related to acceptance and continuance of clients and engagements. Similarly, the human resources element of QC encompasses recruitment, capabilities and competence of Firm personnel which all affect policies and procedures related to engagement performance.

The Standard requires the firm's QC policies and procedures to be documented and communicated to its personnel. Such communication describes the QC policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its QC system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on QC matters.

The Six Elements

Leadership Responsibilities for Quality within the Firm

A firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management that emphasise the firm's QC policies and procedures, and the requirement to:

- perform work that complies with professional standards and regulatory and legal requirements; and
- issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognises and rewards high quality work. These actions and messages may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters or briefing memoranda. They may be incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

Of particular importance in promoting an internal culture based on quality is the need for the firm's leadership to recognise that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all engagements that the firm performs. Sufficient and appropriate experience and ability enables the person or persons responsible for the firm's QC system to identify and understand QC issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

The fundamental principles of professional ethics include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. The conceptual approach to independence follows a threats and safeguards approach where threats to independence are identified, assessed, and appropriate safeguards applied to eliminate or reduce the threats to an acceptable level. Where it is not possible to reduce the threats to an acceptable level, the firm considers withdrawing from the engagement or from the client or both.

The generally recognised threats to independence[1] are:

- ***Self-interest Threat***

A self interest threat arises when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include, direct financial interest or materially significant

[1] The explanation of the various threats to independence – self interest, self review, advocacy familiarity and intimidation – has been drawn from the Guidance Note on Independence of Auditors issued by the Institute of Chartered Accountants of India.

indirect financial interest in a client, loan or guarantee to or from the client, undue dependence on client for fees and hence concerns about losing the engagement, close business relationship with an audit client, potential employment with the client, etc.

- ***Self-review Threat***

A self review threat arises when during a review of any judgment or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or a senior employee of the client.

- ***Advocacy Threat***

An advocacy threat arises when, in reality or in perception, an auditor promotes client's opinion where people may believe that the auditor's objectivity is getting compromised. For example, where the auditor deals with the shares or securities of the audited company or becomes client's advocate in litigation or third party disputes.

- ***Familiarity Threat***

A familiarity threat is self evident and arises when auditors form relationships with the clients where they end up being too sympathetic to the interests of the client. For example, close relative of the audit team working in a senior position in the client company, former partner of the audit firm being a director or senior employee of the client, acceptance of gifts or hospitality from the client, etc.

- ***Intimidation Threat***

An intimidation threat arises when an auditor is deterred from acting objectively with an adequate degree of professional skepticism. For example, threat of replacement over disagreements over application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees, etc.

The fundamental principles of ethics and independence are achieved by the actions of firm's leadership, education and training, monitoring policies and by establishing and implementing a process for dealing with non-compliance.

Acceptance and Continuance of Client Relationships and Specific Engagements

The acceptance and continuance QC policies in respect of client relationships and specific engagements are designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it:

- Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;
- Is competent to perform the engagement and has the capabilities, time and resources to do so; and
- Can comply with the ethical requirements.

The Firm should obtain such information as it considers necessary in each of the following circumstances:

- before accepting an engagement with a new client;
- when deciding whether to continue an existing client relationship and/or engagement; and
- when considering acceptance of a new engagement with an existing client.

Where quality control related issues have been identified, and yet the Firm decides to accept or continue the client relationship or a specific engagement, it should document how those issues were resolved.

Human Resources

Policies and procedures related to human resources normally address the following personnel issues:

- Recruitment;
- Performance evaluation;
- Capabilities;
- Competence;
- Career development;
- Promotion;
- Compensation; and
- The estimation of personnel needs.

The Firm's policies and procedures should be 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.

Engagement Performance

The Firm's policies and procedures should be designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the Firm or the engagement partner issues reports that are appropriate in the circumstances. This also includes establishing policies and procedures around matters such as consistency in the quality of engagement performance, supervision, review, consultation, engagement QC review, dealing with differences of opinion, and engagement documentation.

Monitoring

The Firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of QC are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the Firm's system of QC, including a periodic inspection of a selection of completed engagements, communicating deficiencies, and complaints and allegations.

Applying the Standard to Firms

Every chartered accountant firm is unique in terms of its size, composition, number and nature of employed or contracted professionals, services rendered, kind of clientele, etc. Accordingly, though the fundamental principles of quality control as enshrined in SQC 1 would be applicable to all the Firms equally, each firm would need to design suitable policies to implement the same having regard to the factors mentioned above.

Scope of the Implementation Guide

This Implementation Guide is aimed at providing a set of illustrative policies that a chartered accountant firm may adopt, with or without modification. As mentioned above, the Firm are encouraged to tailor their QC policies to make them relevant to their size, composition, number and nature of employed or contracted professionals, services rendered, kind of clientele, etc. The Implementation Guide, however, is not a substitute for the Standard on Quality Control (SQC) 1.

The Implementation Guide also provides, in the Annexure, the following illustrative forms, checklists and templates that a chartered accountant firm may adopt, with or without modification:

- Annual firm personnel independence confirmation;
- Model independence policies;
- Client/engagement acceptance and continuance form;
- Engagement planning memorandum template;
- Engagement summary memorandum template;
- Engagement QC review report template; and
- Firm QC inspection checklist.

The policies and procedures established by firms and their updates need to be communicated in writing to and are binding on all their partners and professional staff, including articled trainees. Further, the document(s) containing such policies and procedures should also be made available to a reviewer appointed by the ICAI's Peer Review Board.

Element 1
Leadership Responsibilities for Quality Within the Firm

1.1 The objective of this element of QC is to promote an internal culture based on the recognition that quality is essential in performing engagements. Policies and procedures should require the Firm's chief executive officer or the Firm's Managing Partner (MP) or equivalent (MP)[2] to assume ultimate responsibility for the Firm's system of QC. The promotion of a quality oriented internal culture depends on clear, consistent and frequent communications from the Firm's management emphasizing the Firm's QC policies and procedures.

1.2 The Firm satisfies this objective by establishing and maintaining the policies and procedures described below:

Policy 1

The Firm's MP assumes ultimate responsibility for the Firm's system of QC.

1.3 The Firm implements this policy through the following:

- Having the Managing Partner ultimately responsibility for the design, implementation and operating effectiveness of the Firm's system of QC and for setting a tone that emphasizes the importance of quality.
- Educating professional personnel[3] about the requirements and importance of following a system of QC.

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2 In the case of a sole proprietor, the latter is the Managing Partner.

3 The term "professional personnel" includes sole proprietor, partners, qualified chartered accountants (employed or contracted), others involved in performing audit and articled trainee.

- Informing personnel that failure to adhere to the Firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.

Policy 2

Commercial considerations do not override the quality of the work performed.

1.4 The Firm implements this policy through the following procedures:

- Having the MP continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of QC.
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality of work, documentation and other QCs.

Policy 3

Responsibility for developing, implementing, and operating the Firm's QC system is assigned to personnel with sufficient and appropriate experience, authority, and ability.

1.5 The Firm implements this policy through the following procedures by having the MP designate a QC partner[4] who is responsible for designing, implementing, and monitoring the Firm's QC system.

Policy 4

Performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel demonstrate the Firm's overarching commitment to the objectives of the system of QC.

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[4] In case of sole proprietorship, the sole practitioner is the QC partner.

1.6 The Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards.
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
    - Takes into consideration the Firm's feedback based on monitoring results and peer reviews of the work performed.
    - Rewards partners and personnel for timely (a) identification of significant and emerging accounting and auditing issues and (b) consultation with Firm experts.

Policy 5

The Firm devotes sufficient and appropriate resources for the development, communication, and support of its QC policies and procedures.

1.7 The Firm implements this policy through the following procedures:

- Providing the designated QC partner with sufficient time, authority, and resources to develop, implement, and maintain the Firm's QC policies and procedures.
- Providing the Firm's QC documentation to personnel when they are initially hired and reviewing the documentation with them.
- Reviewing the Firm's QC policies and procedures with personnel at Firm training sessions or otherwise at least annually and updating them if required.

Element 2
Ethical Requirements

2.1 One of the objectives of this element of QC is to provide the Firm with reasonable assurance that it and its personnel comply with relevant ethical requirements. Ethical requirements relating to audits and reviews of historical financial information, and other attestation engagements are contained in the Code of Ethics issued by the Institute of Chartered Accountants of India as well as other relevant pronouncements of the Institute[5]. The other objective of this element of QC is that the personnel maintain independence in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.

2.2 The Firm satisfies these objectives by establishing and maintaining the policies and procedures described below:

Policy 1

Personnel adhere to ethical requirements such as those contained in the Code.

2.3 The Firm implements this policy through the following procedures:

- Having the MP designate an Independence and Ethics partner[6] who is responsible for all aspects of the independence and ethics of the Firm's partners and professional staff. The designated Independence and Ethics partner may be the same individual as the designated QC partner if the Firm so desires.
- Empowering the Independence and Ethics partner to

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5 Attention of the members is, for instance, also invited to the Guidance Note on Audit of Banks issued by the Institute of Chartered Accountants of India.

6 In case of a sole proprietorship, the sole proprietor is the Independence and Ethics Partner.

perform such checks as may be required to ensure that all personnel respect and follow the independence and ethics policies of the Firm. Breaches, if any, should be promptly reported to the MP, who should take such disciplinary action as is warranted.

- Establishing a system for identifying all services performed for each client and evaluating whether any of those services might impair independence.
- Regularly consulting the ICAI's journal and website for information about changes in professional ethics and independence standards/requirements.
- Ensuring that all professional personnel attend training in ethics and independence.

Policy 2

The Firm establishes procedures to communicate independence requirements to Firm personnel and, where applicable, others subject to them.

2.4 The Firm implements this policy through the following procedures:

- Informing personnel of their responsibilities with regard to independence by doing the following on a timely basis:
    - o Preparing and maintaining a list of entities with which Firm personnel and others, if any, are prohibited from having a financial or business relationship (such entities would normally include the Firm's audit and attest clients).
    - o Making the list available to the concerned personnel so they may evaluate their independence.
    - o Notifying personnel of changes in the list as soon as such changes occur.
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their

independence or objectivity.

Policy 3

The Firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.

2.5 The Firm implements this policy through the following procedures:

- Requiring the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him to evaluate the overall impact, if any, on independence requirements.
- Providing training to partners and professional staff on what constitutes threats to independence and the nature of safeguards that may be taken to eliminate or reduce the threats to an acceptable level. Such training should include ICAI's responses to matters dealing with ethical conduct.
- Accumulating and communicating relevant information to appropriate personnel so that the following can occur:
  - The Firm, the engagement partner, Firm personnel and others, if any, can readily determine whether they satisfy independence requirements.
  - The Firm can maintain and update information relating to independence.
  - The Firm and the engagement partner can take appropriate action regarding identified threats to independence, in consultation with the Independence and Ethics partner.

- Requiring personnel to promptly report circumstances and relationships that create a threat to independence and independence breaches of which they become aware to the Independence and Ethics partner so that appropriate action can be taken.
- Establishing criteria to determine the need for safeguards for engagements where the following have taken place:
  - The Firm's monitoring procedures or peer review has identified weaknesses in previous years.
  - The same senior personnel have been used for five years or more on an audit or attestation engagement.
  - The client pressurizes the engagement partner to take a particular position or an accounting or auditing issue.
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to the following personnel:
  - The engagement partner who, with the Firm, needs to address the breach.
  - The Independence and Ethics partner who should report the breaches to the MP for necessary action.
  - Other relevant personnel in the Firm and those subject to the independence requirements who need to take appropriate action.
- Requiring the engagement partner and the other individuals referred to in the previous list to confirm to the Firm that the required corrective actions have been taken.
- Having the Independence and Ethics partner, or an individual designated by him, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the Firm's independence.
- Establishing additional procedures that provide

safeguards when the Firm performs audit or other attest work for

a) significant clients or

b) clients at which partners or other senior personnel are offered key management positions or have accepted offers of employment.

- Documenting the threats and the safeguards applied to eliminate or reduce them to an acceptable level in each instance.

Policy 4

The Firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

2.6 The Firm implements this policy through the following procedures:

- Consulting within the Firm, and with legal counsel and other parties if necessary, when the Firm believes that safeguards to reduce threats to independence to an acceptable level cannot be effectively applied.
- Withdrawing from the engagement if safeguards to reduce threats to independence to an acceptable level cannot be effectively applied.

Policy 5

The Firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all Firm personnel and others, if any, who are required to be independent.

2.7 The Firm implements this policy through the following procedures:

- Obtaining written representations from Firm personnel, upon hire and on an annual basis, stating that they have read the Firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation. Any exceptions should be declared by those making these representations.

- Reviewing these independence representations and resolving reported exceptions.
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement.

Policy 6

The Firm establishes procedures for confirming the independence of another Firm that performs part of the engagement.

2.8 The Firm implements this policy through the following procedures:

- Using practice aids that prescribe the form and content of independence representations, and frequency with which they are to be obtained.
- Requiring that such representations be documented in the engagement working papers file.

Annexures A and B to this Implementation Guide contain illustrative annual firm personnel independence confirmation and illustrative independence policies, respectively.

Element 3
Acceptance and Continuance of Client Relationships and Specific Engagements

3.1 The objective of this element of QC is to provide the Firm with reasonable assurance that it will undertake or continue relationships and engagements only where it:

- Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;
- Is competent to perform the engagement and has the capabilities, time and resources to do so; and
- Can comply with the ethical requirements.

3.2 The Firm satisfies this objective, with respect to the initial period for which the Firm is performing its service and other subsequent periods, by establishing and maintaining the policies and procedures described below:

Policy 1

The Firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.

3.3 The Firm implements this policy through the following procedures:

- Informing Firm personnel of the Firm's policies and procedures for accepting and continuing clients.
- Obtaining and evaluating relevant information such as the following before accepting or continuing a client:
    - The nature and purpose of the services to be provided and management's understanding thereof.

  - The identity of the client's principal owners, key management, related parties, and those charged with its governance.
  - Information obtained from internet searches on the client and its associates.
  - Information obtained from inquiries of third parties who have business relationships with the entity about management's reputation and integrity.
  - The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to and from regulators, income tax returns, credit reports and websites.
  - Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.

- Evaluating the risk of providing services for the following engagements:

  - Engagements for entities operating in highly specialized or regulated industries, (including financial institutions, technology companies, and governmental entities) or in industries or environments that are traditionally perceived to be operated in a manner that is less than ethical.

  - Engagements where the Firm has concerns about the attitude of the client's principal owners, key management personnel and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.

  - Engagements where the client is aggressively concerned with maintaining the Firm's fees as low as possible.

  - Engagements where there is an inappropriate limitation in the scope of work.
  - Engagements where there are indications that the client might be involved in money laundering or other criminal activities.
  - Engagements that require an inordinate amount of time to complete relative to the available resources of the Firm.
- Communicating with the predecessor auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of objections, if any.
- Conducting a background checks of the business, its officers, and the person(s) in question, and evaluating the information obtained regarding management's integrity. Background checks are conducted when the Firm is unable to obtain sufficient information about the prospective client after taking the steps described above, or there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the Firm's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a Firm refers to relationships that could diminish an auditor's objectivity and independence in performing attest services. In determining the significance of a client, the Firm considers (a) the amount of time the partner devotes to the engagement, (b) the effect on the partner's stature within the Firm as a result of service to the client, (c) the manner in which the partner is compensated, and (d) the effect that losing the client would have on the partner and the Firm.

Policy 2

The Firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the Firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.

3.4 The Firm implements this policy through the following procedures:

- Evaluating whether the Firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
- Evaluating whether the following are in place:
  - The Firm has sufficient personnel with the necessary capabilities and competence.
  - Specialists are available if needed.
  - Individuals meeting the criteria and eligibility requirements to perform an engagement QC review are available, when needed, whether internally or externally.
  - The Firm is able to complete the engagement within the agreed reporting deadline.
- Specifying conditions that trigger the requirement to re-evaluate a specific client or engagement. The following are examples of such conditions:
  - Significant changes in the client, such as a major change in senior client personnel, ownership, advisers, the nature of its business, or the financial stability of the client.
  - Changes in the nature or scope of the engagement, including requests for additional services.
  - Changes in the composition of the Firm, such as the loss of and inability to replace key personnel who are particularly knowledgeable about a

specialized industry.

- The Firm's decision to discontinue services to clients in a particular industry.
- The existence of conditions that would have caused the Firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
- The client's delinquency in paying fees. (This may also affect the Firm's independence.)
- Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, technology companies and governmental entities.
- Engagements for entities in which there may be substantial doubt about the entity's ability to continue as a going concern.
- Engagements in which the client has ignored prior recommendations, such as those that address deficiencies in internal control.

- Obtaining relevant information to determine whether the relationship should be continued and establishing a frequency for evaluations (for example, continuance decisions are made at least annually).
- Evaluating the information obtained regarding acceptance or continuance of the client or engagement through the following activities:
  - The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the Firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - The engagement partner completes a client acceptance form and submits it to the MP for

approval.

- o The engagement partner signs a step in the planning program noting consideration of client continuance and completes a form documenting the rationale and conclusion regarding client continuance if conditions exist that trigger the requirement to reevaluate a client or engagement between annual audits.
- o The MP assesses and approves the recommendation made by the engagement partner. If the MP recommends not accepting a client or discontinuing a client relationship, the MP discusses reasons for the acceptance or continuance decision with the other partners.

- Establishing procedures for dealing with information that would have caused the Firm to decline the engagement if the information had been available earlier.

Policy 3

The Firm obtains an understanding with the client regarding the services to be performed.

3.5 The Firm implements this policy by requiring that, for all engagements, the Firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

Policy 4

The Firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.

3.6 The Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the Firm might take based on the relevant facts and circumstances.
- Considering whether there is a professional, regulatory, or legal requirement for the Firm to remain in place or for the Firm to report to regulatory authorities its withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal.
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement, or from both the engagement and the client relationship, if the Firm determines that it is appropriate to withdraw.

Policy 5

The Firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

3.7 The Firm implements this policy by documenting, in a memorandum to the engagement working papers file, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements. Alternatively, such memoranda may be preserved at a common location for the Firm as a whole e.g. in the custody of the designated QC partner.

Annexure C to this Implementation Guide contains illustrative client/engagement acceptance and continuance form.

Element 4
Human Resources

4.1 The objective of this element of QC is to provide the Firm 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 engagements partners to issue reports that are appropriate in the circumstances. Attributes or qualities that enhance the competency of personnel who perform, supervise, or review work include integrity, objectivity, intelligence, judgment, experience and motivation. The Firm satisfies this objective by establishing and maintaining the policies and procedures below:

Policy 1

Personnel who are hired possess the characteristics that enable them to perform competently.

4.2 The Firm implements this policy through the following procedures:

- Designating an individual in the Firm to be responsible for the following activities:
  - Managing the human resources function.
  - Evaluating the Firm's personnel needs by considering factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement.
  - Developing criteria for determining which individuals will be involved in the interviewing and hiring process.
- Establishing an understanding among the partners about the qualifications, attributes, achievements, and

experiences desired in entry-level and experienced personnel.

- Setting guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.

Policy 2

The Firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.

4.3 The Firm implements this policy by specifying the competencies that the engagement partners of the Firm's accounting, auditing, and attestation engagements should possess. These competencies include having an understanding of the following:

- The role of the Firm's system of QC and the Code of Ethics issued by the Institute in ensuring the integrity of the accounting, auditing, and attest functions to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement and the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, relevant to the accounting and auditing framework applicable to the engagement as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional

skepticism.

- How the auditee uses information technology and the manner in which information systems are used to record and maintain financial information.

Policy 3

The Firm determines the capabilities and competencies possessed by personnel.

4.4 The Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation.
- Evaluating personnel at least annually to determine their capabilities and competencies.

Policy 4

The Firm assigns the responsibility for each engagement to an engagement partner.

4.5 The Firm implements this policy through the following procedures:

- Assigning responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role.
- Communicating the identity and role of the partner to client's management and those charged with governance.
- Monitoring the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities.

Policy 5

The Firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision

needed.

4.6 The Firm implements this policy through the following procedures:

- Designating an appropriate person to be responsible for assigning personnel to engagements based on such factors as the following:
  - Engagement type, size, significance, complexity, and risk profile.
  - Specialized experience and expertise required for the engagement and competencies gained through prior experience.
  - Personnel availability.
  - Timing of the work to be performed.
  - Continuity and rotation of personnel.
  - Opportunities for on-the-job training.
  - Situations for which independence or objectivity concerns exist.
- Designating a partner to be responsible for partner and manager assignments.
- Requiring approval of partner and manager assignments from the MP in the case of high-risk or significant client engagements.

Policy 6

Personnel participate in general and industry-specific continuing professional education and development (CPED) activities that enable them to accomplish assigned responsibilities.

4.7 The Firm implements this policy through the following procedures:

- Assigning responsibility to a partner to maintain a CPED program that does the following:
  - Requires personnel, including articled trainees, to participate in CPED programs in accordance with Firm guidelines and in subjects that are relevant to their responsibilities.

- Takes into account the requirements of the ICAI and other regulatory agencies in establishing the Firm's CPED requirements.
- Provides CPED course materials to, and maintains records of completed CPED for, professional personnel.
- Provides an orientation and training program for new hires, including articled trainees.

- Encouraging participation by personnel at each level in the Firm in other CPED activities such as completing external CPED programs including self-study courses, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups.
- Communicating and distributing to personnel, including articled trainees, when applicable, changes in accounting, auditing, attestation, and QC standards, as well as independence requirements and the Firm's guidance with respect to those standards and requirements.

Policy 7

Personnel selected for advancement have the qualifications to fulfill the responsibilities they will be called on to assume.

4.8 The Firm implements this policy through the following procedures:

- Assigning responsibility to partners to jointly make advancement and termination decisions. Such responsibilities include the following:
  - Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.

- Informing Firm personnel about the criteria for advancement to the next higher level of responsibility.
- Designating personnel responsible for preparing evaluations and determining when they should be prepared.
- Informing personnel that failure to adhere to the Firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.
- Using forms that include the applicable qualifications when evaluating the performance of personnel. Such forms contain qualifications related to performance quality and adherence to ethical principles.
- Reviewing evaluations on a timely basis with the individual being evaluated.

- Counselling personnel regarding their progress and career opportunities by doing the following:
  - Evaluating employees annually and at the end of each assignment lasting four weeks or longer to provide feedback on performance.
  - Summarizing and reviewing with personnel annually the evaluation of their performance, including an assessment of their progress with the Firm.
- Considerations include past performance, future objectives of the individual and the Firm, the individual's assignment preferences, and career opportunities.
- Evaluating partners periodically by means of counselling, peer evaluation, or self-appraisal, as appropriate.

Element 5
Engagement Performance

5.1 The objective of this element of QC is to provide the Firm with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the Firm or the engagement partner issues reports that are appropriate in the circumstances.

Policy 1

Planning for engagements meets professional, regulatory, and the Firm's requirements.

5.2 The Firm implements this policy by maintaining and providing personnel with the Firm's practice aids that prescribe the factors the engagement team should consider in the planning process for an engagement and the extent of documentation of those considerations. Planning considerations may vary depending on the size and complexity of the engagement.

5.3 Planning generally includes the following activities:

- Assigning responsibilities to appropriate personnel during the planning phase.
- Developing or updating background information on the client and the engagement.
- Considering client significance to the Firm.
- Developing a planning document that includes the following:
  - Proposed work programs tailored to the specific engagement.
  - Staffing requirements and the need for specialized knowledge.

- Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement.
- The risks, including fraud considerations, affecting the client and the engagement and how the risks may affect the procedures performed.
- A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the Firm's QC policies and procedures.

Policy 2

The engagement is performed, supervised, documented, reported and communicated in accordance with the requirements of professional standards, applicable regulators, and the Firm.

5.4 The Firm implements this policy through the following procedures:

- Ensuring that relevant auditing standards such as those dealing with risk assessment, fraud, etc., that deal with the planning phase of an engagement are duly complied with.
- Providing adequate supervision during the course of an engagement, including briefing the engagement team on the objectives of their work. The training, ability, and experience of the personnel are considered when assigning supervisors to the engagement.
- Requiring that a written work program be used and monitored for all engagements.
- Requiring that there is consistency in the quality of engagement performance. Consistency may be accomplished through written or electronic manuals, software tools, checklists, templates, models or other forms of standardized documentation, and industry or subject matter-specific guidance material.

- Requiring that a suitable audit summary memorandum is documented and kept among the engagement working papers to provide a history of the planned risks (including fraud risks), by what audit procedures those risks were mitigated, conclusions on controls and substantive testing, and whether the extent and quality of audit evidence examined supports the audit opinion.
- Addressing significant issues and newly identified risks arising during the engagement, considering their significance, and appropriately modifying the planned approach.
- Adhering to the guidelines set forth by the Firm for the form and content of documentation of the work performed and conclusions reached. Such documentation includes standardized forms, checklists, and questionnaires used in the performance of engagements and explanations, when required, of how the Firm integrates such aids into engagements.
- Requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the Firm's policies.

Policy 3

Qualified engagement team members review work performed by other team members on a timely basis.

5.5 The Firm implements this policy by adhering to the following guidelines established by the Firm regarding review of the documentation of the work performed and conclusions reached, the financial statements and reports, and documentation of the review process:

- All reviewers have appropriate experience, competence, and responsibility.
- For each engagement, there exists evidence of appropriate review of documentation of the work performed, conclusions reached, the financial statements, and the report.

- Engagement documentation is reviewed to determine whether the following have occurred:
  - The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - Significant findings and issues have been raised for further consideration.
  - Appropriate consultations have taken place, and the process and resulting conclusions have been documented and implemented.
  - The nature, timing, and extent of work performed are appropriate and do not need revision.
  - The work performed supports the conclusions reached and is appropriately documented.
  - The evidence obtained in support of financial statement assertions and disclosures is sufficient and appropriate to support the report.
  - The objectives of the engagement procedures have been achieved.

Policy 4

Engagement teams complete the assembly of final engagement files on a timely basis.

5.6 The Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

Policy 5

The Firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

5.7 The Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
  - Prevent unauthorized changes to the engagement documentation.
  - Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.
- Implementing procedures for properly distributing engagement documentation materials to engagement teams at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement.
- Implementing procedures to restrict access to, and enable proper distribution and confidential storage of, hardcopies of the engagement documentation.
- Requiring the use of passwords by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users.
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  - Generate copies that contain the entire content of the original paper documentation, including manual

signatures, cross-references, and annotations.

  - Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  - Enable the copies to be retrieved and printed as necessary.

Policy 6

The Firm retains engagement documentation for a period of time sufficient to meet the needs of the Firm, professional standards, laws, and regulations.

5.8 The Firm implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the applicable professional standards, laws and regulations.
- Establishing procedures that:
  - Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time;
  - Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed; and
  - Enable authorized external parties to access and review specific engagement documentation for QC or other purposes.

Policy 7

The Firm requires that consultation takes place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the

engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.

5.9 The Firm implements this policy through the following procedures:

- Consulting with those having appropriate knowledge, authority, and experience within the Firm (or, where applicable, outside the Firm) on significant technical, ethical, and other matters. The Firm uses advisory services provided by other Firms, professional and regulatory bodies, and commercial organizations that provide such services. Before using such services, the Firm evaluates whether the external provider is qualified for that purpose.
- Informing personnel of the Firm's consultation policies and procedures.
- Requiring sufficiently experienced engagement team members to identify matters for consultation or consideration during the engagement.
- Requiring consultation in specialized areas or situations with appropriate individuals within and outside the Firm when matters such as the following arise:
  - The application and interpretation of technical pronouncements.
  - Industries with special accounting, auditing, or reporting requirements.
  - Emerging practice problems.
  - Choices among alternative generally accepted accounting principles.
  - Re-issuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the

date a report was issued.

- Filing requirements of regulators.
- Meetings with regulators at which the Firm is to be called on to support the application of generally accepted accounting principles or generally accepted auditing standards that have been questioned.

- Providing all professional personnel with access to adequate and current reference materials including all relevant facts, circumstances, the professional literature used, and conclusions reached in the engagement documentation of the work performed and conclusions reached.
- Documenting the issue on which consultation was sought and the results of the consultation, including any decisions taken, the basis for those decisions, and how they were implemented. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting or auditing principles.

Policy 8

The Firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.

5.10 The Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment among members of an engagement team be resolved by the engagement and the QC partners, and the MP if necessary, and that the report not be released until the matter is resolved.
- Requiring that conclusions reached are appropriately documented. If members of the team continue to

disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

Policy 9

The Firm has criteria for determining whether an engagement QC review should be performed, evaluates all engagements against the criteria, performs an engagement QC review for all engagements that meet the criteria, and completes the review before the report is released.

5.11 The Firm implements this policy through the following procedures:

- Establishing criteria such as the following:
  - The identification of unusual circumstances or risks in an engagement or class of engagements as determined by the engagement partner or QC partner.
  - An engagement QC review is required by law or regulation.
- Evaluating all engagements against the criteria and documenting the evaluation.
- Performing and documenting an engagement QC review for all engagements that meet the criteria.

Policy 10

The Firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement QC review.

5.12 The Firm implements this policy through the following procedures:

- Establishing procedures addressing the nature, timing, and extent of the review. The Firm's procedures require that for audit and attestation engagements, the engagement QC reviewer do the following:

  - Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
  - Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions and account balances.
  - Confirm with the engagement partner that there are no significant unresolved issues.
  - Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
  - Review documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with Firm personnel or external sources.
  - Review the summary of corrected and uncorrected misstatements.
  - Review other engagement documentation to the extent considered necessary.
  - Read the financial statements and the report and consider whether the report is appropriate.
  - Complete the review before the release of the report.
- Resolving conflicting opinions between the engagement partner and the engagement QC reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement QC reviewer.
  - The procedures required by the Firm's policies on engagement QC review have been performed.

  - The engagement QC review has been completed before the report is released.
  - No matters have come to the attention of the engagement QC reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Policy 11

The Firm establishes criteria for the eligibility of engagement QC reviewers.

5.13 The Firm implements this policy by establishing the following criteria:

- An engagement QC reviewer:
  - Is selected by the QC partner or the MP.
  - Has sufficient technical expertise and experience.
  - Carries out responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the engagement QC reviewer.
  - Meets the independence requirements relating to the engagements reviewed, even though the engagement QC reviewer is not a member of the engagement team.
  - Does not make decisions for the engagement team or participate in the performance of the engagement except that the engagement partner may consult the engagement QC reviewer at any stage during the engagement.
- When the Firm does not have suitably qualified personnel to perform the engagement QC review, the Firm contracts with a suitably qualified external person to perform the engagement QC review.

Annexures D and E to this Implementation Guide contain illustrative engagement planning and illustrative engagement summary memorandum, respectively.

Element 6
Monitoring

6.1 The objective of this element of QC is to provide the Firm with reasonable assurance that its policies and procedures relating to the system of QC are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the Firm's system of QC, including a periodic inspection of a selection of completed engagements. The Firm satisfies this objective by establishing and maintaining the policies and procedures below.

Policy 1

The Firm assigns responsibility for the monitoring process, including performance, to a partner or competent individual.

6.2 The Firm implements this policy through the following procedures:

- The MP designates a QC partner who is responsible for designing, implementing and monitoring the Firm's QC system.
- The QC partner's responsibilities include ensuring that the Firm's QC policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
    - Changes in professional standards or other regulatory requirements applicable to the Firm's practice.
    - Results of inspections and peer review.
    - Review of litigation and regulatory enforcement actions against the Firm and its personnel.
    - Determining whether personnel have been appropriately informed of their responsibilities for maintaining the Firm's standards of quality in

performing their duties.

- Identifying the need to do the following:
    - o Revise policies and procedures related to QC because they are ineffective or inappropriately designed.
    - o Improve compliance with Firm policies and procedures related to QC.

Policy 2

The Firm performs monitoring procedures that are sufficiently comprehensive to enable the Firm to assess compliance with all applicable professional standards and the Firm's QC policies and procedures.

6.3 The Firm implements this policy through the following procedures:

- Designating one or more partners to be responsible for performing an annual inspection. Inspection procedures include reviewing a cross-section of engagements using the following criteria in selecting engagements:
    - o Significant specialized industries with emphasis on high-risk engagements.
    - o First-year engagements.
    - o Significant client engagements.
    - o Level of service performed (that is, audit and attest, review, or compilation).
    - o Engagements performed by all partners.
    - o Engagements for which there have been complaints or allegations from Firm personnel, clients, or other third parties that the work performed by the Firm failed to comply with professional standards, regulatory requirements, or the Firm's system of QC.
    - o Engagements in which there were significant disagreements between the quality review partner and the engagement partner.
- Establishing an approach and timetable for performing

the inspection procedures and determining the forms and checklists to be used during the inspection and the extent of documentation required.

- Deciding how long to retain detailed inspection documentation (as opposed to summaries).
- Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters and acceptance and continuance decisions.
- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Selecting a sample of engagements for review to determine compliance with the Firm's QC policies and procedures, re-evaluating that selection throughout the process, and reviewing the selected engagements.
- Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and sets forth any recommended changes that should be made to the Firm's policies and procedures.
- Reviewing the recommended corrective actions and reaching final conclusions about the actions to be taken.
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).
- Reviewing and evaluating Firm practice aids, such as audit programs, forms, and checklists, and considering whether they reflect the most recent professional pronouncements.
- Providing information during staff meetings regarding new professional standards, regulatory requirements, and the related changes that should be made to Firm practice aids.
- Reviewing, or designating a manager-level individual to be responsible for reviewing the CPED policies and procedures to determine whether they are appropriate,

effective, and meet the needs of the Firm.

- Reviewing, or designating a manager-level individual to review summaries of the CPED records of the Firm's professional personnel to evaluate each individual's compliance with the CPED requirements of the ICAI.
- Reviewing other administrative and personnel records pertaining to the QC elements.
- Soliciting information from the Firm's personnel during staff meetings regarding the effectiveness of training programs.

Policy 3

The Firm communicates (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its QC system process to relevant Firm personnel at least annually.

6.4 The Firm implements this policy through the following procedures:

- Discussing the engagement related observations of the inspection with the engagement partner and seeking his concurrence therewith.
- Preparing a summary report that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the Firm's policies and procedures.
- Reviewing the recommended corrective actions and reaching final conclusions as to the actions to be taken.
- Communicating to all professional personnel the deficiencies noted and the related changes in QC procedures.
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).

Policy 4

The Firm deals appropriately with complaints and allegations.

6.5 The Firm implements this policy through the following procedures:

- Having the MP inform personnel that they may raise any concerns regarding complaints or allegations about non-compliance with professional standards, regulatory and legal requirements, or the Firm's system of QC with him without fear of reprisals.
- Having a partner who is not otherwise involved in the engagement investigate the following:
  - Complaints and allegations that the work performed by the Firm fails to comply with professional standards and regulatory and legal requirements.
  - Allegations of non-compliance with the Firm's system of QC.
  - Deficiencies in the design or operation of the Firm's QC policies and procedures, or non-compliance with the Firm's system of QC by an individual or individuals, as identified during the investigations into complaints and allegations.
- Documenting complaints and allegations and the responses to them.

Policy 5

The Firm prepares appropriate documentation to provide evidence of the operation of each element of its system of QC.

6.6 The Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of QC, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected.
- A record of the evaluation of the following:

  - Adherence to professional standards and regulatory and legal requirements.
  - Whether the quality control system has been appropriately designed and effectively implemented.
  - Whether the Firm's QC policies and procedures have been appropriately applied so that reports that are issued by the Firm or engagement partners are appropriate in the circumstances.
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be.

Policy 6

The Firm retains documentation providing evidence of the operation of the system of QC for an appropriate period of time.

6.7 The Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the Firm's peer review or other regulatory requirements.

Policy 7

The Firm, in addition to the internal monitoring process described in policies 1 to 6 above, shall strive to get itself "peer reviewed" by an external reviewer under the "Peer Review" process established by the ICAI.

6.8 The Firm implements this policy by voluntarily offering itself for peer review by application to the Peer Review Board of the ICAI if it has not already been selected.

Annexure E to this Implementation Guide contains illustrative firm quality control inspection checklist.

Annexures

Compendium of Implementation Guides

Annexure I
Illustrative Annual Firm Personnel Independence Confirmation

Annexure II
Illustrative Independence Policies

Annexure III
Illustrative Client/Engagement Acceptance and Continuance Form

Annexure IV
Illustrative Engagement Planning Memorandum

Annexure V
Illustrative Engagement Summary Memorandum

Annexure VI
Illustrative Firm Quality Control Inspection Checklist

Annexure I
Illustrative Annual Firm Personnel Independence Confirmation

Instructions

All partners and employees are required to complete a confirmation regarding their independence.

This declaration covers the period from _______________ (date) to_________________ (date). This confirmation should reach _________________ (MP) on or before _________________ (date).

Detailed Declarations

Make the declarations below. If you do not agree, explain in a separate annexure why the 'disagree' responses are not independence-impairing situations.

#	Declaration	Agree	Disagree
1.	During the period, I or my immediate family members[7] did not have investments in an entity[8] to which I rendered any assurance services.		
2.	During the period, I or my immediate family members did not have a borrowing from an entity to which I rendered any assurance services.		
3.	During the period, I or my immediate family members did not give a loan to an entity to which I rendered any assurance services or to an officer, director, or major shareholder of that entity.		

7 "Immediate family members" means the partner or employee's spouse and dependents.

8 "Entity", wherever referred to in this table, includes its holding and subsidiary companies.

4.	During the period, I and my immediate family members were not an executor, administrator, or trustee of a trust/estate, and have authority to make investment decisions for the trust/estate, that had an investment in an entity to which I rendered any assurance services.		
5.	During the period, I and my immediate family members were not associated with an entity to which I rendered any assurance services, in an accounting or financial reporting oversight role.		
6.	During the period, I and my immediate family members did not obtain a new, or make significant changes to an existing, insurance product of any kind, from an insurance company to which I rendered any assurance services.		
7.	During the period, to the best of my knowledge, I and my immediate family members did not have a business relationship with or joint investment (e.g, partnership interests) in (a) an entity to which I rendered any assurance services or with (b) an officer, director, or major shareholder of that entity.		
8.	During the Period, I have advised the Independence and Ethics Partner of the Firm if I have been engaged in employment negotiations with an entity to which I rendered any assurance services.		

Explain below why, in your opinion, a 'disagree' response to any of the declarations above is not an independence - impairing situation:

REPRESENTATION

FOR THE PERIOD FROM ______________TO_____________

By submitting this independence confirmation, I represent that:

- I have read and understand the Firm's independence policies applicable to me and my immediate family, and understand the applicable independence restrictions.
- To the best of my knowledge, I have provided accurate and complete responses to the items in this confirmation. Except as otherwise indicated by my answers above, I have complied with the applicable independence policies, including those policies that pertain to my immediate family.
- I understand that it is my responsibility to comply with the Firm's independence policies and to seek appropriate consultation within the firm when I have any questions relating to my compliance with the Firm's independence policies.
- I understand that my responses are an element of the Firm's independence quality control system and are subject to review by firm management. Further, I understand I will be subject to disciplinary action if I do not cooperate or comply with Firm's independence policies.

Sign ___________________Office ________________________

Name __________________________Date _________________

Annexure II
Illustrative Independence Policies

(Name of Firm)

Application

1. These Independence Policies ("Policy" or "Policies") are applicable, without exception, to all partners and employees ("firm personnel") of:___________________________________ ("the Firm").

The Conceptual Approach

2. If a Policy addresses a specific situation or relationship, such policy should be followed. Where the Policies do not cover a particular circumstance, the conceptual approach requires that threats to independence be identified, evaluated and addressed.
3. Under this approach, when the Firm provides assurance services to an entity ("auditee"), all firm personnel have an obligation to make their best efforts to:

   a) Identify circumstances or relationships that might create threats to independence,

   b) Evaluate whether these threats are clearly insignificant, and

   c) In cases where the threats are not clearly insignificant, consult with the Ethics and Independence Partner and the Assurance Engagement Partner to identify and apply appropriate safeguards to eliminate the threats or reduce them to an acceptable level.
4. If an inadvertent violation occurs, it would generally not compromise independence with respect to an auditee provided the Firm has appropriate quality control policies

and procedures in place to promote independence and, once discovered, the violation is corrected promptly and any necessary safeguards are applied.

Identifying Threats to Independence

5. The generally recognised threats to independence[9] are:
   - Self interest threat;
   - Self-review threat;
   - Advocacy threat;
   - Familiarity threat; and
   - Intimidation threat.

6. When threats to independence are identified, other than those determined to be clearly insignificant, safeguards should be identified and applied to eliminate the threats or reduce them to an acceptable level. The nature of the safeguards to be applied will vary depending upon the circumstances. Consideration should be given to what a reasonable and informed third party having knowledge of all relevant information, including safeguards applied, would reasonably conclude to be unacceptable.

7. When threats to independence are identified that are not clearly insignificant, and the Firm decides to accept or continue the assurance engagement in accordance with its engagement acceptance or continuance processes, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

8. When the safeguards available are insufficient to eliminate the threats to independence or to reduce them to an acceptable level, or when a Firm chooses not to eliminate the activities or interests creating the threat, the only course of action available will be the refusal to perform, or

[9] These threats have been explained in the Chapter, "Introduction" in this Guide.

withdrawal from, the assurance engagement.

9. Some examples of safeguards that might be applied are:
   a) Involving an additional partner or professional staff member to carry out reviews of the work done or to otherwise advise as necessary. This individual could be someone in another Firm or someone within the Firm who was not otherwise associated with the assurance engagement.
   b) Rotation of senior partners or professional staff.
   c) Discussing independence issues with the auditee's audit committee or others those charged with governance.
   d) Removing an individual assigned to the assurance engagement team when that individual's economic or financial interests or other relationships create a threat to independence.

Complying With the Independence Policies and Procedures

10. Partners, professional staff and all others persons employed by the Firm are responsible for understanding and complying with all applicable independence policies and procedures.

11. Partners, professional staff and all others persons employed by the Firm are required to:
    a) Read all relevant independence policies.
    b) Understand the extent to which they apply to them and their immediate family members.
    c) Understand that the financial and employment relationships of immediate family members can threaten or impair independence with respect to an auditee.
    d) Provide information to their immediate family members about the independence policies.
    e) Understand that there are limitations or restrictions

on our ability to provide services to auditees.

f) Comply with applicable independence policies and procedures at all the times.

12. To enable partners and employees to be in compliance with the policies, the Firm leadership shall establish a system that enables each of them to be aware at all times of the most recent list of auditees and, where such auditees are listed companies, of their holding and subsidiary companies, even if the Firm does not render any assurance services to such holding and subsidiary companies.

13. This will be particularly relevant if partners and employees desire to:

    a) Make an investment in the auditee;

    b) Make a borrowing from or give a loan to the auditee;

    c) Obtain or modify an insurance policy with an insurance company auditee;

    d) Accept employment with an auditee; and

    e) Enter into a business relationship with an auditee.

14. Partners and employees of the Firm are required to consult others when they need assistance identifying possible threats to independence or resolving independence issues or concerns.

Confirming Compliance with Independence Policies

15. Partners and employees of the Firm must, upon request, confirm in writing their compliance with all applicable independence policies.

Understanding the Consequences of Non-Compliance

16. Partners and employees of the Firm who fail to comply with all applicable independence policies and procedures should be subject to the Firm's disciplinary process. The

range of possible disciplinary actions may include memos to the individual's personnel file, reductions in compensation and termination. The severity of the disciplinary action will depend on the nature of the violation and other facts and circumstances unique to each case. Ignorance of the policies is not considered a legitimate defense for failure to comply.

Financial Interests

17. Partners and employees of the Firm and their immediate family members are prohibited from making investments in equity or debt instruments in the auditee if they are members of the assurance engagement team ("AET").

18. Should any such investment be made inadvertently (e.g., upon receiving an inheritance or gift), the partner/employee shall ensure that it is disposed of within a period of one month from the date of investment.

19. Partners and employees of the Firm and their immediate family members, if they are members of the AET, are prohibited from making a borrowing from an auditee, unless the auditee is a financial institution that lends in the normal course of business, and the borrowing was on its normal lending terms.

20. Partners and employees of the Firm and their immediate family members, if they are members of the AET, are prohibited from giving a loan to an auditee or to an officer, director, or major shareholder of an auditee.

21. Partners and employees of the Firm and their immediate family members, if they are members of the AET, are prohibited from being an executor, administrator, or trustee of a trust/estate, and have authority to make investment decisions for the trust/estate, that had an investment in an auditee.

22. Partners and employees of the Firm and their immediate family members, if they are members of the AET, are prohibited from obtaining a new, or make significant changes to an existing, insurance product of any kind, from

an insurance company auditee.

Employment Relationships

23. Partners and employees of the Firm, if they are members of the AET, should not serve as an officer or director on the board of an auditee.

24. Partners and employees of the Firm and their immediate family members, if they are members of the AET, are prohibited from being associated with an auditee in an accounting or financial reporting oversight role.

25. Partner and employees of the Firm, if they are members of the AET, are prohibited from being engaged in employment negotiations with or taking up employment with the auditee without first informing the Ethics and Independence Partner. In such situation, they should forthwith withdraw from the assurance engagement.

Business Relationships

26. Partner and employees of the Firm, if they are members of the AET, are prohibited from having a business relationship with or joint investment (e.g., partnership interests) in an auditee or with an officer, director, or major shareholder of that auditee.

Long Association

27. Using the same partners and professional staff on an assurance engagement for an auditee over a long period of time may create a familiarity threat.

28. The Firm shall establish a personnel rotation policy so that members of the AET, including the partner where possible, rotate off the engagement upon rendering assurance services for a determined period of time (e.g., seven years).

29. The Firm's personnel rotation policy shall state that a person who rotates off an engagement does not get reinstated on that engagement except after a specified "cooling off" period (e.g., two years).

Gifts and Hospitality

30. Partner and employees of the Firm, if they are members of the AET, should not accept gifts or hospitality from the auditee, unless the value is clearly insignificant.

31. If there are any questions regarding receipt of the gift or hospitality, the Ethics and Independence Partner should be consulted.

Scope of Services

32. The laws and regulations governing the auditee (eg., the Companies Act, 1956 or rules made thereunder) or a regulator may specifically prohibit the Firm from rendering certain services to an auditee (e.g., internal audit services). In such cases, the proscribed services cannot be provided at all.

33. Besides this, it is not possible to draw up an all-inclusive list of non-assurance services which, if provided to an auditee, might create threats to independence and of the different safeguards that might eliminate these threats or reduce them to an acceptable level.

34. Because the provision of a non-assurance service may create threats to independence, the engagement partner, in consultation with the Ethics and Independence Partner, should evaluate the significance of any such threat before the Firm agrees to provide the service.

35. Where a threat to independence is assessed, the Ethics and Independence Partner shall determine if providing the service after applying suitable safeguards would eliminate or reduce the threat to an acceptable level. If not, the Firm should decide whether it makes better business sense to provide the non-assurance service and withdraw from the assurance engagement or vice versa.

36. The following activities should not be performed:
    a) Acting in a capacity equivalent to that of a member of management.

b) Reporting, in a management role, to those charged with governance.

c) Determining which recommendation of the Firm should be implemented.

d) Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the auditee, or having the authority to do so.

37. The assurance engagement partner, in consultation with the Ethics and Independence Partner, should consider the self-review or self-interest threats that may be created by the following activities and the appropriate safeguards to reduce the threats to an acceptable level:

    a) Having custody of an auditee's assets.

    b) Supervising the auditee's employees in the performance of their normal recurring activities.

    c) Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders).

38. The following safeguards may be particularly relevant in reducing, to an acceptable level, threats created by the provision of non-assurance Services to auditees:

    a) Discussing independence issues related to the provision of non-assurance services and the nature and extent of the fees charged for such services with those charged with governance, such as the audit committee.

    b) Consulting with the Ethics and Independence Partner on the potential impact of the non-assurance engagement on the independence of the AET and the Firm and acting on the recommendations.

    c) Involving an additional partner or professional staff member to provide assurance on a discrete aspect of the assurance engagement.

d) Obtaining the auditee's acknowledgement of responsibility for the results of the work performed by the Firm.

e) Making arrangements so that partners and professional staff members providing non-assurance services do not participate in the assurance engagement.

Fees

39. Total fees generated by an auditee should not represent a large proportion of the Firm's total fees.

40. A self-interest threat may be created when the fees generated by an auditee represent a large proportion of the revenue of an individual partner.

41. If fees for services provided to an auditee remain unpaid over an extended period of time, it may appear that the Member Firm has a loan to the auditee. Because of the significance of the overdue fees, the Firm should consider if it is appropriate for the Firm to be re-appointed. Therefore, fees for a specific accounting period should be received before issuance of an assurance report for the following year. If this is not possible, then consideration should be given as to whether adequate safeguards can be applied.

42. The Firm should not enter into a contingent fee arrangement with an auditee to provide assurance services where the amount of the fee is contingent on the result of the assurance work or on items that are the subject matter of the assurance engagement.

Annexure III

Illustrative Client/ Engagement Acceptance and Continuance Form

Client Name:

Engagement Name:

Period End:

Relationship:

Is this a new client relationship?	Yes	No
Is this a new engagement?	Yes	No
If not a new client relationship, age of the relationship		
If this is a recurring engagement, year of first performance and periodicity *(e.g., annual, quarterly)*		

Prior Audit Information:

Detailed Current Period Analysis:

(For continuing clients/engagements, this analysis should be prepared afresh at the beginning of each period)

#	Does the engagement term have reasons to have concerns about:	Yes[10]	No	Not Applicable
1.	Management's characteristics and integrity			
2.	Management's overall commitment to reliable financial reporting			
3.	Management's commitment to reliable accounting process and information system			
4.	Organizational structure			
5.	Management structure and control			
6.	Characteristics and integrity of significant related parties			
7.	Nature of services to be provided and reports expected			
8.	Ethical considerations in providing the expected service, or in associating the name of the Firm with the client/engagement			

[10] For "Yes" answers provide details in a separate workpaper, cross-referenced in the box.

9.	Management's methods of assigning authority and responsibility			
10.	Senior management control methods			
11.	Impact of computers			
12.	Activities of those charged with governance			
13.	Nature of the business			
14.	Business environment			
15.	Significant pressure on management to report certain financial results			
16.	Going concern assumption			
17.	Conditions surrounding the audit engagement			
18.	The Firm's ability to comply with auditing standards			
19.	Accounting issues that may present unacceptable risk			
20.	Significant transactions and business relationships			
21.	Financial roles and responsibilities			
22.	Likelihood of intentional misrepresentation			
23.	Likelihood of fraud			

24.	Lack of implementation of appropriate internal controls			
25.	Independence and conflicts of interest-threats to independence			
26.	The Firm's ability to complete the engagement with professional competence			
27.	Any other matters:			
	.			
	.			
	.			

Conclusion on client/engagement acceptance or continuance by engagement partner:

____

Signature of engagement partner

Date : ___________________

Concurrence on client/engagement acceptance or continuance by Firm's managing partner, risk management partner, or equivalent:

____

Signature of engagement partner/equivalent

Date : ___________________

Annexure IV
Illustrative Engagement Planning Memorandum

Workpaper reference:

Prepared by:

Date:

Reviewed by:

Date:

(Where space is inadequate, expand or give reference of separate workpaper)

Client Name:

Engagement Name:

Period End:

Deliverables:

Name of Deliverable	Date of Deliverable

Terms of Engagement (Engagement Letter):

Dated:	Acknowledged on:	File Reference:

Engagement Team Members:

Name of Member	Level

Understanding the Entity and its Environment:

Document under the captions below the key features of the engagement team's understanding of the entity and its environment:

Understanding with reference to:	Description of the understanding	Audit risk identified	Response to identified risk
Prior audit information			
Operations			
Ownership and management structure			
Related parties			
Modes of financing activities			
Business objectives and strategies, and related business risks			
Industry-specific matters and trends			
General business environment			
Laws and regulations			
Other external factors			

Understanding with reference to:	Description of the understanding	Audit risk identified	Response to identified risk
Critical accounting policies			
Reporting requirements			
Financial performance			
Taxation			
Needs, expectations and concerns of senior management			
Key entity personnel (name, designation, location)			
Accounting staff (name, designation, location)			
Main address for correspondence			
Bankers			
Attorneys/ solicitors Any other matters			

Evaluation of Internal Controls:

A. Overall Controls:

Control	Evaluation of design and implementation	Audit risks identified	Response to identified risk
A. Control Environment			
B. Management's risk assessment process			
C. Information Systems and Communication			
D. Monitoring			

B. Account-balance Specific Controls:

Account balance (Provide below financial statement line-item captions – e.g. Fixed Assets, Investments, Cash, etc., first for balance sheet and then for statement of profit and loss)	Control (Describe below the related key internal controls for each account balance)	Evaluation of design and implementation (i.e. an evaluation of how the control meets its objective and who owns and monitors the control)	Evaluation of operating effectiveness (i.e. an evaluation of whether the control was found to be operating effectively)	Findings and comments A. Opinion on whether the control can be relied upon by the engagement team; B. Audit risks identified C. Response to risk identified

Understanding the Accounting Process:

A. The use of Computers

Extent of use of computers		
Limited	Moderate	Pervasive

Complexity of the computer environment		
Simple	Moderate	Complex

Importance to the entity's business activities		
Limited	Moderate	Very Important

Overall evaluation of use of computers		
Insignificant	Substantial	Critical

If evaluation of use of computers is at "critical" level, will a computer assurance specialist be involved?

YES	NO
Reason, if "No":	

B. Unusual Transactions

Does the entity have non-routine or unusual transaction? (journal entries)	**Yes** **No**
If "yes", describe such transactions and the resultant audit risks identified	Response to risk identified

C. Discussion among engagement team members on the susceptibility of the entity's financial statements to material misstatement due to fraud.

Date of Fraud Meeting :	
Name and levels of those who attended :	
Name	**Level**
Minutes of discussions at the meeting (give reference to separate work paper)	**WP Ref.**
Significant fraud risks identified	**Response to risk identified**

D. Inquiries and obtaining an understanding of oversight exercised by those charged with governance:

Date of Inquiry by interview	Name of person interviewed and his designation	Reference of separate workpaper documenting minutes of the interview	Has the person interviewed exercised oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate fraud risks

E. Based on an analytical review of the most recently available financial information (including from the entity's management information systems) and on a consideration of fraud risk factors, unusual or unexpected relationships, and other information, determine account-balance specific fraud and other audit risks that the engagement team should consider when performing substantive procedures.

Account balance (Provide below financial statement line-item captions – e.g., Fixed Assets, Investments, Cash, etc., first for balance sheet and then for statement of profit and loss)	**Audit risk identified**		**Response to risks identified**
	Fraud Risk? Y/N	Describe the audit risk	

Materiality:

Materiality, as determined by the engagement team, at overall financial statement level

Rs.

Materiality, as determined by the engagement team, in relation to classes of transactions, account balances, and disclosures (if any)

Classes of transactions/account balances/disclosures	**Rs.**

Annexure V
Illustrative Engagement Summary Memorandum

(Where space is inadequate, expand or give reference of separate workpaper)

Client Name:

Engagement Name:

Period End:

Changes to Materiality:
(Where the quantitative materiality at the financial statement level was changed during the course of audit, give the old and the new materiality, and reasons for the change)

Changes to Audit Plan:
(Where the audit plan was changed after being made as a consequence of discovery and evaluation of new facts during the course of audit, give reasons for and the nature of the change)

Compliance with Accounting Pronouncements:
(Where standard firm checklists were completed to ensure compliance with accounting pronouncements, give reference to the separate workpapers)

Compliance with auditing pronouncements:
(Where standard firm checklists were completed to ensure compliance with auditing pronouncements, give reference to the separate workpapers)

Additional risks identified:
(Where additional risks were identified and added to the audit plan as a consequence of knowledge gained during the course of audit, describe the nature of risk)

Conclusion on risks identified in the audit plan:

Risk identified	Audit programme tailoring done to address the risk	Results of testing (whether the risk was eliminated or reduced to an acceptable level?)

Conclusion about the appropriateness of the going concern assumption:

Conclusion about the effect of subsequent event reviews:

Summary of adjusted misstatements:
(Give details of misstatements due to error/fraud that were discovered during audit and were adjusted by the client in the financial statements)

Nature of misstatement	Amount (Rs)	Account balances affected	Whether adjusted to auditor's satisfaction? Y/N[11]

[11] If "No", consider wholly or partly as unadjusted misstatement.

Summary of unadjusted[12] misstatements:

(Give details of misstatements due to error/fraud that were discovered during audit and not adjusted by the client in the financial statements)

Nature of misstatement	Amount (Rs)	Account balances affected
Total		

Conclusion on unadjusted misstatements:

(Un-adjusted misstatements should be aggregated and their combined net effect measured against the overall materiality level. The aggregate net effect of unadjusted misstatements should be reasonably below the materiality level in order for the auditor to conclude that the financial statements are not materially misstated.)

Net aggregate unadjusted misstatements	Rs.
Materiality	Rs.
Conclusion on whether, based on the above, the financial statements are not materially misstated?	

12 Un-adjusted misstatements = items that were considered as errors/fraud by the auditor but which the client either refused to accept as misstatements or refused to adjust, citing materiality or account closure or any other reason. Typically, these would be projected misstatements, disagreements with auditor on estimates, or unexplained differences in substantive analytical procedures.

Overall conclusion on whether the audit procedures applied and evidence obtained are appropriate and sufficient to support the audit opinion?

Conclusion about independence:

Conclusion about client and engagement continuance in the following period based on findings during the current audit:

Follow-up points (for next audit):
(Describe here matters that the auditor became aware of during the current audit that might have an impact on the audit of the following or a subsequent period)

1.	
2.	
3.	
4.	
5.	
6.	

Annexure VI
Illustrative Firm Quality Control Inspection Checklist

Section A – Firm Level Quality Controls

Leadership Responsibilities

Policy	Y/N	Remarks, if "No"
Has the Firm leadership demonstrated that it has assumed ultimate responsibility for the Firm's system of QC[13]?		
Does the Firm have an effective mechanism in place to ensure that commercial considerations do not override the quality of work performed?		
Has responsibility for the Firm's QC been assigned to a QC partner or other duly empowered individual?		
Are personnel policies designed to reward quality?		
Are sufficient monetary and human resources applied to maintain and augment QC policies and procedures within the Firm?		

RATING	Full / near full compliance	Part compliance	No compliance

[13] QC = quality control

Ethical Requirements

Policy	Y/N	Remarks, if "No"
Does the Firm have effective mechanisms in place to ensure that its personnel adhere to and do not compromise its ethical requirements?		
Has the Firm regularly communicated its independence requirements to all its personnel?		
Does the Firm have internal processes and effective mechanisms by which it ensures that it identifies threats to independence on a timely basis and takes demonstrable steps to eliminate or reduce those threats to an acceptable level?		
Does the Firm have effective internal processes whereby it exits from an engagement or client relationship where threats to independence are significant and such that cannot be reduced to an acceptable level?		
Has annual written confirmation been obtained from all Firm personnel and whether the Firm has taken steps to address defaults?		
Where another Firm performs part of an engagement, has the Firm confirmed that such other Firm and its related personnel meet the independence requirements?		

RATING	Full / near full compliance	Part compliance	No compliance

Acceptance and Continuance of Client Relationships and Specific Engagements

Policy	Y/N	Remarks, if "No"
Does the Firm have a process for making inquiries and obtaining information about a client, its personnel and the intrinsic risks of an engagement on a periodic basis that would identify questionable management integrity or high engagement risk?		
Has the Firm undertaken only those engagements which it can perform with professional competence?		
Does the Firm have an effective policy for obtaining written engagement letters for all its engagements and whether the contents of the engagement letter are sufficiently detailed and clear?		
Does the Firm have in place an effective policy for exiting engagements or client relationships if the situation so warrants?		
Has the Firm maintained proper documentation of its client and engagement acceptance and continuance procedures?		

RATING	Full / near full compliance	Part compliance	No compliance

Human Resources

Policy	Y/N	Remarks, if "No"
Does the Firm have procedures that enable it to ensure that it hires only competent personnel?		
Does the Firm have an effective mechanism that enables it to determine the capabilities and competencies that would be required of its personnel for individual engagements?		
Has the Firm established criteria for evaluating both personal and technical competencies of its personnel and has such criteria been applied consistently?		
Does the Firm have an effective mechanism to assign engagements and review responsibilities to partners and professional staff based on their knowledge, skills and abilities?		
Does the Firm provide its personnel with opportunities, resources and encouragement to participate in continuing professional education and development activities?		
Do the Firm's policies ensure that personnel who are selected for advancement have the competencies to fulfill their new responsibilities?		

RATING	Full / near full compliance	Part compliance	No compliance

Engagement Performance

Policy	Y/N	Remarks, if "No"
Does the Firm have a standard approach to ensuring that engagements are planned as required by the relevant auditing standards and the Firm's policies?		
Does the Firm have a standard approach for performing, supervising, documenting, reporting and communicating its engagements and deliverables in a manner that ensures compliance with the relevant auditing standards and the Firm's policies?		
Does the Firm have a standard approach for timely review of workpapers by competent senior personnel?		
Do the Firm's documentation policies ensure that final engagement files are assembled on a timely basis?		
Does the Firm have standard policies and procedures for maintenance of confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation?		
Does the Firm have a document retention policy?		
Does the Firm have an effective policy for consultation within and outside the Firm? Are consultations adequately documented?		
Does the Firm have an effective mechanism to address and resolve differences of opinion?		
Has the Firm established criteria for selection of engagements that qualify for engagement QC review and for the appointment of reviewers, and does it maintain documentation of engagements that have been subjected to engagement QC review?		
Are procedures addressing the nature, timing, extent, and documentation of the engagement QC review well established, and being followed effectively?		

RATING	Full / near full compliance	Part compliance	No compliance

Monitoring

Policy	Y/N	Remarks, if "No"
Has an empowered partner or other qualified individual been designated to perform the Firm's quality inspection process?		
Are the Firm's inspection procedures sufficiently comprehensive to enable it to assess compliance with all applicable professional standards and its own QC policies and procedures?		
Are the findings of the inspection duly communicated to all concerned persons, and whether the Firm leadership effectively drives the changes required to strengthen the areas of identified weakness?		
Does the Firm have processes in place to deal with complaints and allegations about non-compliance with professional standards, regulatory and legal requirements, or the Firm's system of QC with him without fear of reprisals.		
Does the Firm prepare and retain appropriate documentation to provide evidence of the operation of each element of its system of QC.		

RATING	Full / near full compliance	Part compliance	No compliance

Section B – Engagement Level Quality Controls

Client and engagement acceptance and continuance:

Policy	Y/N	Remarks, if "No"
Whether adequate process was followed to conclude on client acceptance/continuance during/for the year?		
Whether adequate process was followed to conclude on engagement acceptance/continuance during/for the year?		

RATING	Full / near full compliance	Part compliance	No compliance

Selection of engagement team:

Policy	Y/N	Remarks, if "No"
Did the audit engagement partner properly determine that the engagement team selected, including specialists where necessary, had the qualifications and experience appropriate for the audit engagement?		
Where use of computers by the client was evaluated as "critical" to the accounting system, was a computer audit specialist included on the engagement team in testing the computer general and application controls?		

Where an outside specialist was included as a member of the engagement team, did the engagement partner make an adequate evaluation of his competency to perform the work entrusted to him?		

RATING	Full / near full compliance	Part compliance	No compliance

Terms of engagement:

Policy	**Y/N**	**Remarks, if "No"**
Were the terms of the audit engagement properly agreed with the client and documented in writing?		

RATING	Full / near full compliance	Part compliance	No compliance

Understanding the entity and its environment:

Policy	**Y/N**	**Remarks, if "No"**
Did the engagement team obtain an understanding of the entity and its environment sufficient to enable it to identify and assess the risks and develop an effective audit plan?		

RATING	Full / near full compliance	Part compliance	No compliance

Understanding and evaluating internal controls:

Policy	**Y/N**	**Remarks, if "No"**
Did the engagement team obtain an understanding of the overall entity-level controls and evaluate the components of: control environment, management's risk assessment process, information systems and communication, and monitoring?		
Did the engagement team obtain an understanding of the computer general and application controls and evaluate them to enable identification and assessment of the risks of material misstatement of the financial statements, and design and perform further audit procedures?		
Did the engagement team obtain an understanding of the account-balance specific manual controls and evaluate them to enable identification and assessment of the risks of material misstatement of the financial statements, and design and perform further audit procedures?		

RATING	Full / near full compliance	Part compliance	No compliance

Identification of and response to fraud risks:

Policy	Y/N	Remarks, if "No"
Were audit procedures, as required by relevant AAS, followed for identification of fraud risks?		
Where pervasive fraud risks[14] were identified, did the engagement team evaluate the design of the entity's related internal controls and determine whether they have been implemented?		
Where specific fraud risks[15] were identified, were audit programmes for substantive testing adequately tailored to eliminate or reduce the risks to a level that would prevent the likelihood of material misstatement		

	Full / near full compliance	Part compliance	No compliance
RATING			

14 Pervasive risks are risks of material misstatements that are not specific to any individual item or group of related items in the financial statements.

15 Specific risks are risks of material misstatement that are specific to an individual item or group of related items in the financial statements.

Understanding and evaluating the accounting process:

Policy	Y/N	Remarks, if "No"
Did the engagement team obtain a sufficiently detailed understanding of the accounting system, including the transaction and document flows, to be able to evaluate risks of system failure resulting in a material misstatement?		
Was the audit programme at the account balance and significant assertion level suitably tailored to consider the engagement team's findings from its understanding of the accounting system, including the transaction and document flows?		

RATING	Full / near full compliance	Part compliance	No compliance

Controls Testing:

Policy	Y/N	Remarks, if "No"
Were key general computer controls (where use of computers was determined as "critical") tested for their operating effectiveness?		
Were key application computer controls tested for their operating effectiveness?		
Were key manual controls tested for their operating effectiveness?		

RATING	Full / near full compliance	Part compliance	No compliance

Developing an Audit Plan:

Policy	Y/N	Remarks, if "No"
As a result of risk assessment and controls testing, did the engagement team conclude on modifying the nature, timing and extent of substantive procedures?		
Was a detailed audit planning memorandum prepared to guide the engagement team through the audit?		
Were detailed audit programmes, tailored to address fraud and other risks, prepared and used to perform tests of controls and substantive procedures such that the objectives of a "risk based" audit are achieved?		

RATING	Full / near full compliance	Part compliance	No compliance

Internal Audit:

Policy	Y/N	Remarks, if "No"
Was the work performed by the internal auditor reviewed by the engagement team?		
If the engagement team decided to place reliance on the work of the internal auditor, were due procedures as required by the relevant AAS followed?		

RATING	Full / near full compliance	Part compliance	No compliance

External Confirmations:

Policy	Y/N	Remarks, if "No"
Did the engagement team follow procedures for obtaining evidence from external confirmations to support the existence of certain items of assets, liabilities and contingent liabilities, including attorneys' confirmations?		

RATING	Full / near full compliance	Part compliance	No compliance

Audit Sampling:

Policy	Y/N	Remarks, if "No"
In performing tests of account balances and assertions, did the engagement team follow an appropriate method of selecting samples as provided in the related AAS?		
Were the nature and causes of errors detected in testing of samples, and consider their possible effect on the particular audit objective and on other areas of the audit.		
For tests of details, did the engagement team project monetary errors found in the sample to the		

Policy	Y/N	Remarks, if "No"
population, and consider the effect of the projected error on the particular audit objective and on other areas of the audit.		
Did the engagement team evaluate the sample results to determine whether the assessment of the relevant characteristic of the population is confirmed or needs to be revised?		

RATING	Full / near full compliance	Part compliance	No compliance

Accounting Estimates:

Policy	Y/N	Remarks, if "No"
Did the engagement team design and perform adequate audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed.		

RATING	Full / near full compliance	Part compliance	No compliance

Related Parties:

Policy	**Y/N**	**Remarks, if "No"**
Did the engagement team perform adequate procedures to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of material related party transactions?		

RATING	Full / near full compliance	Part compliance	No compliance

Subsequent Events:

Policy	**Y/N**	**Remarks, if "No"**
Did the engagement team perform adequate audit procedures to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified?		

RATING	Full / near full compliance	Part compliance	No compliance

Management Representations:

Policy	Y/N	Remarks, if "No"
Did the engagement team obtain audit evidence that management acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements?		
Did the engagement team obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist?		
Did the written representations obtained from management include the following: • That management acknowledges its responsibility for the design and implementation of internal control to prevent and detect error; and • That management believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Whether a summary of such items was included in or attached to the written representations?		

RATING	Full / near full compliance	Part compliance	No compliance

Section C – Summary of Ratings

QUALITY CONTROL	RATING		
	Full / near full compliance	**Part compliance**	**No compliance**
SECTION A :			
Leadership responsibilities for quality within the Firm			
Ethical requirements			
Acceptance and continuance of client relationships and specific engagements			
Human resources			
Engagement performance			
Monitoring			
SECTION B:			
Client and engagement acceptance and continuance			
Selection of engagement team			
Terms of engagement			
Understanding the entity and its environment			
Understanding and evaluating internal controls			

QUALITY CONTROL	RATING		
	Full / near full compliance	**Part compliance**	**No compliance**
Identification of and response to fraud risks			
Understanding and evaluating the accounting process			
Controls Testing			
Developing an audit plan			
Internal audit			
External confirmations			
Audit Sampling			
Accounting estimates			
Related Parties			
Subsequent events			
Management representations			
Total Number			

Standard on Quality Control (SQC) 1

Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information, and Other Assurance & Related Services Engagements

Contents

Paragraph(s)

Introduction ... **1 - 5**

Definitions ... **6**

Elements of a System of Quality Control ... **7 - 8**

Leadership Responsibilities for Quality within the Firm ... **9 - 13**

Ethical Requirements ... **14 - 27**

Independence ... 18 - 27

Acceptance and Continuance of Client Relationships and Specific Engagements ... **28 - 35**

Human Resources ... **36 - 45**

Assignment of Engagement Teams ... 42 - 45

Engagement Performance ... **46 - 85**

Consultation ... 51 - 56

Differences of Opinion ... 57 - 59

Engagement Quality Control Review ... 60 - 73

Engagement Documentation ... 74 - 85

Monitoring ... **86 - 105**

Complaints and Allegations ... 101 - 105

Documentation ... **106 - 109**

Effective Date ... **110**

Material Modifications to the International Standard on Quality Control (ISQC)1

The following is the text of the Standard on Quality Control (SQC) 1,"Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information, and Other Assurance & Related Services Engagements". The Standard should be read in conjunction with the "Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", issued by the Institute of Chartered Accountants of India[1].

[1] Published in the July 2007 issue of the Journal.

Introduction

1. The purpose of this Standard on Quality Control (SQC) is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This SQC is to be read in conjunction with the requirements of the Chartered Accountants Act, 1949, the Code of Ethics and other relevant pronouncements of the Institute[2] (*hereinafter referred to as "the Code")*.

2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the Auditing and Assurance Standards Board (AASB) issued under the authority of the Council. For example, Standard on Auditing (SA) 220, *Quality Control for Audit Work*[3], establishes standards and provides guidance on quality control procedures for audits of historical financial information.

3. **The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm[4] or engagement partner(s) are appropriate in the circumstances.**

4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.

5. This SQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this SQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

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[2] Attention of the members is invited, for instance, to the Guidance Note on Independence of Auditors, issued by the Committee on Ethical Standards.

[3] Earlier known as Auditing and Assurance Standard (AAS) 17, "Quality Control for Audit Work".

[4] It is clarified that in India the reports are not issued/signed in the firm name, rather they are issued/signed on behalf of the firm by the sole practitioner, proprietor or a partner of the firm, as the case may be, in his individual name. The definition of a 'firm' has been given in paragraph 6(f) of this Standard.

Definitions

6. In this SQC, the following terms have the meanings attributed below:

   a) *Engagement documentation* - the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are also sometimes used). The documentation for a specific engagement is assembled in an engagement file;

   b) *Engagement partner* - the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

   c) *Engagement quality control review* - a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

   d) *Engagement quality control reviewer* - a partner[5], other person in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.

   e) *Engagement team* - all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

   f) *Firm* - a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

   g) *Inspection* - in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams

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[5] Such other person should be a member of the Institute of Chartered Accountants of India.

with the firm's quality control policies and procedures.

h) *Listed entity* - an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.

i) *Monitoring* - a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

j) *Network firm* - an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.

k) *Partner* - any individual with authority to bind the firm with respect to the performance of a professional services engagement.

l) *Personnel* - partners and staff.

m) *Professional standards* - engagement standards, as defined in the AASB's "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," and relevant ethical requirements as contained in the Code.

n) *Reasonable assurance* - in the context of this SQC, a high, but not absolute, level of assurance.

o) *Staff* - professionals, other than partners, including any experts which the firm employs.

p) *Suitably qualified external person* - an individual outside the firm with the capabilities and competence to act as an engagement partner, for example[6] a partner or an employee (with appropriate experience) of another firm.

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[6] Such employee should be a member of the Institute of Chartered Accountants of India.

Elements of a System of Quality Control

7. **The firm's system of quality control should include policies and procedures addressing each of the following elements:**

   a) **Leadership responsibilities for quality within the firm;**

   b) **Ethical requirements;**

   c) **Acceptance and continuance of client relationships and specific engagements;**

   d) **Human resources;**

   e) **Engagement performance; and**

   f) **Monitoring.**

8. **The quality control policies and procedures should be documented and communicated to the firm's personnel.** Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Leadership Responsibilities for Quality Within the Firm

9. **The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.**

10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality

control policies and procedures, and the requirement to:

a) Perform work that complies with professional standards and regulatory and legal requirements, and

b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:

    a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;

    b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and

    c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

12. **Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.**

13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

14. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.**

15. Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements are contained in the Code. The Code establishes the fundamental principles of professional ethics, which include:
    - a) Integrity;
    - b) Objectivity;
    - c) Professional competence and due care;
    - d) Confidentiality; and
    - e) Professional behavior.

16. The Code includes a conceptual approach to independence for assurance engagements, including aspects such as threats to independence, accepted safeguards and the public interest.

17. **The firm's policies and procedures should emphasize the fundamental principles, which are reinforced in particular by**
    - a) **the leadership of the firm;**
    - b) **education and training;**
    - c) **monitoring**; **and**
    - d) **a process for dealing with non-compliance.** Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

Independence

18. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code.**

Such policies and procedures should enable the firm to:

a) **Communicate its independence requirements to its personnel and, where applicable, to others subject to them; and**

b) **Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.**

19. **Such policies and procedures should require:**

    a) **Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;**

    b) **Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and**

    c) **The accumulation and communication of relevant information to appropriate personnel so that:**

       i) **The firm and its personnel can readily determine whether they satisfy independence requirements;**

       ii) **The firm can maintain and update its records relating to independence; and**

       iii) **The firm can take appropriate action regarding identified threats to independence.**

20. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:**

    a) **All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;**

    b) **The firm to promptly communicate identified breaches of these policies and procedures to:**

i) **The engagement partner who, with the firm, needs to address the breach; and**

ii) **Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and**

c) **Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.**

21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations are contained in the Code.

22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm, as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

23. **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.**

24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. **Accordingly, the firm should establish policies and procedures:**

a) **Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and**

b) **For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.**

26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. **Therefore, the firm should establish criteria for determining the need for safeguards to address this threat.** In determining appropriate criteria, the firm considers such matters as

    a) the nature of the engagement, including the extent to which it involves a matter of public interest, and

    b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

27. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the engagement partner should be rotated after a pre-defined period, normally not more than seven years[7].

Acceptance and Continuance of Client Relationships and Specific Engagements

28. **The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only**

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[7] The provision of rotation of partners shall not be applicable in case the audit of listed entities is being done by a sole practitioner/proprietor. However, in order to ensure that appropriate system of quality control exists in the firm and that appropriate reports are issued in the circumstances by sole practitioners/proprietors, such practice unit(s) shall be compulsorily reviewed under the process of peer review.

where it:

a) **Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;**

b) **Is competent to perform the engagement and has the capabilities, time and resources to do so; and**

c) **Can comply with the ethical requirements.**

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

29. With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- 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.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

30. Information on such matters that the firm obtains may come from, for example:

    - Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code, and discussions with other third parties.
    - Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
    - Background searches of relevant databases.

31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:

    - Firm personnel have knowledge of relevant industries or subject matters;
    - Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
    - The firm has sufficient personnel with the necessary capabilities and competence;
    - Experts are available, if needed;
    - Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
    - The firm would be able to complete the engagement within the reporting deadline.

32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of

interest[8]. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.

33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.

34. **Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:**

    a) **The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and**

    b) **The possibility of withdrawing from the engagement or from both the engagement and the client relationship.**

35. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

    - Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.

    - If the firm determines that it is appropriate to withdraw, discussing

[8] Paragraph 1.4 of the **Code of Ethics** issued by the ICAI provides that "When in practice, an accountant should both be, and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity". **The Guidance Note on Independence of Auditors** issued by the ICAI provides that "In addition to ensuring independence during the assignment, it is also essential to avoid any situation in near future which may be interpreted as a threat to independence, as for example, he or any other partner of his firm should not accept any other assignment such as internal audit, system audit and management consultancy services within one year from the completion of audit assignment".

with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.

- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

Human Resources

36. **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.**

37. Such policies and procedures address the following personnel issues:

    a) Recruitment;

    b) Performance evaluation;

    c) Capabilities;

    d) Competence;

    e) Career development;

    f) Promotion;

    g) Compensation; and

    h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:

    - Professional education;
    - Continuing professional development, including training;
    - Work experience; and
    - Coaching by more experienced staff, for example, other members of the engagement team.

39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain and also enhance their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures, the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.

40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:

    a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;

    b) Provides personnel with evaluation of, and counselling on, performance, progress and career development; and

    c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may

employ less formal methods of evaluating the performance of their personnel.

Assignment of Engagement Teams

42. **The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:**

    a) **The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;**

    b) **The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and**

    c) **The responsibilities of the engagement partner are clearly defined and communicated to that partner.**

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

44. **The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform 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.**

45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning engagement teams, and in determining the level of supervision required, include the following:

    - An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
    - An understanding of professional standards and regulatory and legal requirements.
    - Appropriate technical knowledge, including knowledge of relevant

information technology.

- Knowledge of the relevant industries in which the clients operate.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

Engagement Performance

46. **The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.**

47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

    - How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
    - Processes for complying with applicable engagement standards.
    - Processes of engagement supervision, staff training and coaching.
    - Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
    - Appropriate documentation of the work performed and of the timing and extent of the review.
    - Processes to keep all policies and procedures current.

48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

49. Supervision includes the following:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.
- Addressing significant issues arising during the engagement, considering their significance and appropriately modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

    a) The work has been performed in accordance with professional standards and regulatory and legal requirements;

    b) Significant matters have been raised for further consideration;

    c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

    d) There is a need to revise the nature, timing and extent of work performed;

    e) The work performed supports the conclusions reached and is appropriately documented;

    f) The evidence obtained is sufficient and appropriate to support the report; and

    g) The objectives of the engagement procedures have been achieved.

Consultation

51. **The firm should establish policies and procedures designed to provide it with reasonable assurance that:**

    a) **Appropriate consultation takes place on difficult or contentious matters;**

    b) **Sufficient resources are available to enable appropriate consultation to take place;**

    c) **The nature and scope of such consultations are documented; and**

    d) **Conclusions resulting from consultations are documented and implemented.**

52. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

53. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. The firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.

55. A firm needing to consult externally, for example, a firm without appropriate internal resources may take advantage of advisory services provided by (a) other firms, or (b) professional and regulatory bodies. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

    a) The issue on which consultation was sought; and

    b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

57. **The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.**

58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. **The report should not be issued until the matter is resolved.**

59. A firm using a suitably qualified external person(s) to conduct an engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

60. **The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:**

    a) **Require an engagement quality control review for all audits of financial statements of listed entities;**

b) **Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and**

c) **Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).**

61. **The firm's policies and procedures should require the completion of the engagement quality control review before the report is issued.**

62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

63. **The firm should establish policies and procedures setting out:**

a) **The nature, timing and extent of an engagement quality control review;**

b) **Criteria for the eligibility of engagement quality control reviewers; and**

c) **Documentation requirements for an engagement quality control review.**

Nature, Timing and Extent of the Engagement Quality Control Review

64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected

working papers relating to the significant judgments that the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

65. An engagement quality control review for audits of financial statements of listed entities includes considering the following:

    - The engagement team's evaluation of the firm's independence in relation to the specific engagement.
    - Significant risks identified during the engagement and the responses to those risks.
    - Judgments made, particularly with respect to materiality and significant risks.
    - Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
    - The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
    - The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
    - Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
    - The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Criteria for the Eligibility of Engagement Quality Control Reviewers

68. **The firm’s policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:**

    a) **The technical qualifications required to perform the role, including the necessary experience and authority; and**

    b) **The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.**

69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

    a) Is not selected by the engagement partner;

    b) Does not otherwise participate in the engagement during the period of review;

    c) Does not make decisions for the engagement team; and

    d) Is not subject to other considerations that would threaten the reviewer's objectivity.

71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 69-72.

Documentation of the Engagement Quality Control Review

73. **Policies and procedures on documentation of the engagement quality control review should require documentation that:**

    a) **The procedures required by the firm's policies on engagement quality control review have been performed;**

    b) **The engagement quality control review has been completed before the report is issued; and**

    c) **The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.**

Engagement Documentation

Completion of the Assembly of Final Engagement Files

74. The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.

75. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation, the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

76. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

77. **The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.**

78. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm’s personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

79. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for engagement documentation to:

a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;

b) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the Internet;

c) Prevent unauthorized changes to the engagement documentation; and

d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

80. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

81. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;

b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and

c) Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

Retention of Engagement Documentation

82. **The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.**

83. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report.

84. Procedures that the firm adopts for retention of engagement documentation include those that:

- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Ownership of Engagement Documentation

85. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

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

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

    a) Adherence to professional standards and regulatory and legal requirements;

    b) Whether the quality control system has been appropriately designed and effectively implemented; and

    c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

88. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.

89. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

    ■ Analysis of:

        • New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;

- Written confirmation of compliance with policies and procedures on independence;
- Continuing professional development, including training; and
- Decisions related to acceptance and continuance of client relationships and specific engagements.

- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

90. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

91. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

92. Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

93. **The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:**

    a) **Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or**

    b) **Systemic, repetitive or other significant deficiencies that require prompt corrective action.**

94. **The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.**

95. **The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:**

    a) **Taking appropriate remedial action in relation to an individual engagement or member of personnel;**

    b) **The communication of the findings to those responsible for training and professional development;**

    c) **Changes to the quality control policies and procedures; and**

d) **Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.**

96. **Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.**

97. **At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing partner(s). Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should include the following:**

    a) **A description of the monitoring procedures performed.**

    b) **The conclusions drawn from the monitoring procedures.**

    c) **Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.**

98. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

99. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this SQC, and these firms place reliance on such a monitoring system:

    a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;

b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and

c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

100. Appropriate documentation relating to monitoring:

a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;

b) Records the evaluation of:

i) Adherence to professional standards and regulatory and legal requirements;

ii) Whether the quality control system has been appropriately designed and effectively implemented; and

iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and

c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

Complaints and Allegations

101. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:**

a) **Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and**

b) **Allegations of non-compliance with the firm's system of quality control.**

102. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

103. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

104. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

105. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 95.

Documentation

106. **The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.**

107. How such matters are documented is the firm's decision. For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more simpler and informal methods such as manual notes, checklists and forms.

108. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:
    - The size of the firm and the number of offices.
    - The degree of authority both personnel and offices have.
    - The nature and complexity of the firm's practice and organization.

109. The firm retains this documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

110. This Standard on Quality Control is recommendatory for all engagements relating to accounting periods beginning on or after April 1, 2008 and is mandatory for all engagements relating to accounting periods beginning on or after April 1, 2009.

Material Modifications to the International Standard on Quality Control (ISQC) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

Additions

1. Paragraph 6(d) of the ISQC 1, dealing with the definition of “engagement quality control reviewer” mentions that “other person in the firm” with sufficient and appropriate experience and authority can also act as quality control reviewer. The SQC 1 has retained this concept subject to the condition that such “other person in the firm” should also be a member of the Institute of Chartered Accountants of India.
2. Paragraph 6(d) of the ISQC 1, while defining the “engagement quality control reviewer” provides that the review can be done by a team of individuals comprising the partner, other person in the firm and/or the suitably qualified external person. The SQC 1 has retained this concept subject to the condition that in case of review by a team of individuals, such team should be headed by a member of the Institute.
3. Paragraph 6(f) of the ISQC 1 defines “firm” as “a sole practitioner, partnership, corporation or other entity of professional accountants”. Since in India an individual can practice in his individual name and also in the name of the firm as proprietor of that firm, accordingly, the term 'Proprietor' has been added to the definition of the firm.
4. Paragraph 83 of the ISQC 1 prescribes the minimum period of engagement documentation as five years. The SQC 1 prescribes the minimum period of retention of engagement documentation as ten years since, as per the provisions of the Chartered Accountants Act, 1949, including regulations therein, prescribes the minimum period of retention of working papers as ten years.

Deletions

1. Paragraph 6(f) of the ISQC 1 defines "firm" as "a sole practitioner, partnership, corporation or other entity of professional accountants". Since in India, the practitioners establish any corporate entity for practice, the word 'Corporation' has been deleted from the definition.

2. In terms of paragraph 6(p) of the ISQC 1, defining a "suitably qualified external person" as a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organisation that provides relevant quality control services. Since, in India only the Institute of Chartered Accountants of India is the professional body whose members can carry out an audit or a review of historical financial information or other assurance engagement, a specific reference to this fact appearing in the context of "partner of another firm or an employee" has been deleted from the definition of "suitably qualified external person".

3. Paragraph 6(p) lays down that "an organisation that provides relevant quality control services" can also act as a suitably qualified person. The SQC does not include any such requirement since it is felt that a review of a firm of accountants should be done by a similar firm of accountants only.

4. Paragraph 27 of the ISQC 1 requires that in all engagements of audit of listed companies, the engagement partner of the firm should be rotated within a period of seven years in order to avoid the familiarity threat. The SQC 1 does not mandate such a provision in the audit engagements of the listed entities that are audited by the sole practitioner/proprietors as it is not possible to apply the provision in such cases. However, the SQC 1 provides for peer review of those firms in order to mitigate familiarity threat.

5. The ISQC 1 also deals with the public sector perspective. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Standard does not specifically mention that aspect.

2
Implementation Guide to Risk-based Audit of Financial Statements
(Revised 2012)

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Foreword

The Institute is the regulator of the accountancy profession in India. As a part of its regulatory functions, it issues auditing standards which are performance benchmarks for the auditors. To enhance the global acceptability and competence of the Indian auditors, the auditing standards issued by the Institute are based on the International Standards issued by the International Auditing and Assurance Standards Board. It is essential that auditing standards issued by the Institute are properly understood and applied in true spirit by the members.

In the above context, it is therefore, necessary that the Institute, in addition to bringing out auditing standards, also develops guiding literature on those standards for the members. Implementation Guides to auditing standards are an important tool for the auditors to understand and implement the requirements of these standards in an appropriate manner to meet the objectives of these standards. The Implementation Guides also provide solutions to the practical problems being faced by the auditors in implementing these standards in the real life situations.

I am happy to note that the Auditing and Assurance Standards Board has brought out this Revised Edition of the *Implementation Guide to Risk-based Audit of Financial Statements* whose first edition was issued in 2008. I am sure the Revised Implementation Guide would be able to address the apprehensions, concerns and difficulties, if any, being faced by the auditors regarding the risk based auditing standards.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives in bringing out guiding literature on auditing standards and other technical literature on auditing for the benefit of the members. I also eagerly look forward to more such Implementation Guides and other technical publications from the Auditing and Assurance Standards Board.

May 2, 2012 **CA. Jaydeep Narendra Shah**
New Delhi President, ICAI

Preface

The Institute, in the year 2007, had issued two Standards on Auditing, SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks". Both these Standards brought into focus the risk based approach to audit of financial statements.

In 2008, the Auditing and Assurance Standards Board brought out the 1st Edition of the *Implementation Guide to Risk-based Audit of Financial Statements* with the objective of helping the members understand the requirements of above mentioned standards and make their implementation easier. The Implementation Guide also discussed the implications of SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 300, "Planning an Audit of Financial Statements" on carrying out risk based audits.

Since 2008, a number of new/revised Standards on Auditing have been issued by the Institute under the Clarity Project. Accordingly, the Auditing and Assurance Standards Board deemed it proper to revise the implementation guide. The Board is bringing out this thoroughly revised 2nd Edition of the *Implementation Guide to Risk-based Audit of Financial Statements* for the benefit of the members. The Guide provides practical guidance on various aspects relating to risk-based audits in an easy and lucid language. It covers matters such as Basic Concepts of Risk based Audits (for example, what is risk-based audit, audit risk components, interrelationship of audit risk components, risk-based approach etc.), Risk Assessment (for example, understanding the entity, internal controls, financial statement assertions, materiality and audit risk, risk assessment procedures, overall audit strategy, business risks, fraud risks, significant risks etc.) and Risk Response (for example, detailed audit plan, accounting estimates, related parties, subsequent events, going concern etc.). The Appendices to the Guide contain illustrations on overall audit strategy, understanding the entity, understanding the information system, risk assessment procedures, risk table, identification of risks, overall responses to the financial statements in general, etc.

I am extremely grateful to CA. Bhavani Balasubramanian, Chennai and her team comprising Ms. Sudha Prakash and Mr. Balajee Subramanian for squeezing time out of their pressing preoccupations for reviewing and revising the existing Guide and for preparing the draft of the Revised Guide.

At this juncture, I also wish to express my sincere thanks to, CA. Jaydeep N. Shah, President, ICAI as well as, CA. Subodh Kumar Agrawal, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, *viz.*, CA. Shiwaji Bhikaji Zaware, Vice Chairman, CA. Amarjit Chopra, CA. Anuj Goyal, CA. G. Ramaswamy, CA. Jayant P. Gokhale, CA. J. Venkateswarlu, CA. Naveen N.D. Gupta, CA. Nilesh S. Vikamsey, CA. Pankaj Inderchand Jain, CA. Pankaj Tyagee, CA. Rajendra Kumar P., CA. S. Santhanakrishnan, CA. V. Murali, and Central Government nominee, Shri Gautam Guha and also to the co-opted members at the Board, *viz.*, CA. Raj Agarwal, CA. Vinay Dattatray Balse, CA. Purshotam Gaggar, and CA. Pramod S. Shingte, for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, *viz.*, Prof. Manoj Anand, CA. B. Padmaja, CA. Amit Roy, Shri S. Ravindran for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the draft its final shape.

I am sure that the members and other interested readers would find this Implementation Guide useful. I also eagerly look forward to the feedback of readers on the publication.

May 2, 2012
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

Contents

Foreword

Preface

PART A: BASIC CONCEPTS

Chapter 1: What is Risk-based Audit............................ 153-168

Overview 153

Audit Risk Components 158

Interrelationship of Audit Risk Components 161

The Risk-based Approach 161

Risk Assessment 162

Risk Response 164

Reporting 165

Summary 166

Part B : Risk Assessment

Chapter 2: Risk Assessment 170-274

Understanding the Entity **..** 170

Overview 171

Sources of Information... 174

Scope of Understanding Required................................ 176

Classifying the Information Obtained 180

Documentation... 182

Internal Control 183

Financial Statement Assertions 187

Materiality and Audit Risk 193

Risk Assessment Procedures.. 205

Overview 206

Nature of Evidence Obtained.. 206

Required Procedures.. 207

Inquiries of Management and Others 207
Analytical Procedures 209
Observation and Inspection 211
Other Risk Assessment Procedures 212
Overall Audit Strategy 213
Overview 214
Developing the Overall Audit Strategy 216
Consideration in Planning 218
The Four Planning Steps 223
Communicating the Plan with Management and Those Charged with Governance 232
Documentation 232
Business Risks 234
Overview 234
Risk Factors 235
The Entity's Risk Assessment Process 238
Assessment of Risks 241
Documentation of Risks 245
Fraud Risks 246
Overview 246
Fraud 250
Audit Team Discussions 253
Identification of Fraud Risk Factors 255
Assessment of Fraud Risk 264
Significant Risks 266
Overview 267
Determination of Significant Risks 269
Areas to Consider 270
Responding to Significant Risks 272

PART C : RISK RESPONSE

Chapter 3: Risk Response 276-324

Detailed Audit Plan 276
- Overview 276
- Responding to Assessed Risks 278
- Design of Audit Procedures 281
- Timing of Procedures 284
- Extent of Procedures 285
- The Audit Toolbox 285
- Tests of Controls 287
- Documenting the Audit Plan 299
- Communication of the Plan 301

Accounting Estimates 301
- Overview 302
- Risk Assessment 303
- Responses to Assessed Risks 305
- Reporting 306

Related Parties 306
- Overview 307
- Risk Assessment 308
- Risk Response 309
- Reporting 311

Subsequent Events 312
- Overview 312
- Dual Dating 316

Going Concern 316
- Overview 317
- Risk Assessment Procedures 318
- Evaluating Management's Assessment 320
- Risk Response — When Events are Identified 321
- Reporting 323

Part D : APPENDICES 325-384

Appendix 1 : Examples.. 326-331

Appendix 2 : Case Study 332-353

Appendix 3 : Overall Audit Strategy..................................... 354-356

Appendix 4 : Understanding the Entity 357-364

Appendix 5: Understanding the Information System 365-371

Appendix 6 : Risk Assessment Procedures......................... 372-377

Appendix 7 : Risk Table 378

Appendix 8 : Steps for Risk Identification 379-380

Appendix 9 : Overall Responses Relating to the Financial Statements in General 381-384

Part A
Basic Concepts

Chapter 1
What is Risk-Based Audit

Overview

1.1 The auditor's objective in a risk-based audit is to obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements. This involves the following three key steps:

- Assessing the risks of material misstatement in the financial statements;
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing an appropriate audit report based on the audit findings.

Reasonable Assurance

1.2 Reasonable assurance relates to the whole audit process. It is a high level of assurance but is not absolute. The auditor cannot provide absolute assurance due to the inherent limitations in the work carried out, the human judgments required, and the nature of evidence examined. The following Table outlines some of the limitations of an audit.

Limitations	Reasons
Use of Testing	Any sample of less than 100% of a population introduces some risk that a misstatement will not be detected.

Internal Control Limitations	Even the best designed and most effective controls can be overridden or negated by management or by collusion among employees.
Fraud that Goes Undetected	Because fraud is specifically designed to not be detected, there is always the possibility that it will not be discovered.
Nature of Audit Evidence Available	Most audit evidence tends to be persuasive in character rather than conclusive.
Availability of Audit Evidence	Insufficient support may be available for drawing absolute conclusions on specific assertions such as fair value estimates.
Reliance on Judgments Made by the Auditor	Professional judgment is required to: • Appropriately identify and address risk factors; • Decide what evidence to gather; • Assess estimates made by management; and • Draw conclusions based on the evidence and management representations.
Difficulty in Ensuring Completeness	There is a risk that some important information is not known about, not obtained or has been concealed from the auditor.

Audit Risk

1.3 Audit risk is the risk of expressing an inappropriate audit opinion on financial statements that are materially misstated. The objective of the audit is to reduce this audit risk to an acceptably low level. The audit risk contains two key elements:

- The risk that the financial statements contain a material misstatement (inherent and control risk); and
- The risk that the auditor will not detect such a misstatement (detection or engagement risk).

To reduce audit risk to an acceptably low level, the auditor has to:

- Assess the risks of material misstatement; and
- Limit the detection risk.

  This may be achieved by performing procedures that respond to the assessed risks at the financial statement, class of transactions, account balance and assertion levels.

Assertions

1.4 Included in management's representations about the financial statements are a number of embedded assertions. These relate to the recognition, measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements.

However, for ease of use, this Guide has combined some of the assertions as follows:

- C = Completeness;
- E = Existence, which includes occurrence;
- A = Accuracy, which includes cut-off, classification and rights and obligations; and
- V = Valuation.

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur, as follows:

"(a) Assertions about classes of transactions and events for the period under audit:

(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

(ii) Completeness—all transactions and events that should have been recorded have been recorded.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cut-off—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

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

(i) Existence—assets, liabilities, and equity interests exist.

(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

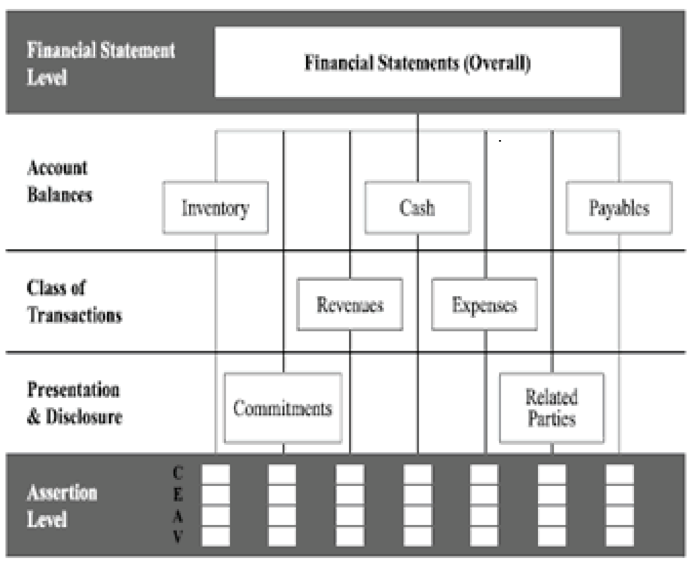
(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are

clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts."

1.5 Auditors are required to assess the risks of material misstatement at two levels. The first is at the overall financial statement level, which refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions. The second relates to risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. This means that for each account balance, class of transactions and disclosure, an assessment of risk (such as high, moderate, or low) should be made for each individual assertion (C, E, A, and V in the diagram below) being addressed. The difference between assessing risk at the overall financial statement level and the assertion level is illustrated (in partial form only) below.



Note: The assertions used in this diagram are C = Completeness, E = Existence, A= Accuracy and cut-off, V = Valuation.

Audit Risk Components

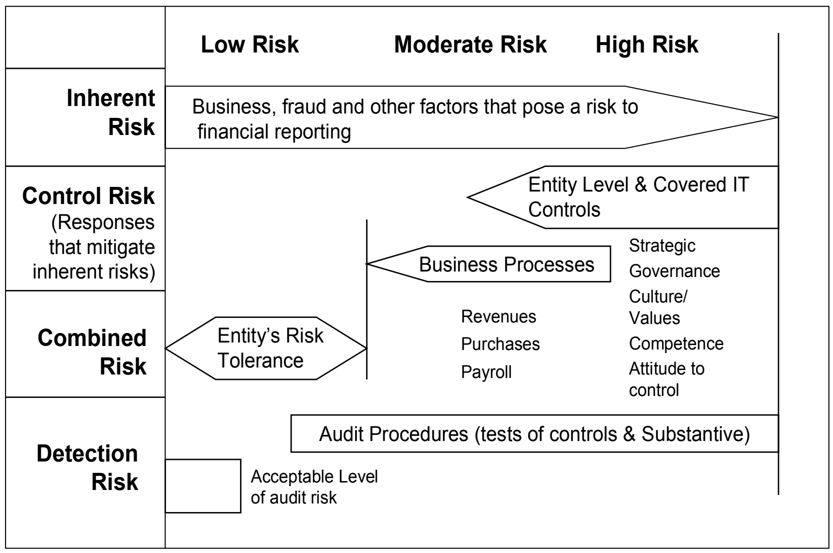
1.6 The major components of audit risk are described in the Table below.

Nature	*Description*	*Commentary*
Inherent Risk	Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is addressed at both the financial statement level and at the assertion level.	These are the business and other risks that arise from the entity's objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity. The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: • Complex calculations which could be misstated; • High value inventory; • Accounting estimates that are subject to significant measurement uncertainty; • A lack of sufficient working capital to continue operations; • A declining or volatile industry with many business failures; and • Technological developments that might make a particular product obsolete.

Fraud Risk (Part of inherent or possible control risk)	The risk of an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.	There are two types of intentional misstatement that are relevant to the auditor: • Misstatements resulting from fraudulent financial reporting; and • Misstatements resulting from misappropriation of assets.
Control Risk (Do internal controls in place mitigate the inherent risks?)	Risk that the entity's internal control system will not prevent, or detect and correct on a timely basis, a misstatement that could be material, individually or when aggregated with other misstatements.	The entity should identify and assess its business and other risks (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally relate to specific assertions. Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.

Combined Risk	This is a term that is sometimes used to refer to the assessed (inherent and control risk) risks of material misstatement at both the financial statement level and the assertion level.	Auditors can make separate or combined assessments of inherent and control risks depending on preferred audit techniques or methodologies and practical considerations.
Detection Risk	This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level	The auditor identifies assertions where there are risks of material misstatement and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: • Selecting an inappropriate audit procedure; • Misapplying an appropriate audit procedure; or • Misinterpreting the results from an audit procedure.

Interrelationship of Audit Risk Components



Risks of Material Misstatement

Notes:

1. The term "entity level controls" incorporates many elements of the control environment, risk assessment and monitoring components of internal control.

2. Many business risks can also be fraud risks. For example, a poorly controlled sales system may result in risks of misstatement and also provides opportunity for fraud to occur. For this reason, it is suggested that separate lists be maintained of business and fraud risk factors.

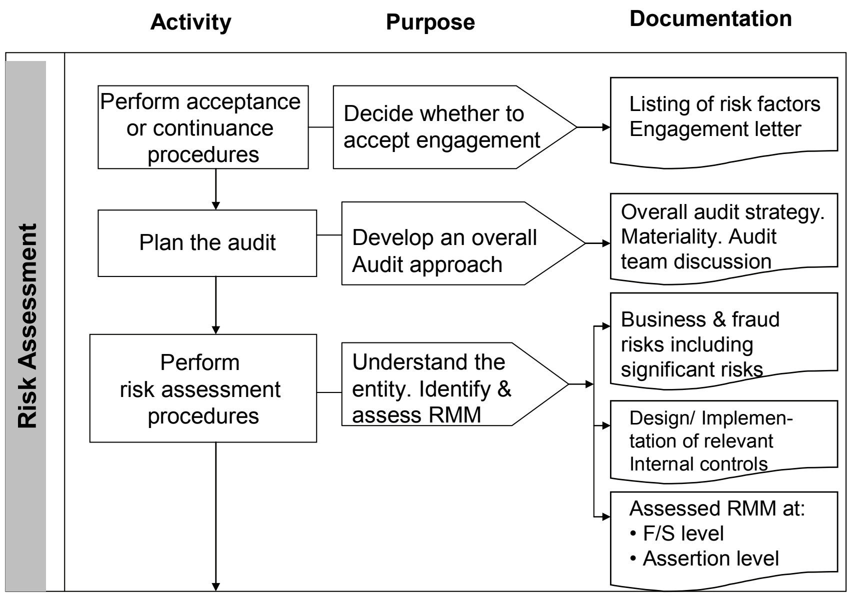
The Risk-based Approach

1.7 Throughout this Guide, the audit process is presented in three distinct phases:

- Risk assessment;
- Risk response; and
- Reporting.

The various tasks involved in each of these phases are outlined below. Each phase is addressed in more detail in subsequent chapters of this Guide.

Risk Assessment



1.8 Risk-based audits require practitioners to understand the entity and its environment, including internal control. The purpose is to identify and assess the risks of material misstatement of the financial statements. Because risk assessments require considerable professional judgment, this phase will likely require the time of the audit partner and senior audit personnel in identifying and assessing the various types of risk and then developing the appropriate audit response.

1.9 The risk assessment phase of the audit involves the following steps:

- Performing client acceptance or continuance procedures;
- Planning the overall engagement;
- Performing risk assessment procedures to understand the business and identify inherent and control risks;

- Identifying relevant internal control procedures and assessing their design and implementation (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the risks of material misstatement in the financial statements;
- Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- Communicating any material weaknesses in the design and implementation of internal control to management and those charged with governance; an
- Making an informed assessment of the risks of material misstatement at the financial statement level and at the assertion level.

Parts of the risk assessment phase of the audit can often be carried out well before the year end.

1.10 The time involved in performing risk assessment procedures may be offset by reducing, or even eliminating, audit work in low risk areas. The knowledge and insight gained can also be used to provide the entity's management with practical comments and recommendations on how to minimize or reduce risk.

1.11 An effective risk assessment process requires that all members of the engagement team be involved and that they communicate effectively. The audit team[1] should meet or talk together on a regular basis to share their insights. This can be achieved through:

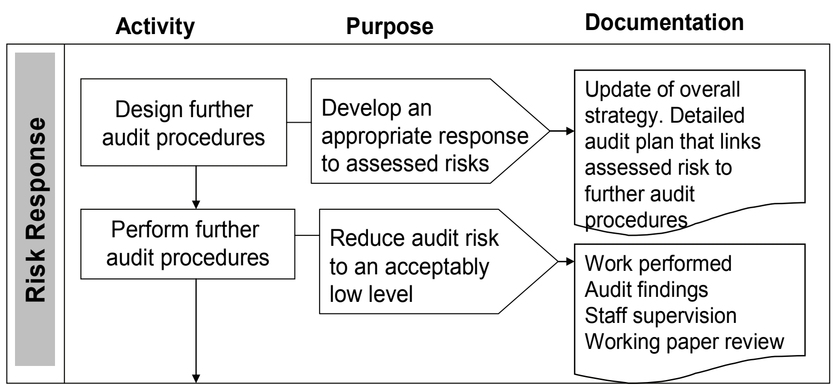
- A *team planning meeting* to discuss the overall audit strategy and detailed audit plan, brainstorm how fraud

[1] This Guide often refers to an audit team, which implies more than one person is involved in conducting the audit engagement. However, the same general principles also apply to audit engagements performed exclusively by one person (the practitioner).

could occur, and design audit procedures that may detect whether such fraud did in fact occur; and

- A *team debriefing meeting* (towards or at the end of the fieldwork) to discuss the implications of audit findings, identify any indications of fraud and determine the need, if any, to perform any further audit procedures.

Risk Response



1.12 The second phase of the audit is to design and perform further audit procedures that respond to the assessed risks of material misstatement and will provide the evidence necessary to support the audit opinion.

1.13 Some of the matters the auditor should consider when planning the audit procedures include:

- Assertions that cannot be addressed by substantive procedures alone. This can occur where there is highly automated processing of transactions with little or no manual intervention.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.

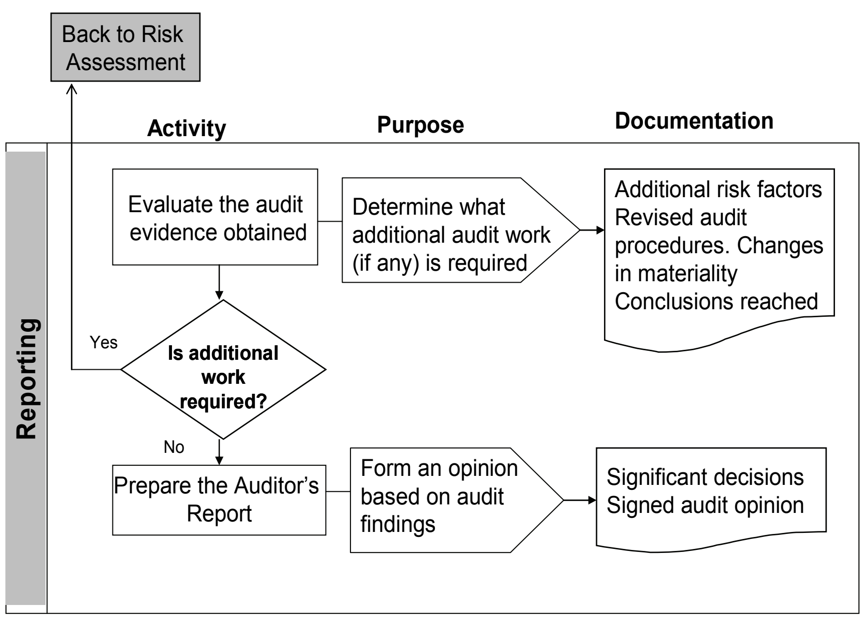
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.
- The need to perform specific procedures to address "significant risks" that have been identified.

1.14 Audit procedures designed to address the assessed risks could include a mixture of:

- Tests of the operational effectiveness of internal control; and
- Substantive procedures such as tests of details and analytical procedures.

1.15 Refer Appendix 7 and Appendix 9 in this Guide for a template on Risk Table and Responses to the Risks Identified.

Reporting



1.16 The final phase of the audit is to assess the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risks of material misstatement in the financial statements to an acceptably low level. It is important at this stage to determine:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- If any suspicious circumstances have been encountered.

1.17 Any additional risks should be appropriately assessed and further audit procedures performed as required.

When all procedures have been performed and conclusions reached:

- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed and a decision made on the appropriate wording for the auditor's report.

Summary

1.18 The risk-based audit requires auditors to first understand the entity and then to identify/assess the risks of material misstatement in the financial statements. This enables auditors to identify and respond to:

- Possible account balances, classes of transactions or financial statement disclosures that may be incomplete, inaccurately stated or altogether missing from the financial statements. Example:
  - Understated liabilities;
  - Unrecorded assets;
  - Assets such as cash/inventory that may have been misappropriated; and

  - Missing/incomplete disclosures.

- Areas of vulnerability where management override and manipulation of the financial statements could take place. Example:

  - Preparation of journal entries;
  - Revenue recognition policies; and
  - Management estimates.

- Other control weaknesses that, if not corrected, could lead to material misstatements in the financial statements.

1.19 Some of the benefits of this approach are summarised as follows:

- **Time flexibility for audit work**

  Risk assessment procedures can often be performed earlier in the entity's fiscal period than was possible before. Because risk assessment procedures do not involve the detailed testing of transactions and balances, they can be performed well before the year end, assuming no major operational changes are anticipated. This can help in balancing the workload of staff more evenly throughout the year. It may also provide the client with time to respond to identified (and communicated) weaknesses in internal control and other requests for assistance before the commencement of year-end audit fieldwork.

- **Audit team's effort focused on key areas**

  By understanding where the risks of material misstatement can occur in the financial statements, the auditor can direct the audit team's effort toward high-risk areas and away from lower-risk areas. This will also help to ensure audit staff resources are used effectively.

- **Audit procedures focused on specific risks**

  Further audit procedures are designed to respond to assessed risks. Consequently, tests of details that only address risks in general terms may be significantly reduced or even eliminated. The required understanding of internal control enables the auditor to make informed decisions on whether to test the operating effectiveness of internal control. Tests of controls (for which some controls may only require testing every three years) will often result in much less work being required than performing extensive tests of details.

- **Communication of matters of interest to management**

  The improved understanding of internal control may enable the auditor to identify weaknesses in internal control (such as in the control environment and general IT controls) that were not previously recognised. Communicating these weaknesses to management on a timely basis will enable them to take appropriate action, which is to their benefit. Also, this may in turn save time in performing the audit.

- **Improved audit file documentation**

  The SAs place a lot of emphasis on the need to carefully document each step of the audit process. Although this may add some additional cost at first, careful documentation will ensure that an audit file can stand by itself without the need for any oral explanations of what was done, why it was done, or how the audit conclusions were reached.

Part B
Risk Assessment

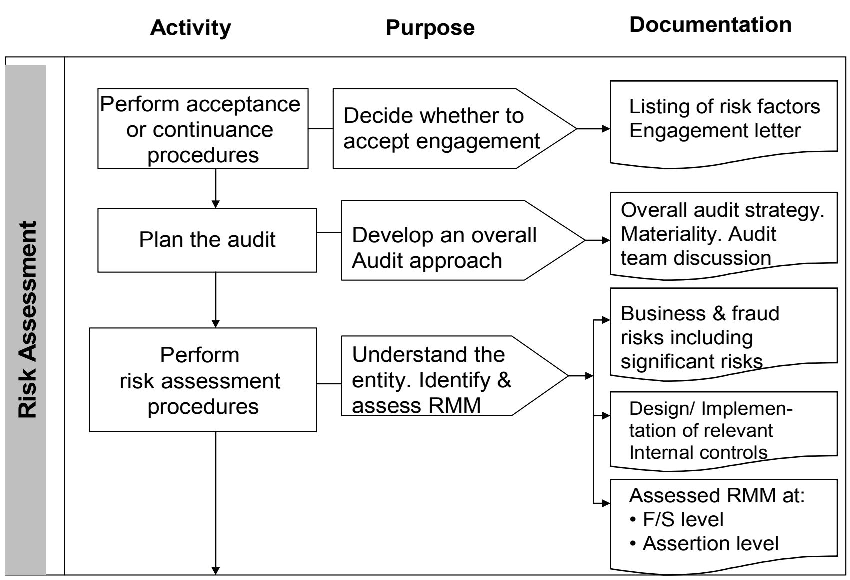
Chapter 2
Risk Assessment

Understanding the Entity

2.1 The purpose of this Section is to provide guidance on what is involved in understanding the entity and its environment necessary to:

- Identify and assess potential risk factors; and
- Sufficiently design and perform further audit procedures.

In this context SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" is the primary source of reference.



Overview

2.2 Paragraph 3 of SA 315 states:

"3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level."

2.3 Understanding the entity is an iterative process, continuing throughout the entire duration of the audit.

Paragraph 11 of SA 315 states:

"11. The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A15-A20)

(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. (Ref: Para. A21-A23)

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and

accounting policies used in the relevant industry. (Ref: Para. A24)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A25-A31)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A32-A37)."

2.4 Each year, the auditor's understanding of the entity should be updated and details of significant changes documented.

2.5 Financial statements provide a formal record of an entity's financial activities. Financial activities start with the entity's decision-making process, which will result from the business strategy, the control environment, and the business processes in place. As the decision-making process is implemented, business transactions take place which are recorded in the accounting records and summarised in financial statements. This is illustrated below.

2.6 Until the current risk-based Standards on Auditing (SAs) were issued, auditors would often gain a basic knowledge of the entity and then focus on obtaining sufficient audit evidence to support the content of the financial statements. Audit effort was primarily directed at the information about decisions made by management and the content of the financial statements.

2.7 The weakness of this approach was that the auditor may not be aware of, or fully comprehend, the significance of the information being recorded about decisions made by management. It is only by spending time to understand the nature of the business, the business strategy, its culture and values (control environment), the competence of the people, and the entity's structure and processes that it is possible to develop expectations about what types of information should, in fact, be recorded by the information system.

2.8 SAs require the auditor to take the time to properly understand the entity's decision-making processes. This includes the business strategy, the business and fraud risks factors, the culture, people and accountability relationships (control environment), and the internal controls established to address the risks. This foundation of understanding about the entity enables the auditor to:

- Identify business trends, risk factors, and key information that should be recorded in the entity's information system; and
- Plan more focused audit procedures (by responding to the specific risks identified) and thereby reduce the time being spent auditing certain financial statement balances.

2.9 Understanding the nature of the entity and its environment includes the following steps, as discussed in the corresponding Sections:

- What are Risk Assessment Procedures
- Business Risk
- Fraud Risk
- Significant Risks
- Internal Control
- Assessing Internal Control Design and Implementation
- Assessing the Risks of Material Misstatement

2.10 Understanding the nature of the entity and its environment, including internal control, provides the auditor with a frame of reference for making judgments about risk assessments and developing appropriate responses to risks of material misstatement in the financial statements.

2.11 This understanding assists the auditor in:

- Establishing materiality;
- Assessing management's selection and application of accounting policies;
- Considering the adequacy of financial statement disclosures;
- Identifying audit areas for special consideration (for example, related-party transactions, unusual or complex contractual arrangements, going-concern or unusual transactions);
- Developing expectations needed for performing analytical procedures;
- Designing/performing further audit procedures to reduce audit risk to an acceptably low level; and
- Evaluating sufficiency/appropriateness of audit evidence obtained (for example, Appropriateness of assumptions used and management's oral and written representations).

Consider Point

2.12 The information gained from risk assessment procedures conducted before engagement acceptance or continuance should be used as part of the audit team's understanding of the entity. It should be ensured that the information collected is readily available to the audit team after the engagement has been approved.

Sources of Information

2.13 Information about the entity and its environment can be obtained from both internal and external sources. In most cases, the auditor will start with the internal sources of information; however, these should be checked for consistency with information obtained from external sources. The following exhibit shows some of the potential sources of information available.

	Internal Sources	External Sources
Financial Information	• Financial statements • Budgets • Reports • Financial performance measures/metrics • Minutes • Income tax returns • Decisions made on accounting policies • Judgments and estimates	• Industry information • Competitive intelligence • Credit rating agencies • Creditors • Government Agencies • Franchisors • The media and other external parties
Non-financial Information	• Vision • Mission • Values • Objectives • Strategies • Organisation structure • Minutes • Job descriptions • Operating performance • Business drivers • Capabilities • Policy & procedure manuals • Non-financial performance measures/ metrics	• Trade association data • Industry forecasts • Government agency reports • Newspaper/ magazine articles • Information on the Internet

Consider Point

2.14 A major source of information is the auditor's own working paper files from previous years' engagements, if any, these often contain valuable information on matters such as:

- Considerations or issues to address in planning current year's audit;
- Evaluation and source of possible adjustments and uncorrected errors;

- Areas where there are recurring disagreements such as the assumptions used for accounting estimates;
- Areas which appear to be susceptible to error; and
- Matters raised in the auditor's communication with management and those charged with governance.

Scope of Understanding Required

2.15 In addition to the need to understand the relevant internal control, the auditor needs to understand and document four key areas, as outlined below.

1. External Factors	Nature of Industry Regulatory environment Financial reporting framework
2. Nature of Entity	Operations, ownership & governance People, investments & structure Application of accounting policies
3. Entity Objectives & Strategies	Related business risks Financial consequences
4. Measurement/ Review of Financial Performance	What key measures are used What pressures are on management to improve business performance

2.16 Additional information on each of the four areas is provided as follows.

External Factors

2.17 Matters to consider include:

- Industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments.
- The regulatory environment, including the applicable financial reporting framework.

- Specific risks arising from the nature of the business or the degree of regulation.
- The legal and political environment and environmental requirements affecting the industry and the entity.
- Laws or regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements.
- Other external factors, such as general economic conditions.

Nature of Entity

2.18 Matters to consider include:

- Entity's operations.
- Ownership and governance, including owners, family members, those charged with governance and relationships between owners and other people or entities.
- Types of investments (acquisitions, equipment, people, new products, locations, R&D, etc.) that the entity is making and plans to make.
- Entity structure (locations, subsidiaries, etc.) Complex structures may give rise to risks of material misstatement such as:
  - Allocation of goodwill and its impairment; and
  - Accounting for investments.
- How related party transactions are identified and accounted for.
- How the entity is financed.
- Whether the accounting policies appropriate for the business?
- Whether the accounting policies used in the relevant industry?

- Whether the accounting policies consistent with the applicable financial reporting framework?
- What methods are used to account for significant and unusual transactions?
- Whether there significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus? If so, consider the effect of using such policies.
- Whether there are any changes in the entity's accounting policies during the period? (This includes new financial reporting standards/regulations.) If so:
    - Document the reasons and consider appropriateness; and
    - Consider consistency with requirements of the applicable financial reporting framework.
- Whether there is adequate disclosure of material matters in the financial statements? Consider form, arrangement and content of the financial statements and footnotes, classification of items, amount of detail provided and basis of amounts set forth.

Entity Objectives and Strategies

2.19 Matters to consider include:

- Obtaining a copy of any mission, vision or values statement produced by the entity (such as in promotional or web-based materials) and consider its consistency with the entity's strategy and objectives. In smaller entities, this information will not often be documented but could possibly be obtained through discussions with management and observation of how they respond to such matters.

- Identifying and documenting the entity's strategies (that is, operational approaches by which management intends to achieve its objectives).
- Identifying and documenting the entity's current objectives (that is, its overall plans for the entity both short term and long term). In smaller entities, this information will likely be obtained through inquiry of management and observation of how they respond to such matters.
- Based on the understanding obtained about mission, vision, business strategies and objectives, identifying and documenting the related business risks.
- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies or through the setting of inappropriate objectives and strategies.

Measurement/ Review of Financial Performance

2.20 Matters to consider include:

- Identifying the key measures used by management to assess the entity's performance and achievement of objectives.
- Are there external parties that measure and review the entity's financial performance (regulators, franchisors, lending institutions, and so forth)? If so, consider whether copies of such reports should be obtained from the entity (for example, credit rating agency reports).
- Did the performance measures motivate management to take action to:
    - Improve the business performance?
    - Heighten risk by taking aggressive actions to achieve objectives?
    - Meet personal goals such as achieving a bonus threshold?

- Do the performance measures:
  - Highlight any unexpected results or trends?
  - Indicate trends or results consistent with the industry as a whole?
- Are the performance measures based on reliable information and precise enough to be used as a basis for analytical procedures?

2.21 Each industry tends to have its own key performance indicators (financial and non-financial) which the auditor should identify and consider first. Some typical key performance indicators include:

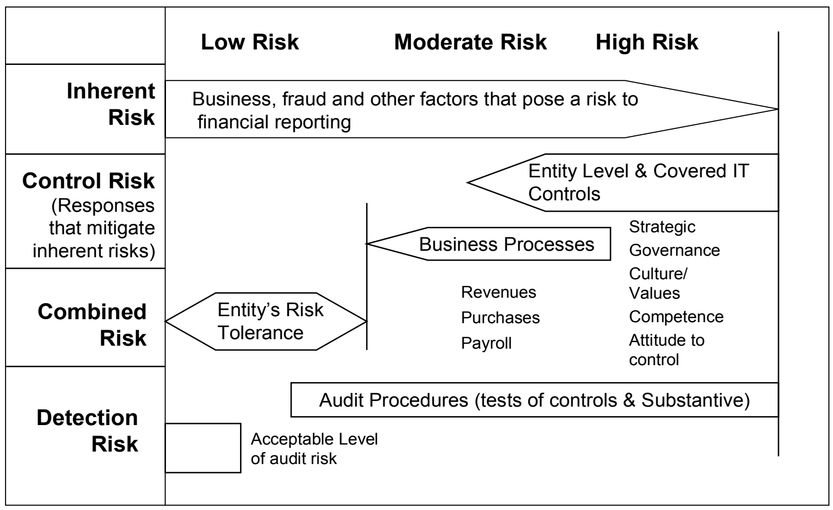
- Comparisons of performance to budgets;
- Variance analysis;
- Gross margin by product;
- Unit sales;
- Repeat contracts;
- New and lost customers;
- Segment information;
- Divisional, departmental or other level performance reports; and
- Comparison of the entity's performance with that of its competitors.

2.22 In smaller entities, management may rely on just one or two key indicators that may be reliable for evaluating financial performance and taking appropriate action.

2.23 The auditor should also consider information obtained from other sources, such as engagement acceptance and continuance procedures, that may be relevant to any of the four key areas that the auditor needs to understand and document.

Classifying the Information Obtained

2.24 The purpose of understanding the entity is to perform a risk assessment. This involves the identification and then the assessment of potential risks of material misstatement in the financial statements. The information obtained will consist of risk factors or sources of risk and the internal control system in place that will mitigate such risks, as illustrated in the exhibit below.

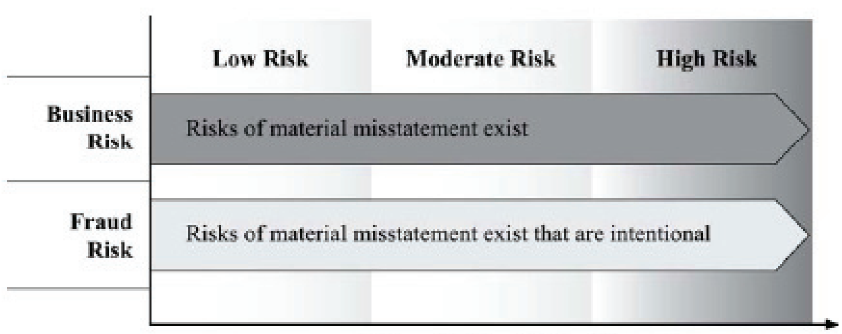


Risks of Material Misstatement

Note: The term "entity level controls" incorporates many elements of the control environment, risk assessment, and monitoring components of internal control.

The sources of risk and the mitigation of risk can be further broken down as illustrated in the exhibit below.

Sources of Risk



Risks of Material Misstatement

Note: The term "entity level controls" incorporates many elements of the control environment, risk assessment, and monitoring components of internal control.

2.25 The term "business risk" is broader than the risks of material misstatement in the financial statements. Business risk may also arise from change, complexity, or the failure to recognize the need for change. Change may arise, for example, from:

- The development of new products that may fail;
- An inadequate market, even if successfully developed; or
- Flaws that may result in liabilities and risk to reputation.

2.26 The auditor's understanding of the business risks increases the likelihood of identifying the risks of material misstatement. However, there is no responsibility for auditors to identify or assess all business risks.

2.27 The sufficiency of information (depth of understanding) required by the auditor is a matter of professional judgment. It is less than that possessed by management in managing the entity.

2.28 Subsequent sections in this Guide address the identification of business risk factors, fraud risk factors, internal control, and the combined risk assessment.

Documentation

2.29 The auditor should document key elements of the understanding obtained regarding each of the aspects of the entity and its environment, as outlined above. Professional judgment should be used regarding the manner in which these matters are documented. The more complex the entity and the audit procedures required, the more extensive the documentation will be.

2.30 Documentation will, normally, include:

- Discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud and the significant decisions reached.

- Key elements of the understanding of the entity obtained regarding:
  - Each of the aspects of the entity and its environment outlined above;
  - Each of the internal control components;
  - 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 assertion level.
- Significant risks identified and evaluation of related controls.

2.31 In the documentation, it is important to obtain, in writing, management's acceptance of responsibility for the design and implementation of internal control. Refer Appendix 4 and Appendix 5 to the Guide for a template for understanding the entity and information systems.

Consider Point

2.32 It may not be necessary to prepare new documentation each year. The previous year's documents may be updated with changes and fresh information. But it should be ensured that changes can be identified as being made in the current audit period to document the fact that the information was updated.

Internal control

2.33 Internal control is designed and implemented by management to address identified business and fraud risks that threaten the achievement of stated objectives, such as the reliability of financial reporting. A control is always designed to respond (mitigate) to a possible risk. A control that does not address a risk is obviously redundant.

2.34 The first step in evaluating control design is to identify the risks that require mitigation by control. The second step is to identify what controls are in place to address those risks. This is often called the top-down approach to assessing control risk. The alternative is to first identify the controls in place and then match the controls to the risks that require mitigation.

Internal Control Objectives

2.35 Internal control is management's response to mitigate an identified risk factor or achieve a control objective. There is a direct relationship between an entity's objectives and the internal control it implements to ensure their achievement. Once objectives are set, it is possible to identify and assess potential events (risks) that would prevent the achievement of the objectives. Based on this information, management can develop appropriate responses, which will include the design of internal control.

2.36 Internal control objectives, and therefore the entity's internal control, can be broadly grouped into four categories:

- Strategic, high-level goals that support the mission of the entity;
- Financial reporting (internal control over financial reporting);
- Operations (operational controls); and
- Compliance with laws and regulations.

2.37 Internal control relevant to an audit primarily pertains to financial reporting. This addresses the entity's objective of preparing financial statements for external purposes.

2.38 Operational controls, such as production and staff scheduling, quality control and employee compliance with health and safety requirements, would not normally be relevant to the audit, except where:

- The information produced is used to develop an analytical procedure; or
- The information is required for disclosure in the financial statements.

For example, if production statistics were used as a basis for an analytical procedure, the controls to ensure the accuracy of such data would be relevant. If non-compliance with certain laws and regulations has a direct and material effect on the financial statements, the controls for detecting and reporting on such non-compliance would be relevant.

Internal Control Components

2.39 The term "internal control" is much broader than some of the traditional definitions of internal control that focused narrowly on control activities, such as segregation of duties, authorizations and account reconciliations, etc. Internal control encompasses five key components:

- The control environment;
- The entity's risk assessment process;
- The information system, including the related business processes relevant to financial reporting and communication;
- Control activities; and
- Monitoring of internal control.

2.40 These components as they relate to the entity's financial reporting objectives are illustrated below.

The division of internal control into these five components provides a useful framework for auditors in understanding the different aspects of an entity's internal control system. However, it should be noted that:

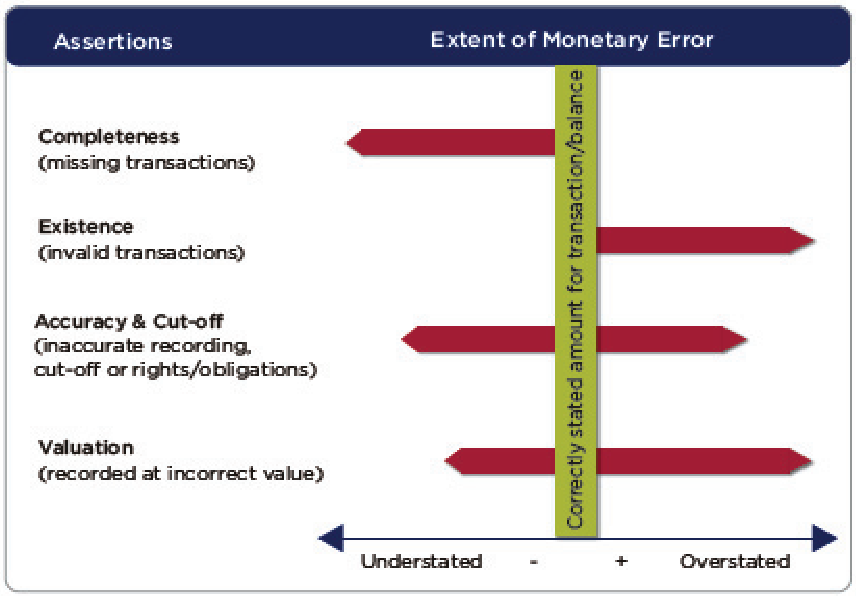
- The way in which the internal control system is designed and implemented will vary based on the entity's size and complexity. Smaller entities often use less formal means and simpler processes and procedures to achieve their objectives. The five components of internal control may not be so clearly distinguished; however, their underlying purposes are equally valid. For example, an owner-manager may (and, in the absence of additional staff, should) perform functions belonging to several of the components of internal control.

- Different terminology or frameworks can be used to describe the various aspects of internal control and their effect on the audit, but all five components are to be addressed in the audit.

- The auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances or disclosures and their related assertions, rather than its classification into any particular internal control component.

A summary of the five internal control components is provided in the sections that follow.

Financial Statement Assertions



2.41 Representations by management, such as that the financial statements as a whole are presented fairly in accordance with the applicable financial reporting framework, contain a number of embedded assertions. These assertions relate to the recognition, measurement, presentation and disclosure of the various elements (amounts and disclosures) in the financial statements. Examples of management's assertions include:

- All the assets in the financial statements exist;
- All sales transactions have been recorded in the appropriate period;
- Inventories are stated at appropriate values;
- Payables represent proper obligations of the entity;
- All recorded transactions occurred in the period under review; and

- All amounts are properly presented and disclosed in the financial statements.

2.42 These assertions are often summarized by appropriate terms such as completeness, existence, occurrence, accuracy, valuation, etc. For example, management may assert to the auditor that the sales balance in the accounting records contains all the sales transactions (completeness assertion), the transactions took place and are valid (occurrence assertion), and transactions have been properly recorded in the accounting records and in the appropriate accounting period (accuracy and cut-off assertion).

Description of Assertions

2.43 The categories of assertions that can be used by the auditor to consider the different types of potential misstatements are described below.

	Assertion	Description
Classes of Transactions and Events for the Period under Audit	Occurrence	Transactions and events that have been recorded have occurred and pertain to the entity.
	Completeness	All transactions and events that should have been recorded have been recorded.
	Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately.
	Cut-off	Transactions and events have been recorded in the correct accounting period.
	Classification	Transactions and events have been recorded in the proper accounts.

	Assertion	Description
Account Balances at the Period End	Existence	Assets, liabilities, and equity interests exist.
	Rights and Obligations	The entity holds or controls the rights to assets and liabilities are the obligations of the entity.
	Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded.
	Valuation and Allocation	All assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

	Assertion	Description
Presentation and Disclosure	Occurrence, Rights and Obligations	Disclosed events, transactions and other matters have occurred and pertain to the entity.
	Completeness	All disclosures that should have been included in the financial statements have been included.
	Classification and Understandability	Financial information is appropriately presented and described and disclosures are clearly expressed.
	Accuracy and Valuation	Financial (and other) information is disclosed fairly and at appropriate amounts.

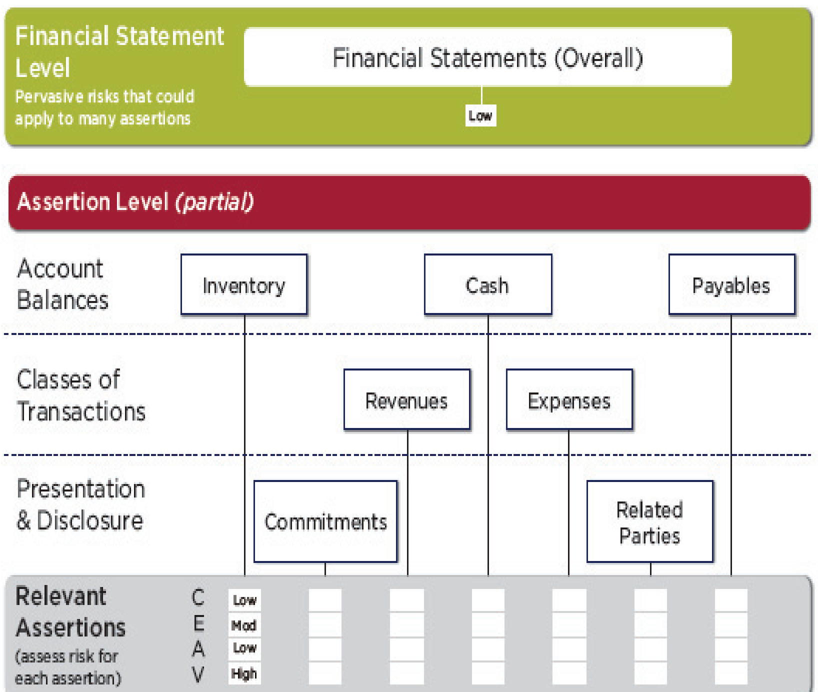
Using Assertions in Auditing

2.44 As previously stated, the financial statements contain a number of embedded assertions. Assertions can be used by the auditor in assessing risks at the financial statement level and the assertion level.

Assessing Risks at	Commentary
Financial Statement Level	The risks of material misstatement at the financial statement level tend to be pervasive and therefore address all the assertions. For example, if the top accountant is not competent enough for the assigned tasks, it is quite possible that errors could occur in the financial statements. However, the nature of such errors will not often be confined to a single account balance, transaction stream or disclosure. In addition, the error will not likely be confined to a single assertion such as the completeness of sales. It could just as easily relate to other assertions such as accuracy, existence and valuation.
Assertion Level	Risks at the assertion level relate to individual account balances at a point in time (i.e., the period end), classes of transactions (for the fiscal period) and presentation and disclosure in the financial statements. Pervasive risks that address all assertions are assessed at the financial statement level. The relevance of each assertion to an individual account balance (or class of transactions or presentation and disclosure) will vary based on the characteristics of the balance and the potential risks of material misstatement. For example, when considering the valuation assertion, the auditor could assess the risk of error in payables as low; however, for inventory where obsolescence is a factor, the auditor would assess the valuation risk as high.

	Another example would be where the risks of material misstatement due to completeness (missing items) in the inventory balance are low, but high in relation to the sales balance.

2.45 The difference between the two levels of risk assessment is illustrated in partial form in the exhibit below.



2.46 Assertions are used by the auditor to form a basis for:

- Considering the different types of potential misstatements that may occur;
- Assessing the risks of material misstatement; and
- Designing further audit procedures that are responsive to the assessed risks.

Use of Assertions	Procedures
Considering Types of Potential Misstatement	This would include performing risk assessment procedures to identify possible risks of material misstatement. For example, the auditor might ask questions such as the following: • Does the asset exist? (Existence) • Does the entity own it? (Rights obligations) • Are all the sales transactions properly recorded? (Completeness) • Has the inventory balance been adjusted for slow-moving and obsolete items? (Valuation) • Does the payable balance include all known liabilities at the period end? (Completeness) • Were transactions recorded in the right period? (Cut-off) • Are amounts properly presented and disclosed in the financial statements? (Accuracy)
Assessing Risks of Material Misstatement	The risk of material misstatement is a combination of inherent risk and control risk. The assessment process

	includes: • Inherent risk Identify potential misstatements and the assertions involved and then assess the likelihood of the risk's occurrence and possible magnitude. • Control risk Identify and evaluate any relevant internal controls in place that mitigate the assessed risks and address the underlying assertions.
Designing Audit Procedures	The final step is to design audit procedures to be responsive to the assessed risks by assertion. For example, if the risk is high that receivables are overstated (existence assertion), the audit procedures should be designed to specifically address the existence assertion. If sales completeness was a risk, the auditor could design a test of controls that addresses the completeness assertion.

Materiality and Audit Risk

2.47 Materiality addresses the significance of financial statement information to economic decisions taken by users on the basis of the financial statements. The determination of materiality by an auditor is a matter of professional judgment.

2.48 The concept of materiality recognizes that some matters, either individually or in the aggregate, are important to people making an economic decision based on the financial statements. This could include decisions such as whether to invest in, purchase, do business with, or lend money to an entity.

2.49 When a misstatement (or the aggregate of all misstatements) is significant enough to change or influence the decision of an informed person, a material misstatement has occurred. Below this threshold, the misstatement is generally regarded as not material. For example, if it is determined that the decision of a financial statement user group would be influenced by a misstatement of Rs. 10,000 in the financial statements, the auditor would need to plan and perform procedures to detect any misstatements of that amount or in excess of that amount.

2.50 Materiality is often explained (such as in financial reporting frameworks) in the terms set out below.

Influence on Making Economic Decisions

2.51 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.

Surrounding Circumstances

2.52 Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement or a combination of both.

Common Needs of Users

2.53 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.

2.54 The auditor determines materiality based on his/her perception of the needs of users. In applying his/her professional judgment, it is reasonable for the auditor to assume that users of the financial statements:

- Have a reasonable knowledge of business, economic activities, and accounting and have a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared and audited to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.
- Misstatements may arise from a number of causes and can be based on the following.
- Size — the monetary amount involved (quantitative);
- Nature of the item (qualitative); and
- Circumstances surrounding the occurrence.

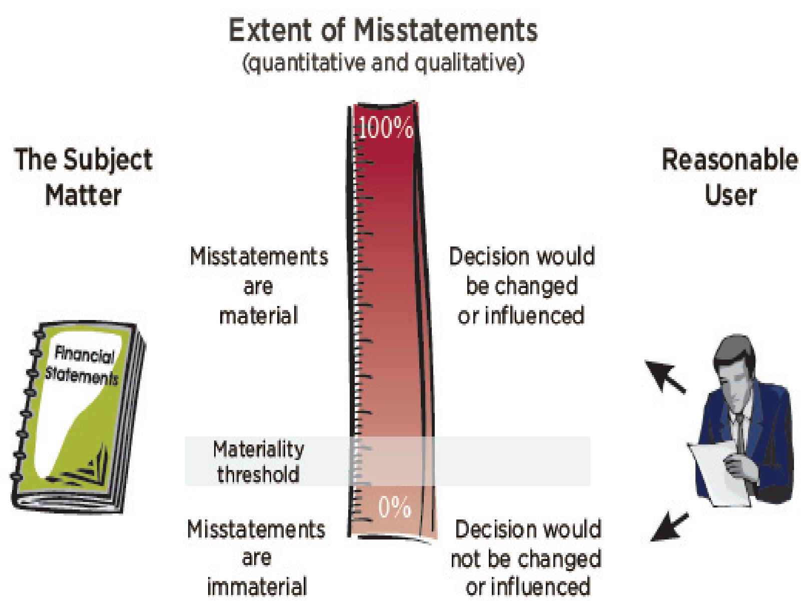
Typical Misstatements

- Errors and fraud identified in the preparation of the financial statements;
- Departures from the applicable financial reporting framework;
- Employee and management fraud;
- Management error;
- Preparation of inaccurate or inappropriate estimates; or
- Inappropriate or incomplete descriptions of accounting policies or note disclosures.

2.55 Materiality is not an absolute number. It represents a grey area between what is very likely not material and what is very likely material. Consequently, the assessment of what is material is always a matter of professional judgment.

2.56 In some situations, a matter well below the quantitative materiality level may be determined as material based on the nature of the item or the circumstances related to the misstatement. For example, the information that there are a number of transactions with related parties may be very significant to a person making a decision based on the financial statements.

2.57 Finally, a series of immaterial items may well become material when aggregated.



Materiality and Audit Risk

2.58 Materiality (as discussed above) and audit risk are related and are considered together throughout the audit process. Audit risk is the possibility that an auditor expresses an inappropriate audit opinion on financial statements that are materially misstated.

Audit Risk Components

Risks of Material Misstatement (RMM)	The risk that the financial statements are materially misstated prior to the start of any audit work. These risks are considered at the financial statement level (often pervasive risks, affecting many assertions) and at the assertion level, which relates to classes of transactions, account balances, and disclosures. RMM is a combination of inherent risk (IR) and control risk (CR), which can be summarized as IR x CR = RMM
Detection Risk	The risk that the auditor fails to detect a misstatement that exists in an assertion that could be material. Detection risk (DR) is addressed through: • Sound audit planning; • Performing audit procedures that respond to the risks of material misstatement identified; • Proper assignment of audit personnel; • The application of professional skepticism; and • Supervision and review of the audit work performed.

2.59 Detection risk can never be reduced to zero. This is because of the inherent limitations in the audit procedures carried out, the human (professional) judgments required and the nature of the evidence examined.

Audit risk (AR) can therefore be summarized as:

AR = RMM x DR

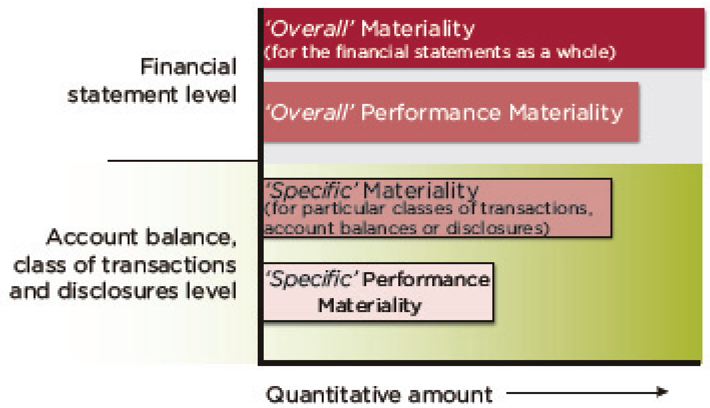
2.60 Materiality and audit risk are considered throughout the audit in:

- 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.

2.61 Using a simple analogy of a high jump in athletics, materiality would be equivalent to the height of the bar that the athlete has to jump over. Audit risk is equivalent to the level of difficulty inherent in the jump at that particular height (RMM) combined with the additional risk of making a mistake in jump strategy or execution (detection risk).

Materiality Levels

2.62 For purposes of the SAs, 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.



Note: Overall materiality refers to the financial statements as a whole and specific materiality relates to materiality of particular classes of transactions, account balances or disclosures.

2.63 At the start of the audit, the auditor makes judgments about the size and nature of misstatements that would be considered material. This includes establishing materiality amounts as set out below.

Establishing Materiality Amounts

Overall Materiality (for the financial statements as a whole)

2.64 Overall materiality relates to the financial statements as a whole. It is based on the extent of error of what could reasonably be expected to influence the economic decisions of the financial statement users, taken on the basis of the financial statements. It would not be changed as a result of audit findings.

Overall Performance Materiality

2.65 Performance materiality is set at a lower amount than the overall materiality. Performance materiality enables the auditor to respond to specific risk assessments (without changing the overall materiality) and to allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount. Performance materiality would be changed based on audit findings (such as where a risk assessment was revised).

Specific Materiality

2.66 Specific materiality is established for classes of transactions, account balances or disclosures where misstatements of lesser amounts than overall materiality could reasonably be expected to influence the economic decisions of users, taken on the basis of the financial statements.

Specific Performance Materiality

2.67 Specific performance materiality is set at a lower amount than the specific materiality. This enables the auditor to respond to specific risk assessments and to allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount.

Overall Materiality

2.68 Overall materiality level (for the financial statements as a whole) is based on the auditor's perception of the financial information needs of users of the financial statements. Using professional judgment, the auditor would set materiality at the highest amount of misstatement that would not influence the economic decisions of financial statement users.

2.69 Once established, the overall materiality amount becomes the standard by which the ultimate success or failure of the audit will be judged. For example, assume overall materiality was set at an amount of Rs. 20,000. If as a result of performing audit procedures:

- No errors were found — an unqualified opinion would be provided.
- Uncorrected errors exceeding materiality (of Rs. 20,000) were found and the client was unwilling to make the necessary adjustments — a qualified or adverse opinion would be required.
- Uncorrected errors exceeding materiality (of Rs. 20,000) exist in the financial statements but were not detected by

the auditor — an inappropriate unqualified audit opinion may be issued.

2.70 Auditors are sometimes tempted to lower the overall materiality amount when the risk of material misstatement is assessed as high. This would not be appropriate, however, as overall materiality addresses the needs of financial statements users, not the level of audit risk involved.

2.71 If audit risk was a factor in setting overall materiality, a high-risk audit would end up with a lower overall materiality amount than that set for a similar-sized entity where audit risk was low.

2.72 Assuming that the information needs of financial statement users are the same, regardless of audit risk, setting the overall materiality amount at a lower level would result in:

- Providing financial statement users with an expectation that smaller misstatements in the financial statements (than is actually necessary) will be identified by the auditor; and
- Additional audit work to ensure the risk of material misstatement (defined as errors and fraud in excess of the amount set for overall materiality) has been reduced to an appropriately low level.

Because overall materiality is set in relation to the needs of financial statement users, it would not be changed as a result of the audit findings and changes in assessed risks. Overall materiality would only be updated for a change in the perceived needs of financial statements users.

2.73 At the conclusion of the audit, overall materiality will be used for evaluating the effect of identified misstatements on the financial statements and the appropriateness of the opinion in the auditor's report.

Performance Materiality

2.74 Performance materiality allows the auditor to address the risks of misstatement in account balances, classes of transactions and disclosures without having to change the overall materiality. Performance materiality enables the auditor to establish materiality amounts that are lower than overall materiality to reflect the risk assessments. This lower amount establishes a safety buffer between the materiality used for determining the nature and extent of testing (performance materiality) and the materiality amount for the financial statements as a whole (overall materiality).

2.75 Setting an appropriate amount for performance materiality will ensure that more work is performed, which increases the likelihood that misstatements (if they exist) will be identified.

For example, if overall materiality was Rs. 20,000 and audit procedures were planned to detect all errors in excess of Rs. 20,000, it is quite possible that an error of say Rs. 8,000 would go undetected. If three such errors existed, amounting to Rs. 24,000, the financial statements would be materially misstated. However, if performance materiality was set at Rs. 12,000, it would be much more likely that at least one or all of the Rs. 8,000 errors would be detected. Even if only one of the three errors was identified and corrected, the remaining misstatement of Rs. 16,000 would be less than the overall materiality and the financial statements as a whole would not be materially misstated.

2.76 Setting an appropriate amount for performance materiality involves the exercise of professional judgment and is not a simple mechanical calculation such as a percentage (for example, 75%) of the overall materiality level. However, based on the particular circumstances of the entity being audited, it could be set as a single amount for the financial statements as a whole, or at individual amounts for particular balances, transactions and disclosures.

2.77 The determination of performance materiality involves the exercise of professional judgment based on factors that address audit risk such as the following:

- Understanding of the entity and results of performing risk assessment procedures;
- Nature and extent of misstatements identified in previous audits; and,
- Expectations of possible misstatements in the current period.

2.78 Performance materiality as a whole or for individual balances, transactions and disclosures can be changed at any time during the audit (without impacting overall materiality) to reflect revised risk assessments, audit findings and new information obtained.

2.79 At the conclusion of the audit, the overall materiality would be used for evaluating the effect of identified misstatements on the financial statements and determining the opinion to be expressed in the auditor's report.

Specific Materiality

2.80 There are some situations where 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.

Decision Influencers	Possible Examples
Laws, Regulations and Requirements of the Financial Reporting Framework	• Sensitive financial statement disclosures such as the remuneration of management and those charged with governance. • Related-party transactions. • Non-compliance with loan covenants, contractual agreements, regulatory provisions and statutory /

	regulatory reporting requirements. • Certain types of expenditures such as illegal payments or executives' expenses.
Key Industry Disclosures	• Reserves and exploration costs for a mining entity. • Research and development costs for a pharmaceutical entity.
Disclosure of Significant Events and Important Changes in Operations	• Newly acquired businesses or expansion of operations. • Discontinued operations. • Unusual events or contingencies (e.g., lawsuits). • Introduction of new products and services.

2.81 The auditor would consider the existence of matters such as the above for one or more particular classes of transactions, account balances or disclosures. The auditor may also find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

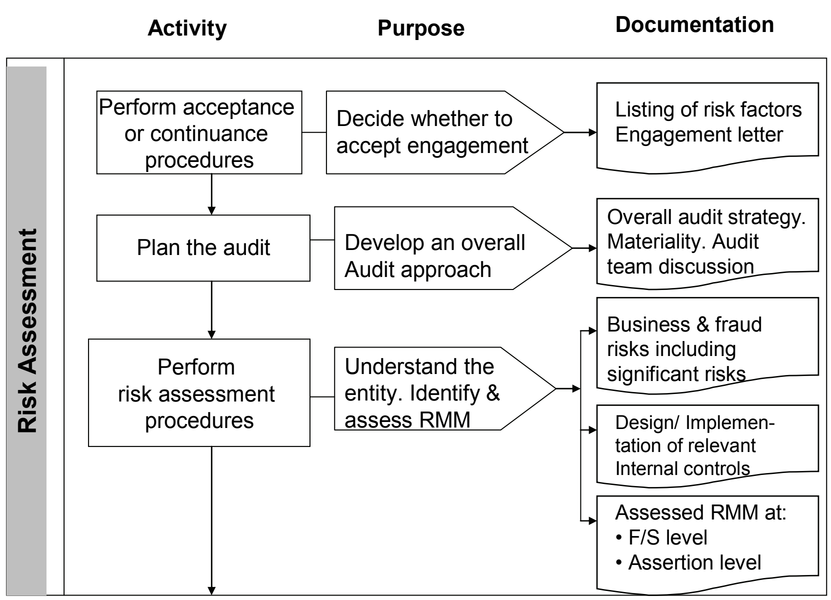
2.82 Once a specific materiality amount has been determined a specific performance materiality may be set. This would be a smaller amount than the specific materiality to ensure sufficient audit work is performed to allow for the possible existence of undetected and immaterial misstatements aggregating to a material amount.

Documentation of Materiality

2.83 Because materiality amounts are based on the auditor's professional judgment, it is important that the factors and amounts involved in determining materiality at the various levels be properly documented. This would typically occur during the planning phase and then later in the audit should revisions be required. Documentation would address:

- The users of the financial statements;
- Determination of overall materiality relating to the financial statements as a whole;
- Performance materiality indicating any specific considerations relating to particular classes of transactions, account balances or disclosures and any revisions made to performance materiality during the audit; and
- Nature of revisions (if any) made to the overall or performance materiality amounts.

Risk Assessment Procedures



2.84 The purpose of this Section is to explain the purpose and nature of risk assessment procedures and how they relate to the development of the detailed audit plan and overall audit strategy.

In this context SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" is the primary source of reference.

Overview

2.85 Paragraph 6 of SA 315 states:

"6. The risk assessment procedures shall include the following:

(a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6)

(b) Analytical procedures. (Ref: Para. A7-A8)

(c) Observation and inspection. (Ref: Para. A9)"

2.86 Paragraph 9 of SA 315 states:

"9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A10-A11)"

2.87 The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit.

2.88 Risk assessment procedures are designed for obtaining an understanding of the entity and its environment, including its internal control. This understanding should be a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit.

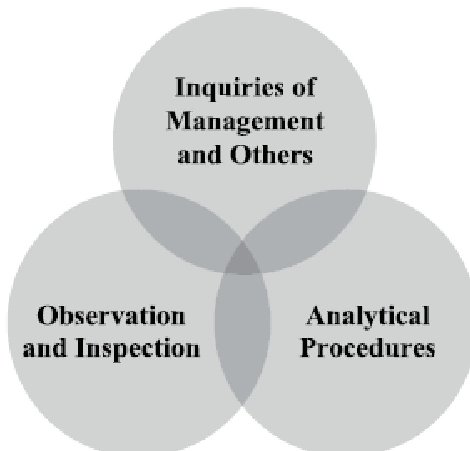
Nature of Evidence Obtained

2.89 Risk assessment procedures provide the audit evidence necessary to support the assessment of risks at the financial statement and assertion levels. However, this evidence does not stand alone. At the risk response phase of the audit, the evidence obtained will be supplemented by further audit procedures (that respond to the risks identified) such as tests of controls and/or substantive procedures.

Where efficient, further procedures such as substantive procedures or tests of controls may be performed concurrently with the risk assessment procedures.

Required Procedures

2.90 There are three risk assessment procedures, as illustrated below.



Each of these procedures should be performed during the audit, but not necessarily for each aspect of the understanding required. In many situations, the results from performing one type of procedure may lead to another. For example, the findings from analytical procedures on preliminary operating results may trigger inquiries of management. The answers to the inquiries may then lead to requests to inspect certain documents or observe some activities.

The nature of the three procedures is outlined below.

Inquiries of Management and Others

2.91 The goal of this procedure is to understand the entity and to identify/assess the various sources of risk that exist. Some areas of inquiry would include those outlined in the following table.

Inquire To	Inquire About
Management and Those Responsible for Financial Reporting / Those Charged with Governance	• The processes in place for identifying and responding to the risks of fraud and error in the financial statements. • How management communicates, if at all, to employees regarding its views on business practices, adherence to policies and procedures, and ethical behavior. • The role they play. • The entity's culture (values and ethics). • Management's operating style. • Management incentive plans. • Potential for management override. • Knowledge of fraud or suspected fraud. • The financial statement preparation and review process. Also consider attending a meeting of those charged with governance and reading the minutes of their meetings.
Key Employees (Purchasing, payroll, accounting, etc.)	• The initiating, processing or recording of complex or unusual transactions. • The extent of management override (have they ever been asked to override internal controls). • The appropriateness/application of the accounting policies used.

Marketing or Sales Personnel	• Marketing strategies and sales trends. • Sales performance incentives. • Contractual arrangements with customers. • The extent of management override (have they ever been asked to override internal controls or revenue recognition accounting policies?).

Consider Point

2.92 The questions, especially in smaller audits, should not be confined to the owner-manager and the accountant. Others in the entity (such as the sales manager, production manager or other employees) may also be inquired about trends, unusual events, major business risks, the functioning of internal control, and any instances of management override.

Analytical Procedures

2.93 Analytical procedures used as risk assessment procedures help to identify matters that have financial statement and audit implications. Some examples are unusual transactions or events, amounts, ratios, and trends.

2.94 There are two other major purposes for using analytical procedures:

- As the primary source of evidence for a financial statement assertion. This would be a substantive analytical procedure; and
- In performing an overall review of the financial statements at, or near, the end of the audit.

2.95 Most analytical procedures are not very detailed or complex. They often use data aggregated at a high level, which means the results can only provide a broad initial indication about whether a material misstatement may exist.

2.96 The steps involved in performing analytical procedures are outlined below.

What to do	How to do it
Identifying Relationships Within the Data	Develop expectations about plausible relationships among the various types of information that could reasonably be expected to exist. Seek to use independent sources of information (that is, not internally generated) where possible. The financial and non-financial information could include: • Financial statements for comparable previous periods; • Budgets, forecasts, and extrapolations, including extrapolations from interim or annual data; and • Information regarding the industry in which the entity operates and current economic conditions.
Comparing	Compare expectations with recorded amounts or ratios developed from recorded amounts.
Evaluating Results	Evaluate the results. Where unusual or unexpected relationships are found, consider potential risks of material misstatement.

2.97 The results of these analytical procedures should be considered along with other information gathered to:

- Identify the risks of material misstatement related to assertions embodied in significant financial statement items; and
- Assist in designing the nature, timing and extent of other auditing procedures.

Observation and Inspection

2.98 Observation and inspection support the inquiries made of management and others and provide information about the entity and its environment.

2.99 Observation and inspection procedures ordinarily include a procedure and its application, as outlined below.

Procedure	Application
Observation	• How the entity operates and is organized; • Management's operating style and attitude toward internal control; • Operation of various internal control procedures; and • Compliance with certain policies.
Inspection	• Business plans and strategies; • Accounting policies and records; • Internal control manuals; • Reports prepared by management (such as

	interim financial statements); and • Other reports such as minutes from meetings of those charged with governance, reports from consultants, etc..

Other Risk Assessment Procedures

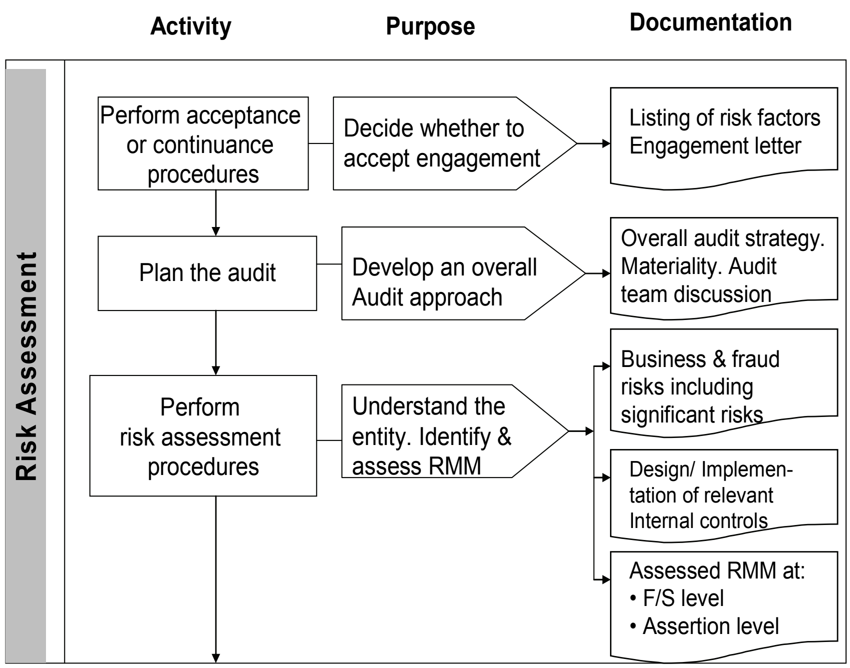
2.100 Other procedures not listed above may also be used for risk assessment purposes. Examples include:

- Information obtained from pre-engagement procedures;
- Experience gained from previous engagements and other engagements performed for the entity;
- Information about the entity and its environment obtained in prior periods such as:
  - Organizational structure, business processes, and internal control,
  - Past misstatements and whether they were corrected on a timely basis, and
  - Before such information can be used, the auditor should first determine (through inquiries, walkthroughs, etc.) whether changes have occurred that may affect its relevance to the current audit;
- Inquiries of the entity's external legal counsel or of valuation experts;
- Reviewing information obtained from external sources such as reports by banks or rating agencies, trade and economic journals, and regulatory and financial publications;

- Evidence obtained from evaluating the design of internal control and determining whether the control procedures have been implemented; and
- Results of discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatements.

Refer Appendix 6 and Appendix 8 to the Guide for a template on risk assessment procedures and risk identification.

Overall Audit Strategy



2.101 The purpose of this Section is to describe the steps involved in developing the overall audit plan, including the overall audit strategy to address the identified risks of material misstatement. In this context, SA 300, "Planning an Audit of Financial Statements" is the primary source of reference.

Overview

2.102 SA 300 states:

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

Planning is important to ensure that the engagement is performed in an efficient and effective manner and that audit risk has been reduced to an acceptably low level.

Audit planning is not a discrete phase of the audit. It is a continual and iterative process that starts shortly after completion of the previous audit and continues until the completion of the current audit.

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

8. The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”.

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 “The Auditor’s Responses to Assessed Risks”.

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.”

2.103 There are two levels of planning for the audit as illustrated in the exhibit below.

2.104 The overall strategy begins during the risk assessment phase of the audit. The detailed audit plan can begin when there is sufficient information about assessed risks to develop an appropriate audit response. This will most often take place at the risk response phase of the audit.

2.105 The nature and extent of planning activities will vary according to several factors:

- The size and complexity of the entity;
- The composition and size of the audit team. Smaller audits will also have smaller teams, making planning, coordination, and communication easier;
- The auditor's previous experience with the entity; and
- Changes in circumstances that occur during the audit engagement.

2.106 The benefits of audit planning are outlined in the table below.

Benefits of Audit Planning	• Team members learn from the experience/insight of the partner and other key personnel. • The engagement is properly organized, staffed, and managed. • Experience gained from previous years' engagements and other assignments is properly utilized. • Important areas of the audit receive the appropriate attention. • Potential problems are identified and resolved on a timely basis. • Audit file documentation is reviewed on a timely basis. • Work performed by others is coordinated (other auditors, experts, etc.).

Developing the Overall Audit Strategy

2.107 As mentioned, 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.

2.108 The first step in planning is to gather information about the entity and determine the nature and extent of the required risk assessment procedures, and who will perform them. It also includes the scheduling of the audit team meeting to discuss the susceptibility of the entity to material misstatements (including fraud) in the financial statements. Then, as risks are identified and assessed, the appropriate audit response can be developed which will involve determining the nature, extent, and timing of the further audit procedures required. Other considerations involved in planning could involve the determination of materiality, involvement of experts, and any additional risk assessment procedures that may be required.

2.109 When the risks of material misstatement have been identified and assessed, the overall strategy (including timing, staffing, and supervision) can be finalized, and a detailed audit plan developed. The detailed plan will set out the further audit procedures required at the assertion level that will be responsive to the identified risks.

2.110 As work commences, changes may be required to the overall and detailed plans to respond to new circumstances, audit findings, and other information obtained.

Refer Appendix 3 to the Guide for a template of determining the Overall Audit Strategy.

Consider Point

Small entity audits are often conducted by very small audit teams. This makes coordination and communication among the team easier and the overall audit strategy can be straightforward. Documentation for small entities may be in the form of a brief memorandum that includes:

- Nature of engagement and timing;
- Issues identified in the audit just completed;
- What has changed in the current period;
- Any revisions required in the overall audit strategy or in the detailed audit plan; and
- The specific responsibilities of each member of the audit team.

Planning for the current year can start with a brief memo prepared at the end of the previous audit. This memo can be used as the basis for planning the current period when it has been changed and updated for the current period, based on discussions with the owner-manager.

Learn from the Prior Year's Experience

2.111 Once the previous audit is complete, it is useful to obtain feedback from the audit team on what could be improved. This would include identifying:

- Any audit areas that might require additional or less attention in the future;
- Any planned changes that will affect future engagements such as an acquisition, new product or service, or the installation of a new accounting system; and
- Where additional assistance could be provided by the entity such as analysis of certain accounts.

Consideration in Planning

2.112 Planning is a critical step in performing an efficient and effective engagement. Time spent in planning can focus work effort toward material matters and away from insignificant matters. Planning helps to:

- Focus partner / staff attention on the engagement objectives;
- Identify the critical issues to be addressed and develop an appropriate response;
- Ensure that a coherent set of audit procedures are developed to achieve the engagement objectives. This also includes the removal of audit procedures considered unnecessary (based on the practitioner's judgment); and
- Identify ways in which the entity could assist the engagement, such as preparing certain working papers and analysis.

2.113 Some of the benefits of planning a review engagement are as follows.

Benefits of Planning

- Team members are properly briefed on the engagement objectives and expectations.
- Problem areas can be anticipated and surprises avoided.
- Review procedures are focused on areas of potential material misstatement.
- The engagement is properly organized, staffed and managed.

Ideally, the planning discussions would involve all of the engagement team but it is most important that senior engagement personnel be involved. The partner and senior staff usually have the most information about the entity and they are in a position for making the key decisions.

Planning Agenda Items

- Informing the team on what the entity is all about and what has changed this period.
- Discussion about where misstatements are most likely to occur and the appropriate response.
- Responses to specific concerns such as related-party transactions, complex estimates, litigation or claims and going-concern events / conditions.
- Any potential for improving the quality of file documentation and the efficiency / effectiveness of the review procedures performed.
- Any concerns identified during the preliminary engagement activities.
- Discussion on what staff will be required to do and why.

2.114 The results of the planning process should be documented in a planning memorandum and could include the following.

- Planning Documentation
- Nature of the engagement and any special requests.
- Guidance on what should be considered material.

- An overall strategy (significant risk factors to consider, timing and approach to the engagement).
- A detailed plan of action (the review procedures to be performed).
- Assignment of specific responsibilities to team members.

2.115 The core areas to consider in planning are as follows.

Planning Area Considerations

Understanding the Entity

- Discuss what the entity does, state of the economy and industry trends;
- Discuss the organizational structure and the roles of the board of directors, key personnel and state of their accounting knowledge;
- Identify any financial issues such as poor cash flow, bank covenants close to being breached, need for new capital investment or inability to attract people with the required skills;
- Identify any concerns regarding the choice and consistent use of accounting policies; and
- Identify and discuss those areas most susceptible to material misstatements in the financial statements.

Results of Previous Work Performed

- Where were misstatements identified and how were they resolved? These details about previous work can provide valuable insight on how the entity is managed and flag potential risks of material misstatement?
- What information was difficult to obtain or arrived late?
- Were there any matters noted in the file for carry forward or additional attention in this period?
- What was management's response to other matters bought to their attention?
- Engagement Efficiency
- Are there areas where we spent time unnecessarily or on insignificant matters or alternatively are there areas where we need to perform more work?
- Is there information that the client could be requested to prepare (i.e., saving our engagement time)?

Timing of Engagement

- What are the deadlines or timelines for engagement completion?
- When will the information to be prepared by the client be available?
- Who is available to perform the work at the required times, and is staff continuity possible?

Major Changes during Period

- What changes have taken place in the entity (such as changes in operations, information technology and business processes, key management, new financing activities and any acquisitions, mergers and divestments, etc.)?
- Have there been any changes in the financial reporting framework, such as accounting standards?

- Are there any other industry-specific matters to consider (such as new regulations, or competition, declining sales, obsolescence of products or availability of finance)?

Materiality and Risk Factors

- What would constitute a material misstatement with regard to the users of the financial statements?
- Were any new risk factors identified as a result of changes during the period?
- Are there any indicators that fraud may be taking place?

Consider Points

Staff briefings

- Brief staff about the entity and industry before they start work.
- Management does not like having to deal with new staff members who ask the same questions that other staff had already asked in the previous period.

Determine who to ask

- Identify the right people (those with the most information) to whom the review inquiries will be directed.

Assistance

- Ask management to prepare work papers, reconciliations, letters and analysis of balances where possible.

Automation

- Consider using a trial balance management program to perform time-consuming tasks such as posting journal entries, analytical comparisons, preparation of lead sheets and the financial statements.

Complete work in field

- Where applicable, ensure staff complete the work in the field before it comes back to the office for review. Going back to the entity at a later time and requesting additional information is inefficient.

The Four Planning Steps

2.116 The steps involved in developing an overall plan and strategy are illustrated below.

1	**Gather Information**
2	**Assess RMM at the Financial Statement Level**
3	**Develop Overall Responses**
4	**Develop Resource Management Plan**

RMM – Risks of Material Misstatement

Step 1 – Gather Information

2.117 The first step is to establish the scope of the engagement, reporting requirements and any significant changes that have taken place since the last engagement. Some factors to consider are outlined below.

The Scope of the Engagement
What characteristics will define the scope of engagement? Consider the following: • The financial reporting framework used; • Industry-specific reporting requirements; Need for a statutory audit of stand-alone financial statements in addition to an audit for consolidation purposes; • The availability of client personnel and data at the times required; Use of a service organization (such as for payroll, etc.) and

availability of evidence about internal control; and • Entity components and locations (if any) audited by other firms.
Reporting Requirements, Timing and Communications
What is required and when? Consider: • Timing of audit work and deadlines for issuing the audit report(s); • Communications and key dates for other auditors or third parties involved; and Key dates for expected communications with management and those charged with governance to discuss: • Status of audit work throughout the engagement; • The nature, timing, and extent of the audit work; and • Expected deliverables resulting from the audit procedures.

Requirements, Timing, and Communications

Important Factors for Audit Team to Focus on
Key factors to consider include: Lessons learned from prior experience and client acceptance and continuance procedures; • Determination of appropriate materiality levels; • Identification of areas where there may be higher risks of material misstatement; • Preliminary identification of material components and account balances; • Management's commitment to the design and operation of sound internal control, including documentation of such internal control;

• Potential for management override; • Evaluation of relevant internal controls • Discussions of audit matters with other firm personnel with knowledge of the entity; and • Effect of information technology (availability of paper trails, etc.) on the audit.
Significant Changes that will Impact the Audit Approach
What changes will impact the audit approach in the current period? Consider the following: • Changes in the financial reporting framework, such as accounting standards; • Entity-specific, industry, financial reporting, or other relevant developments; Business developments affecting the entity, including changes in information technology and business processes, changes in key management, and any acquisitions, mergers and divestments; and Industry developments such as changes in industry regulations and new reporting requirements.

Changes that will Impact the Audit Approach

Consider Point There may be some very small entities requiring an audit where the owner-manager runs the entity, has few (if any) formal documented controls in place, and can therefore override just about everything. In these situations, the auditor has to determine whether it is possible to perform an audit at all. If not, the auditor must exercise professional judgment in determining whether the engagement should be declined or a denial of opinion provided.

2.118 Factors to consider include:

- The entity's control environment. Is the owner trustworthy, competent and has a good attitude toward control? A competent owner-manager can often be control strength, as he or she will know the business, approve most transactions, and therefore be able to detect misstatements. However, the control weakness would create the potential for management override.
- Is it possible to develop further audit procedures that would respond appropriately to the assessed risk factors? The most difficult factor to determine is often what is not included (but should be) in the financial statements. For example, are all revenues and liabilities properly recorded in the accounting records?

Step 2 – Assess the RMM at the Financial Statement Level

2.119 The risks of material misstatement (RMM) at the overall financial statement level relate to the pervasive risks that affect the entity as a whole (such as nature of the industry, management's integrity, and their attitude toward control and competence). Risks at the assertion level generally relate to specific risks (such as high value of inventory or goods shipped but not invoiced) that occur at the business process level.

2.120 A preliminary assessment of the RMM at the overall financial statement level can be used to develop the preliminary overall audit strategy. The reason is that a low assessment of risk overall (appropriately documented) may be used to reduce substantive procedures required at the assertion level. Conversely, a high risk assessment would result in more work being required at the assertion level.

2.121 This preliminary assessment can be based on findings from the previous audit or as a result of performing risk assessment procedures in the current period.

2.122 The assessment of risk at the financial statement level can range from high to low. Some of the implications that flow from the risk assessment are outlined in the chart below.

Impact on Overall Audit Responses	
Risk Assessment is **LOW**	Some ability to place increased reliance on management representations and audit evidence generated internally by the entity. Greater potential for an audit approach that uses tests of internal controls as well as substantive procedures (combined approach). This should reduce the need for or extent of some substantive procedures. Ability to perform more audit procedures at an interim date rather than at period end.
Risk Assessment is **HIGH**	Emphasize to the audit team the need for an even higher level of professional skepticism in gathering and evaluating audit evidence. Consider the effectiveness of actions (if any) taken by management to address identified internal control weaknesses. Assign more experienced staff to the engagement team and consider the need to use experts. Ensure continuity of staff on the engagement to maximize knowledge of the entity. • Provide more staff supervision. • Obtain more extensive audit evidence from substantive procedures. Make changes to the analytical or other audit procedures applied as risk assessment procedures.

	• Modify the nature of audit procedures to obtain more persuasive audit evidence. Consider changes in the nature, timing, or extent of other audit procedures. • Obtain additional corroborative evidence for management representations.

Responses

Consider Point
Consider communicating weaknesses in internal control to management (particularly in the control environment or entity level controls) before the year-end audit work commences. This communication provides management with an opportunity to take corrective action on a timely basis, which may improve the assessed level of audit risk. A recommendation to replace an old accounting software with the latest and more improved one or a recommendation to provide more training and support to the accounts department staff on working on the accounting software could help the entity improve control and result in less audit time being required at the period end.

Step 3 – Develop Overall Responses

2.123 The next step is to consider all the information obtained (in Steps 1 and 2 above) about the entity and the assessed risks to develop an overall audit strategy for conducting the engagement.

2.124 The overall audit strategy sets the scope, timing, and approach to the audit and guides the development of the more detailed audit plan.

Factors to Consider
Results from previous audit experience (including tests of controls that could be relied upon in the current period) and other assignments for the entity. • Response(s) by management to weaknesses identified in internal control. • The required staff resources and skills required for the audit. Consider need for experts to address complex, specific, and high-risk audit areas. • Audit timing, including inventory counts and other required procedures. • The most effective way to respond to the assessed risks of material misstatement at both the financial statement and assertion levels. • Effect of information technology (availability of paper trails, etc.) on the audit. • Management's commitment to the design and operation of sound internal control, including documentation of such internal control. • Potential for management override. • Need to introduce some unpredictability in performing audit procedures.

Step 4 – Develop a Resource Management Plan

2.125 SA 300 states:

"10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work (Ref: Para A15-A16)."

2.126 The final step in completing the overall audit strategy is to ascertain the nature, timing, and extent of resources necessary to perform the engagement.

Selecting the Engagement Team
• Does the proposed audit team have the necessary skill levels and resources? • Have some team members been assigned supervisory responsibilities in the audit? • Is there some continuity of staff on the engagement? • Have audit tasks such as attending the inventory count and sending out confirmations before the year end been assigned to specific staff members? • Has an engagement quality control reviewer been assigned (where applicable)?
Time Allocations
• Has a time budget been allocated to each team member for his or her assignments? • Has time been set aside for areas where there may be higher risks of material misstatement? • How much time is budgeted overall to complete the assigned work?
Communications
• Have roles, responsibilities and expectations of each audit team member been communicated? • Have team members been reminded about the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence? • Have dates for audit team meetings been set to discuss: o Detailed audit plans and sharing information about the entity?

- Identify possibility of fraud? (see paragraph 25 of SA 240)
- Engagement deadlines and timing of file reviews?

- Have dates been established for fieldwork to commence (interim and year end) and other activities such as sending out confirmations, inventory count, and cut-off procedures?
- Have key dates been established for other auditors, experts, and third parties involved in the audit?

Management, Direction, and Supervision

- Has a plan been developed for:
  - The day-to-day supervision of staff on the engagement?
  - Senior staff being available to answer questions, respond to potential problems, and generally keep informed about progress?
  - File reviews at either the entity's premises or in the office?
  - Team debriefing meetings (where appropriate)?
- Is there a need for increased supervision and review as a result of a high level of assessed risk at the overall financial statement level?

Consider Point

In addition to the audit planning meeting at the start of the engagement it is highly desirable for the audit team (however small) to meet (or arrange a conference phone call) and discuss audit findings after performing:

- Risk assessment procedures; and
- Further audit procedures.

2.127 These debriefing sessions do not need to be formal or long, and enable audit team members to report verbally on their findings, exceptions found, and concerns noted. They can also report on any matters (however small) that seemed odd or did not make sense. It is often the small matters that, when combined with information obtained by other team members, point to a possible risk factor (such as fraud) that may require further work to be performed. Even when the audit team is just two people, these meetings can yield significant results. At the planning meeting, a time and date for these debriefing sessions can be scheduled.

Communicating the Plan with Management and Those Charged with Governance

2.128 The overall audit strategy and the detailed audit plan are entirely the auditor's responsibility. It is often useful to discuss elements of the detailed audit plan (such as timing) with management. These discussions often result in some minor changes to the plan to coordinate timing and facilitate performance of certain procedures. However, the exact nature, timing and scope of planned procedures should not be discussed in detail and should not be changed or scaled back to accommodate a management request. Such requests could compromise the effectiveness of the audit, make audit procedures too predictable, and could even constitute a scope limitation.

2.129 Where management reports to a separate group of people charged with governance, the overall audit strategy should be discussed with them or communicated in writing, including:

- Overall audit strategy;
- Timing of the audit; and
- Any additional requirements or limitations.

Documentation

2.130 SA 300 states:

"11. The auditor shall document:

(a) The overall audit strategy;

(b) The audit plan; and

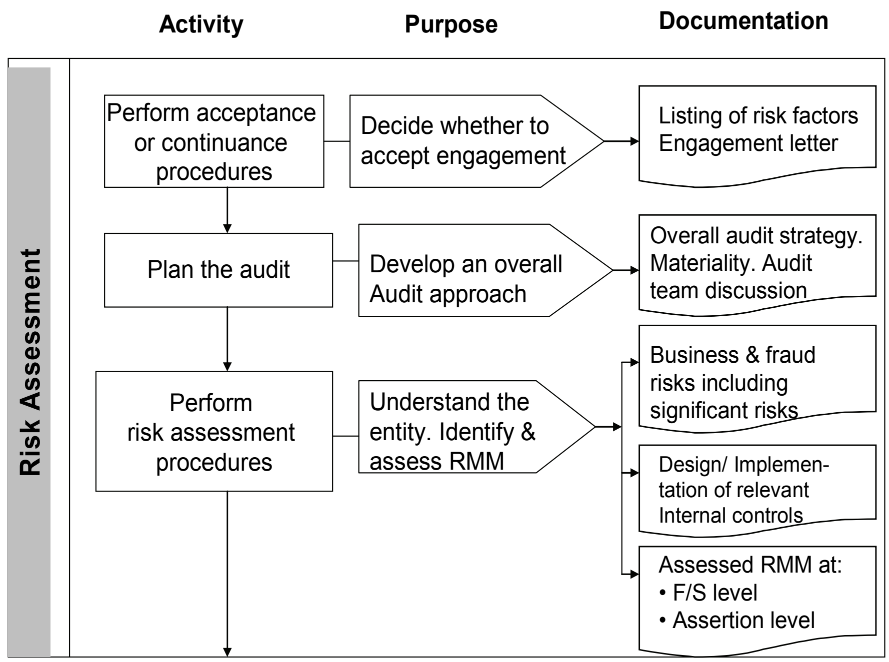
(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)"

The overall audit strategy and detailed audit plan, including details of any significant changes made during the audit engagement, should be documented.

2.131 The form and extent of documentation will depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement. It may take the form of a memorandum or a standard planning checklist.

Areas that documentation should address
• The key decisions (scope, timing, and conduct of the audit) considered necessary to properly plan the audit. • Information needed for communicating significant matters to the engagement team. • Planned nature, timing, and extent of risk assessment procedures and of further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks. • Reasons for significant changes to the original strategy, such as responding to new events and conditions or the results of performing audit procedures. Also include details of the revised/further procedures performed as a result. • Identification of a temporary materiality level and relevant sampling factors such as confidence levels planned and used.

Business Risks



The purpose of this Section is to provide guidance on the identification and assessment of business risks. The primary source of reference for this is SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

Overview

2.132 SA 315 states:

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

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk."

2.133 The assessment of the risks of material misstatement is made at the:

- Financial statement level; and
- Assertion level for classes of transactions, account balances, and disclosures. This section focuses on the identification and assessment of business risks resulting from the performance of risk assessment procedures.

Risk Factors

2.134 An understanding of business risks increases the likelihood of identifying the risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks.

2.135 Business risks result from conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies.

Consider Point
It is best to separate the identification of risks from their assessment. As business risks can be identified during any stage of the engagement, the audit team should be encouraged to document them in a single place (for ease of reference and review) before they are assessed. This will ensure that all risks are documented and considered, even if some of the risks identified are later assessed as being insignificant and requiring no further work.

2.136 The chart below outlines some examples of risk factors that may indicate the existence of risks of material misstatement.

Source of Risk Factors	
External Factors	• State of the economy and government regulation; • High degree of complex regulation; • Changes in the industry in which the entity operates; • Changes in the supply chain; • Declining demand for the entity's products or services; • Inability to obtain required materials or the personnel with skills required for production; • Deliberate sabotage of an entity's products or services; and • Constraints on the availability of capital and credit.
Business	• Operations in regions that are

Strategies	economically unstable; • Operations exposed to volatile markets; • Developing or offering new products or services, or moving into new lines of business; • Entering into business areas/transactions with which the entity has little experience; • Setting of inappropriate or unrealistic objectives and strategies; • Aggressive expansion into new locations; • Acquisitions and divestitures; • Complex alliances and joint ventures; • Use of complex financing arrangements; • Corporate restructurings; and • Significant transactions with related parties.
Entity's Organization	• Poor corporate culture and governance; • Incompetent personnel in key positions; • Changes in key personnel including departure of key executives; • Complexity in operations, organization structure and products; • Failure to recognize the need for change such as in skills required or the use of technology; • Response to rapid growth or decline in sales that can strain internal control systems and people's skills; • Lack of personnel with appropriate accounting and financial reporting skills; • Weaknesses in internal control, especially

	those not addressed by management; and • Inconsistencies between the entity's IT strategy and its business strategies.
Other	• Product or service flaws that may result in liabilities and reputation risk; • Relationships with external funders, such as banks; • Going-concern and liquidity issues including loss of significant customers; and • Installation of significant new IT systems related to financial reporting.

The Entity's Risk Assessment Process

2.137 Risk assessment is one of the five components of internal control that the entity should be using for:

- Identifying business risks relevant to financial reporting objectives; and
- Forming the basis for how management will determine what risks to manage.

2.138 In smaller entities, the risk assessment process is likely to be informal and less structured. Risk in these entities is often recognized implicitly rather than explicitly. Management may be aware of risks related to financial reporting through direct personal involvement with employees and outside parties. As a result, the auditor will make inquiries of management as to how they identify and manage risk, what risks have been identified and managed, and then document the results.

Consider Point
When risk factors are documented and assessed by the auditor, it is important that the results are discussed with management of the entity. This will help to ensure that a significant risk factor has not been overlooked and that the assessment of risks (likelihood and impact) is reasonable. As management understands the benefits of a more formalized risk assessment process, they may decide to develop, implement, and document their own processes. When this occurs the auditor is required to evaluate its design and implementation. This involves determining how management: • Identifies business risks relevant to financial reporting; • Estimates the significance of the risks; • Assesses the likelihood of their occurrence; and • Decides upon actions to manage them.

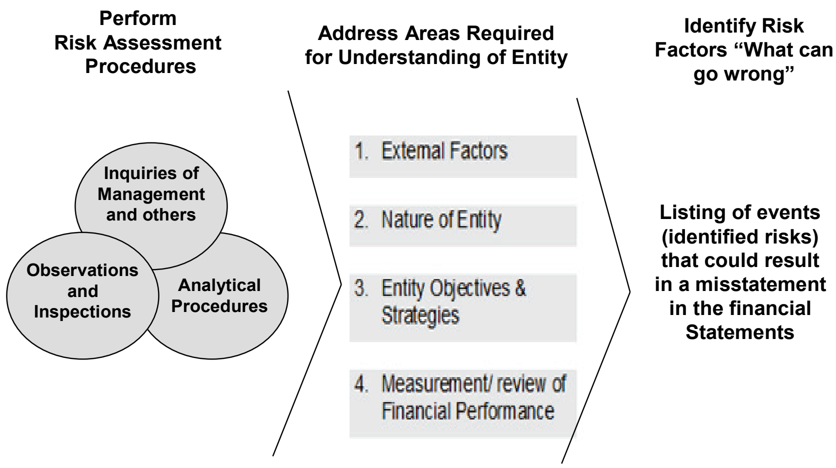
2.139 In addition to considering the entity's process, the auditor should also inquire about:

- Business risks that management has identified and whether they may result in material misstatement; and
- Business risks that management may have failed to identify under the entity's process. If additional risks are found, consideration should be given as to whether there is a material weakness in the entity's risk assessment process, which should be communicated to those charged with governance.

Identification of Risks

2.140 Risk identification is derived from information gathered in performing the three risk assessment procedures. First, identify risks without consideration of any internal control that might mitigate such risks. Separately assessing risks before considering the internal control system will help to identify any significant risks and provide the necessary basis for assessing the design and implementation of management's internal control.

2.141 The risk identification process is illustrated in the exhibit below.



2.142 For each risk identified, the auditor would carefully consider:

- **What are the implications?**

2.143 What type of misstatement could occur in the financial statements as a result of the risk? For example, if the entity handles diamonds there is a high level of inherent risk (that is, before consideration of any internal control) that it could be stolen. The implication of this risk is the possibility that the diamonds inventory in the financial statements might not exist (existence assertion) or the value may be misstated (valuation assertion). This question becomes even more difficult for pervasive risks where the possibilities for misstatement could be numerous. For example, if those charged with governance were ineffective, all sorts of misstatements (deliberate or otherwise) could potentially go unnoticed.

- **What financial statement areas and assertions are affected?**

2.144 To what specific classes of transactions, account balances, and disclosures and related assertions does the risk relate? Note that a number of the risks identified will be pervasive across the entity, as they cannot be related to specific areas or assertions. For example, the failure of the entity to set objectives and operating budgets could result in various types of errors being missed. Another example would be an incompetent bookkeeper/accountant. These risks cannot easily be allocated to specific financial statement areas or disclosures.

2.145 Pervasive risks often derive from a weak internal control environment and potentially affect many financial statement areas, disclosures, and assertions. These risks will likely affect the assessment of risk at the financial statement level and require an overall response (such as more audit work, assigning more experienced staff members, etc.) by the auditor.

2.146 Avoid the temptation to only list risk factors that are likely to be significant or important. A key part of risk or event identification is to develop as complete a listing of risk factors as possible. Inconsequential risk factors can always be removed later after each risk is appropriately assessed. This will help to ensure that all material risks are indeed identified.

2.147 As the audit progresses, additional risks may be identified. These should be added to the list of identified risks and appropriately assessed before making a decision as to any further audit procedures required.

Assessment of Risks

2.148 After the auditor has identified the risk factors and the types of misstatement in the financial statements that could result, the next step is to assess or rank their significance. Again, it is preferable to assess these risks before consideration of any internal control that mitigates the risks.

2.149 For each identified risk consider:

- Likelihood of risk occurrence; and
- Monetary impact of risk occurrence.

Likelihood of risk occurrence

2.150 What is the probability that the risk will occur? The auditor can evaluate this probability simply as high, medium, or low or by assigning a numerical score, such as 1 to 5. The higher the score, the more likely the risk could occur.

Monetary impact of risk occurrence

2.151 If the risk occurred, what would be the monetary impact? This judgment needs to be assessed against a specified monetary amount. If not, different people (with different amounts in mind) could come to entirely different conclusions. For audit purposes, the specified amount would relate to what constitutes a material misstatement of the financial statements. This can also be evaluated simply as high, medium, or low or by assigning a numerical score, such as 1 to 5.

2.152 Numeric scores for the likelihood and impact can be multiplied to give a combined or overall score. This can be helpful in sorting the risks in order of importance.

2.153 Using a simple format within an electronic worksheet can be an efficient way of conducting this step. The risks can then be sorted so that the most significant identified risks are at the top of the list.

2.154 The "risk register" below provides a sample format for identifying and assessing risks.

Risk Register

Entity ABC Co.
Risk Tolerance for Materiality 2500e

S.No.	Risk Factor	Assertions Addressed	Risk Assessment		
			Likeli-hood	**Impact**	**Comb**
			1-5	**1-5**	**Li x Lm**
1	New technology is significantly reducing production costs on some products	Inventory or older products could become obsolete and therefore overvalued.	3	4	12
2	New environmental law is being introduced	New liabilities and contingent liabilities will be created for environmental clean-up costs.	2	4	8
3	New accounting system is being introduced	Errors could occur during the changeover that would not be prevented or detected.	4	2	8
4	Senior production manager is retiring	Not finding a suitable replacement could result in many types of mistakes being made.	3	2	6
5	Significant management bonuses based on sales	Pressure could exist to inflate sales to ensure bonus threshold is achieved.	2	2	4

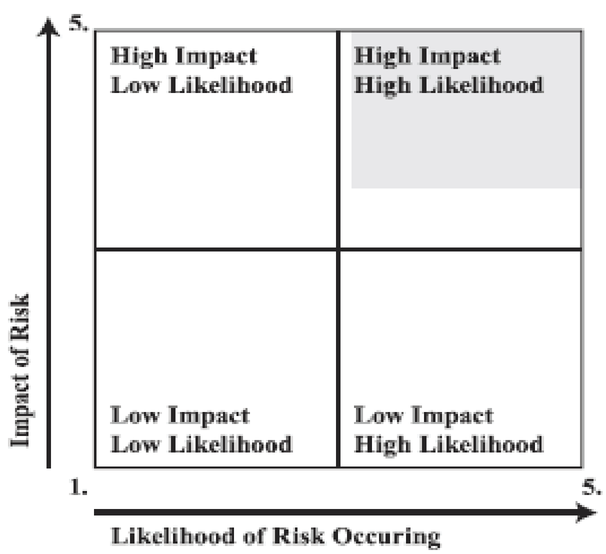
Comb – Combined risk score

Note: An additional column can also be added to the above format to identify or cross-reference the internal control or steps taken by management to mitigate the risk

Consider Point

The most important, but also the most difficult, column to complete on the above form is "What can go wrong in the financial statements (F/S) as a result". It is in this column that the auditor sets out the implication of the identified risk. Declining sales is a risk factor but if recorded accurately by the entity, this would not result in risks of material misstatement. However, declining sales could result in inventories being obsolete or overvalued and receivables may become difficult to collect. It is the implication of each risk factor that the auditor needs to identify so that an appropriate audit response (such as further audit procedures) can be developed.

2.155 The results of the risk assessment process can also be set out in a chart, as illustrated below.



2.156 Risks falling in the "high impact, high likelihood" area of the chart clearly require management action to mitigate. In addition, these will likely be determined as being significant risks, which require special audit consideration.

Documentation of Risks

2.157 The auditor should document the key elements of the understanding obtained regarding each of the aspects of the entity and its environment, as outlined above. Documentation may be memoranda or forms may be used to ensure information is captured in a structured format. Often the auditor will use a mixture of both formats – memoranda and forms.

> ***Consider Point***
>
> 2.158 A key point to consider is how the documentation will be updated in subsequent years. If information is captured in a structured way, it may take longer to prepare initially but may be much easier to update at a later time.

2.159 Using a "risk register" such as the example above helps to ensure all risks are documented in a central place and are assessed in a consistent and systematic manner. When such a list is recorded on an electronic worksheet, the risks can also be sorted based on likelihood, impact, or by the combined risk score.

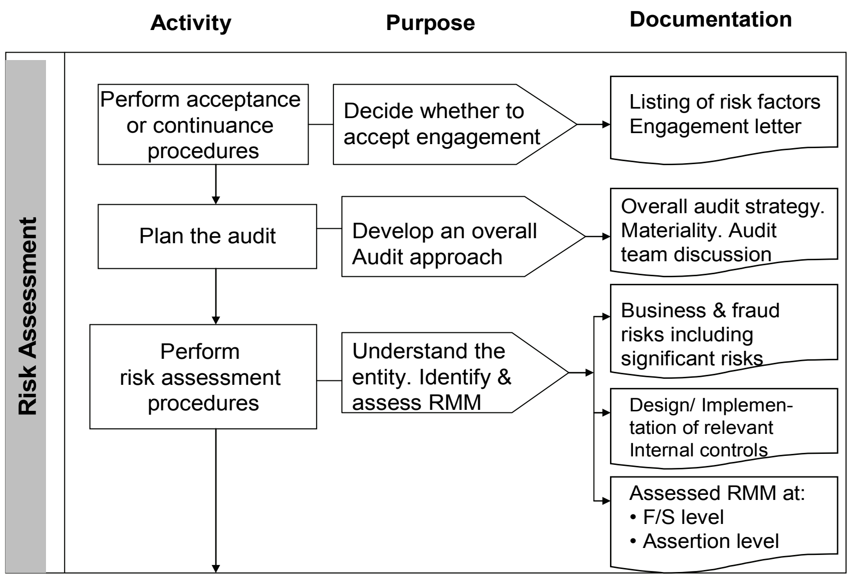
2.160 A structured format helps to ensure:

- Consistent basis for risk assessment and identifying significant risks;
- Ease of review;
- Ability to sort risks using various criteria; and
- Ability for the auditor to share the list with the client for their input or request that the client prepare it for the auditor's review.

2.161 The more complex the entity and the audit procedures required, the more extensive the documentation required.

Note: The auditor should use his/her professional judgment regarding the manner in which these matters are documented.

Fraud Risks



2.162 The purpose of this Section is to outline the auditors' role in assessing risk factors that could result in financial statement fraud and misappropriation of assets. The primary source of reference for this is SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

Overview

2.163 SA 315 states:

"3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A12-A14)

A12. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- *…*

- *Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.*

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

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk."

2.164 SA 240 states:

"10. The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.

12. In accordance with SA 200 (Revised), the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

17. The auditor shall make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

20. Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate *the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)"*

2.165 The risk assessment described in this Section focuses on the auditor's responsibility to consider fraud that causes a material misstatement in the financial statements. This is described in SA 240 but still forms part of the overall risk assessment performed in accordance with SA 315.

Fraud

2.166 The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

2.167 Fraud involving one or more members of management or those charged with governance is referred to as "management fraud". Fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion within the entity or with third parties outside of the entity.

2.168 The table below outlines the types and characteristics of fraud.

Types and Characteristics of Fraud

	Misappropriation of Assets **(Converting Assets to personal use)**	**Manipulation of F/S** **(reporting a higher/lower level of earnings than actually occurred)**

Who?	Management	Employees	Management	Employees
Pressures	Personal benefit	Personal benefit	Personal benefit such as saving taxes, selling business at an inflated price or justifying a bonus	Personal benefit such as meeting a performance based threshold for a bonus
Opportunities	Override of functioning internal control (IC) Exploit weakness in internal control	Exploit weakness in internal control	Override of functioning internal controls Exploit weakness in internal control (IC)	Exploit weakness in internal control (IC)
Amounts Involved	Tend to be large due to position in entity and knowledge of IC	Often small but could potentially be large	Tend to be large due to position in entity and knowledge of IC	Size would be relative benefit (bonus) paid

2.169 Although fraud can occur at any level in the organization, it tends to be more serious (and involve higher monetary amounts) when senior management is involved.

2.170 Some of the major conditions that create an environment for fraud include:

- Ineffective corporate governance;
- Lack of leadership and “tone at the top” by management;
- High incentives provided for financial performance;

- Complexity in entity rules, regulations, and policies;
- Unrealistic budget targets for staff to attain; and
- Inadequate internal control, especially in the presence of organizational change.

2.171 As can be determined from the above, the most effective anti-fraud internal control would be a strong commitment by those in governance and senior management to doing the right thing. This is evidenced through articulated entity values and a commitment to ethics that are modelled on a day-to-day basis. This is true for any size of organization.

The Fraud Triangle

2.172 The nature of fraud outlines the following three conditions that often provide clues to its existence. Forensic accountants often refer to this as the "fraud triangle" because when all three conditions are present, it is highly likely that fraud may be occurring.

2.173 The conditions are:

- **Opportunity**

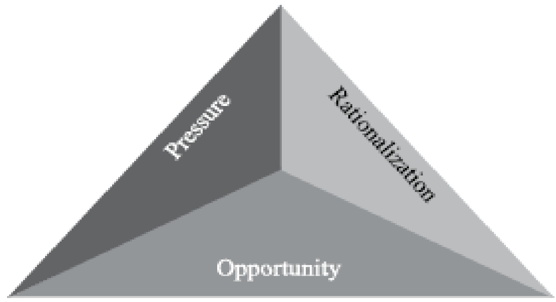
A poor corporate culture and a lack of adequate internal control procedures can often create the confidence that a fraud could go undetected.

- **Pressure**

This is often generated by immediate needs (such as having significant personal debts or meeting an analyst's or bank's expectations for profit) that are difficult to share with others.

- **Rationalization**

Rationalization is the belief that a fraud has not really been committed. For example, the perpetrator rationalizes "this is not a big deal" or "I am only taking what I deserve".



2.174 In conducting risk assessment procedures, the audit team members may identify a fraud risk factor that relates to one of the triangle elements. However, it is less likely that any one auditor will identify all three conditions (opportunity, pressure, rationalization) together. For this reason, it is very important for the audit team to continually discuss their findings throughout the engagement.

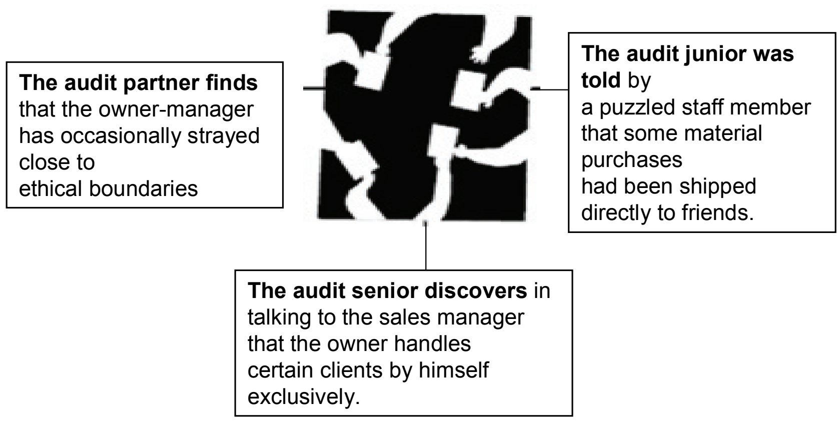
2.175 For example, an owner-manager in the construction business may offer to build a significant addition to a friend's house for a good price, as long as it is a cash-only transaction with no paperwork involved. Because of the owner-manager's position, the opportunity exists for him or her to override the internal controls over revenue recognition and not record the revenue from the sale. The pressure might be to reduce taxes that would otherwise be payable and the rationalization would be that he or she is paying far too much in taxes already. In conducting risk assessment procedures, the auditor may discover several findings.

Audit Team Discussions

2.176 An important part of gathering information about fraud risk factors and effectively utilizing the firm's knowledge of the entity is sharing that information with the other members of the audit team. Encourage team members to come to the meeting with a questioning mind, setting aside any beliefs (possibly built over a number of years) that management is honest and has unquestioned integrity.

2.177 The benefits of audit team discussions are outlined in the exhibit below.

Benefits of Audit Team Discussions



2.178 In the absence of communication, it would be difficult for any member of the above audit team to see the big picture. However, the audit team discussion allows them to pull the different pieces of information together so that the bigger picture can indeed be seen. Fraud is always intentional and involves concealment of information. Its detection is often discovered by looking for patterns, oddities, and exceptions in what might be very small monetary amounts.

Professional Skepticism

2.179 It is the responsibility of auditors to maintain an attitude of professional skepticism at all times during the engagement. An attitude of professional skepticism involves:

- Making critical assessments, with a questioning mind, of the validity of audit evidence obtained;
- Being alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance; and

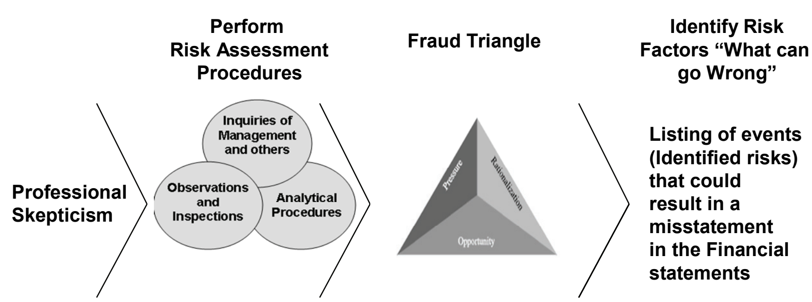
- Recognizing that management is always in a position to override otherwise good internal control.

2.180 In conducting their work, auditors need to be careful to avoid:

- Overlooking unusual circumstances;
- Over-generalizing when drawing conclusions from audit observations;
- Using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof;
- Accepting less than persuasive audit evidence on a belief that management and those charged with governance are honest and have integrity; and
- Accepting representations from management as a substitute for obtaining sufficient appropriate audit evidence.

Identification of Fraud Risk Factors

2.181 Because fraud is concealed and management override is always a possibility, auditors need to carefully consider all the information obtained from performing the three risk assessment procedures and have regular discussions among the audit team, as illustrated below.



2.182 These procedures will include gaining an understanding and consideration of the "tone at the top" or management's attitudes toward the internal control environment. For example:

- How do those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud?
- How does management address the design and implementation of internal control to mitigate these risks? In smaller entities, management may consciously choose to accept the risk associated with a lack of segregation of duties due to high levels of day-to-day supervision of operations.
- Is there actual, suspected or alleged fraud affecting the entity and has management discovered any material errors?
- What perspective do persons other than the owner or senior management have on the culture, management operating style, management override, and existence of fraud risk factors?
- Are there specific areas of vulnerability such as management estimates, revenue recognition, use of journal entries, transactions with related parties, etc.?

2.183 This understanding of the entity should also include the internal control over financial reporting.

Examples of Fraud Risk Factors

2.184 The fraud risk factors identified in Appendix 1 of SA 240 (summarized in the following chart for smaller entities) are examples of such factors typically faced by auditors in a broad range of situations.

<table>
<tr><td colspan="2">Fraudulent Financial Reporting</td></tr>
<tr><td rowspan="2">Tone at the Top

Pertains to management's abilities, pressures, style and attitude relating to internal control and the financial reporting process.</td><td>1. Pressures

• Bonuses

A significant portion of management or staff's compensation is represented by bonuses (or other incentives), the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position, or cash flow.

• Forecasts

Management commits to financial institutions, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.

• Tax reduction

Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.</td></tr>
<tr><td>2. Opportunities

• Management's attitudes

Failure by management to display/communicate an appropriate attitude regarding internal control and the financial reporting process such as:

o Management does not effectively communicate and support the entity's values or ethics or Management communicates inappropriate</td></tr>
</table>

	values or ethics; ○ Management is dominated by a single person or a small group without the compensating internal control such as effective oversight by those charged with governance; ○ Management does not monitor significant internal control procedures adequately; ○ Management fails to correct known material weaknesses in internal control on a timely basis; ○ Management sets unduly aggressive financial targets and expectations for operating personnel; ○ Management displays a significant disregard for regulatory authorities; and ○ Management continues to employ ineffective accounting and/or information technology staff. • Turnover There is a high turnover of management, legal counsel or board members. • Management/auditor relationships There is a strained relationship between management and the current/predecessor auditor such as:

	○ Frequent disputes on accounting, auditing, or reporting matters; ○ Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report; ○ Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information or limit the auditor's ability to communicate effectively with those charged with governance; and ○ Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work. • Corporate governance structure The corporate governance structure is weak or ineffective as evidenced by inexperience or lacking members, members who are not independent of management or where little attention is being paid to financial reporting matters and accounting and internal control systems.
Industry Conditions Pertains to the economic and regulatory	• New compliance requirements New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.

environment in which the entity operates.	• Operational challenges A high degree of competition or market saturation, accompanied by declining margins. • Industry trends ○ A declining industry with increasing business failures and significant declines in customer demand; and ○ Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
Operating Characteristics and Financial Stability Pertains to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.	• Cash flows ○ Inability to generate cash flows from operations while reporting earnings and earnings growth; and ○ Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures). • Estimates ○ Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties; and ○ Estimates subject to significant change in the near term that

	may have a financially disruptive effect on the entity (such as collectibility of accounts receivable, valuation of inventory, timing of revenue recognition. or a significant deferral of costs). • Related parties o Significant related-party transactions which are not in the ordinary course of business; and o Significant related-party transactions which are not audited or are audited by another firm. • Complexity o Significant, unusual or highly complex transactions (especially those close to year end) that pose difficult questions concerning substance over form; o Significant bank accounts or subsidiary operations in tax-haven jurisdictions for which there appears to be no clear business justification; • Reporting o An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority; or contractual arrangements without apparent

	business purpose; and ○ Difficulty in determining the organization or person (or persons) controlling the entity. • Growth/profitability Unusually rapid growth or profitability, especially compared with that of other companies in the same industry. • Dependencies/vulnerabilities ○ Especially vulnerable to changes in interest rates; ○ Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain; ○ Unrealistically aggressive sales or profitability incentive programs; ○ A threat of imminent bankruptcy, foreclosure; or hostile takeover; ○ Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported; and ○ A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Misappropriation of Assets	
Susceptibility of Assets to Theft	• Large amounts of cash on hand or processed; • Inventory characteristics, such as small size combined with high value and high demand; • Easily convertible assets, such as bearer bonds, diamonds, or computer chips; and • Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.
Absence of Internal Control	• Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations); • Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation; • Inadequate record keeping for assets susceptible to misappropriation; • Lack of an appropriate segregation of duties or independent checks; • Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing); • Poor physical safeguards over cash,

	investments, inventory or fixed assets; • Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns); and • Lack of mandatory vacations for employees performing key internal control functions.

Assessment of Fraud Risk

2.185 Once the fraud risk factors have been identified (from performing risk assessment procedures), the next step is to assess the likelihood of the risk occurring and whether it could result in a material misstatement in the financial statements. The same risk assessment procedures should be followed as for business risks.

Documentation

2.186 The auditor should document the fraud risk factors identified and their assessment. When deciding what form of documentation is required, consider how it will be updated in subsequent years. If information is captured in a structured way, it may take longer to prepare initially but may be much easier to update at a later time.

Consider Point

2.187 Separate the listing of fraud risk factors from business risks. Some business risks, such as complex financing arrangements, could result in simple errors being made but could also be used to conceal fraud. It is preferable to document assessed business and fraud risks separately.

2.188 The same 'risk register' for business risks can be used to document fraud risk factors. A simple example is provided below.

Risk Register - Fraud

Materiality 15,000%

Assess each risk in terms of likelihood and impact on a scale of 1-5 (1st low, 5th high)

Discuss this worksheet (risk register) with management to ensure completeness and appropriateness of the risk assessment

Risks Identified	What would go Wrong in the F/S as a Result	FSA Impact – CEAV		Inc.	Risk Assessment		Combined Risk	Significant risk? Y/N
		Assets	Liabilities		Likelihood to occur	impact		
Cash flow is tight due to late delivery on a major contract. Problems will take some time to rectify	Owner manager may try to cover up losses on contract to avoid more tough questions from the bank	EV	C	A	3	3	9	No
Sales targets for bonuses may be narrowly missed this year by a number of salespersons	Sales persons may be tempted to inflate their sales revenue to ensure targets are met	EV		C	3	3	9	No
Inconsistency in revenue recognition	Revenues could be inflated or recorded in the wrong period	ECA		ECA	4	5	20	Yes

Note: Revenue recognition is considered a significant risk that will require special attention.

2.189 When such a list is recorded on an electronic worksheet, the risks can also be sorted based on likelihood, impact, or by the combined risk score. Professional judgment should be used regarding the manner in which these matters are documented.

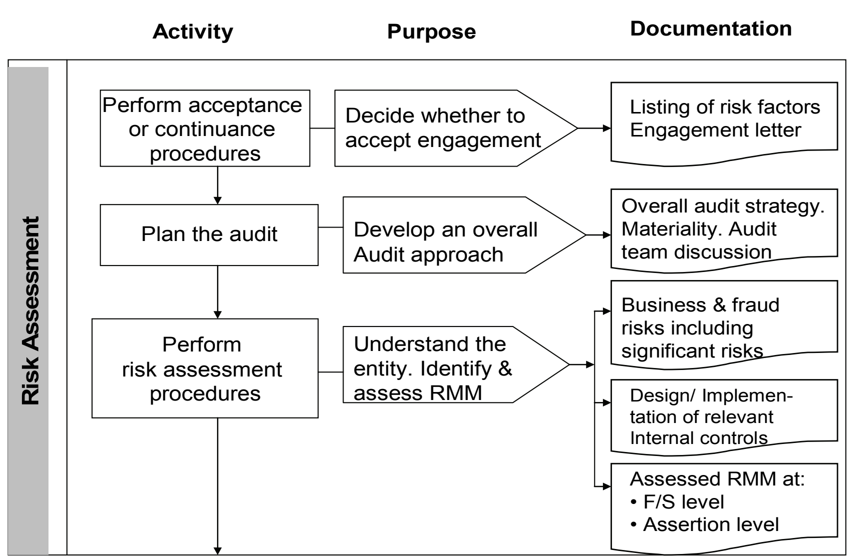
Consider Point

2.190 Maintain separate lists for business risk factors and fraud risk factors. Note that some business risk factors will also be fraud risk factors. For example, revenue recognition is included on the business/operating "risk register" and on the fraud risk register above.

2.191 This separation is also helpful in:

- Identifying possible pressures, opportunities, and rationalizations for fraud;
- Identifying the susceptibility of particular account balances and transactions to fraud; and
- Designing an appropriate audit response.

Significant Risks



2.192 The purpose of this Section is to provide guidance on the nature and determination of significant risks and the consequences for the audit. The primary source of reference for this is SA 315.

Overview

2.193 SA 315 states:

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

(a) the financial statement level; and (Ref: Para. A98-A101)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A102-A106)

to provide a basis for designing and performing further audit procedures.

26. As part of the risk assessment as described in paragraph 24, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A117-A119)"

2.194 SA 240 states:

"29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

(a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)

(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)"

2.195 SA 330 states:

"6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, (as appropriate and notwithstanding the requirements of this SA), the auditor may determine that:

(a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;

(b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or

(c) A combined approach using both tests of controls and substantive procedures is an effective approach.”

Determination of Significant Risks

2.196 A key part of the risk assessment process is to determine which of the business and fraud risks identified are, in the auditor’s judgment, significant.

2.197 Significant risks will:

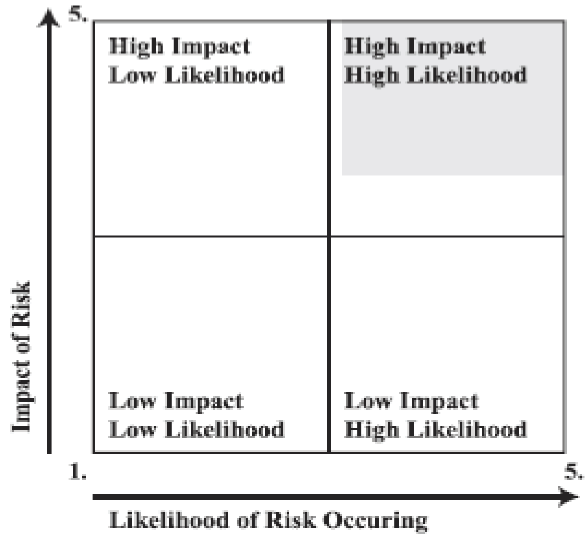
- Arise on most audits; and
- Require special audit consideration.

2.198 Determination of which risks are significant is based on:

- The nature of the risk;
- Consideration of the effect of any identified internal control related to the risk;
- The likely magnitude (size) of the potential misstatement (or multiple misstatements); and
- The likelihood (probability) of the risk occurring.

2.199 Note that the determination of significant risk is based on the inherent risk (before considering related internal control) and not the combined risk (considering both inherent and internal control risks). For example, a company with a large inventory of diamonds would have a high inherent risk of theft. Management’s response is to maintain secure facilities and keep the diamonds locked in a safe that is guarded at all times. The combined risks of material misstatement are therefore minimal. However, because the risk of loss (before considering internal control) is highly likely and its size would have a material impact on the financial statements, the risk would be determined as “significant”.

2.200 A chart that maps the assessment of risks based on likelihood and impact. Risks that fall within the shaded area of the chart below (high impact, high likelihood) would certainly be considered as being significant risks.



Areas to Consider

2.201 When considering whether significant risks exist, the auditor would consider the following matters:

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant economic, accounting or other developments 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 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.

2.202 In smaller entities, significant risks often relate to the matters outlined in the chart below.

Subject Matter/ Information	**Characteristics**

Significant Non-routine Transactions	• High inherent risk (likelihood and impact).
	• Occur infrequently.
	• Not subject to systematic processing.
	• Unusual due to their size or nature (such as the acquisition of another entity).
	• Require management intervention:
	  ○ To specify accounting treatment; and
	  ○ For data collection and processing.
	• Involve complex calculations or accounting principles.
	• Nature of transactions makes it difficult for entity to implement effective internal controls over the risks.

Significant Judgmental Matters	• High inherent risk. • Involve significant measurement uncertainty (such as the development of accounting estimates). • Accounting principles involved may be subject to differing interpretation (such as preparation of accounting estimates or application of revenue recognition). • Required judgment may be subjective, complex, or require assumptions about the effects of future events (such as judgments about fair value, valuation of inventory subject to rapid obsolescence, etc.).

2.203 The auditor should also consider the following factors when identifying significant risks:

- Is there a potential for fraud to occur?
- Is the risk related to recent significant economic or accounting changes or other developments?
- Are complex transactions involved?
- Are there significant transactions with related parties?
- Is there a high degree of subjectivity in the measurement of financial information, especially those areas involving a wide range of measurement uncertainty?
- Are there significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual?

Responding to Significant Risks

2.204 When a risk is classified as being "significant", the auditor should respond as outlined below.

Evaluating Internal Control Design and Implementation

2.205 The auditor should evaluate the design of the entity's related internal control system, including relevant internal control activities, and determine whether they have been implemented. This is necessary to provide the auditor with adequate information to develop an effective audit approach.

2.206 Internal control activities could include:

- A review of assumptions (used in estimates) by senior management or experts;
- A formal process for preparing estimations; and
- Approval of the response by those charged with governance.

2.207 Where significant non-routine or judgmental matters are not subject to routine internal control (such as a one-off or an annual event), the auditor should evaluate management's awareness of the risks and the appropriateness of their response. For example, if the entity purchased the assets of another business, the entity's response might include hiring an independent valuator for the acquired assets, the application of appropriate accounting principles, and proper disclosure of the transaction in the financial statements.

2.208 Where the auditor judges that management has not appropriately responded (by implementing internal control over significant risks) and a material weakness exists in the entity's internal control:

- The matter should be communicated (as soon as possible) to those charged with governance; and
- Consideration should be given to the implications for the auditor's risk assessment (determining the further audit procedures may be required to address the assessed risk).

Reliance on evidence attained in previous audits not allowed

2.209 Where a test of operating effectiveness is planned for a control that mitigates a significant risk, the auditor may not rely on audit evidence about the operating effectiveness of internal control obtained in prior audits.

Substantive procedures should specifically respond to the identified risk

2.210 Substantive procedures related to significant risks should address the specific risk identified. They should also be designed to obtain audit evidence with high reliability.

2.211 In many cases, the audit procedures for significant risks will be an extension of procedures that would be planned in any case. For example, if the significant risk related to potential management bias lies in the preparation of an estimate, the substantive procedures would address the validity of the assumptions used, identifying the sources and considering the reliability of the information used (both external and internal), the existence of any bias in the prior year's estimates as compared to actual facts, and the methods used in the estimate calculation.

Substantive analytical procedures alone are not a sufficient response

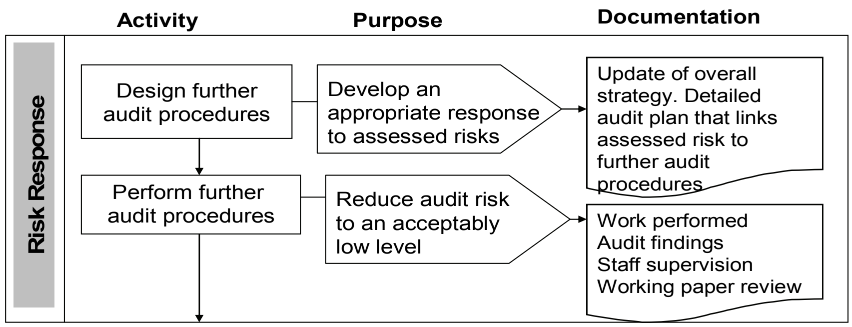
2.212 The use of substantive analytical procedures by themselves is not considered an appropriate response to address a significant risk. When the approach to significant risks consists only of substantive procedures, the audit procedures can consist of:

- Tests of details only; or
- A combination of tests of details and substantive analytical procedures.

Part C
Risk Response

Chapter 3
Risk Response

Detailed Audit Plan



3.1 The purpose of this Section is to respond to the identified risks of material misstatement by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. The primary source of reference for this is SA 300, "Planning an Audit of Financial Statements".

Overview

3.2 SA 300 states:

"8. The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)

11. The auditor shall document:

(a) The overall audit strategy;

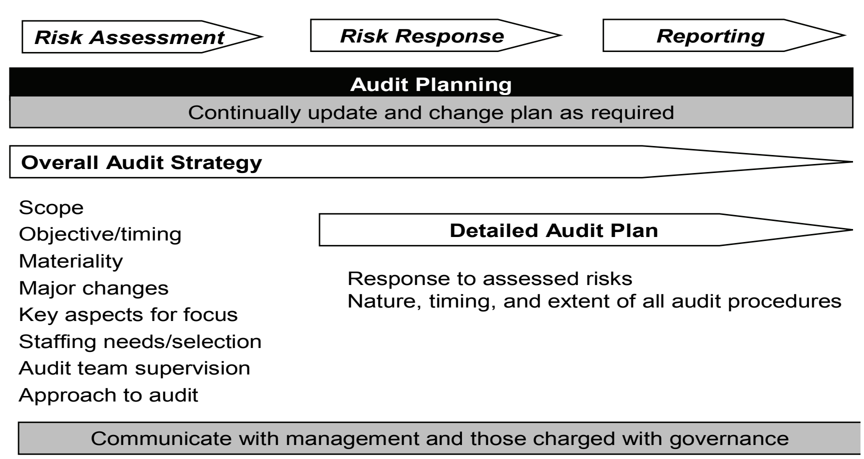
(b) The audit plan; and

(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)"

3.3 The overall audit strategy sets out the scope, timing, and direction of the audit and guides the development of the more detailed audit plan, which is discussed in this section. The more detailed audit plan addresses the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

3.4 Although the overall audit strategy will be established before developing the detailed audit plan, the two planning activities are not necessarily discrete or sequential processes. They are closely interrelated since changes in one may result in consequential changes to the other.

This is illustrated below.



3.5 The objective of the detailed audit plan is to respond appropriately to the identified and assessed risks, thereby reducing audit risk to an acceptably low level.

3.6 The detailed plan:

- Provides a clear linkage between the assessed risks and the further audit procedures; and
- Outlines the nature, timing, and extent of such further audit procedures (tests of controls and substantive procedures).

Consider Point

3.7 The detailed plan should link the design of further audit procedures to the assessed risks addressed during the risk assessment phase of the audit. This "linkage" is quite different from some traditional audit approaches where standard audit programs were completed with few, if any, changes made to reflect the specific risks present within the entity.

Responding to Assessed Risks

3.8 The nature, timing and extent of further audit procedures should:

- Respond to the assessed risks (identified during the risk assessment process);
- Reduce audit risk to an acceptable level; and
- Respond to assessed risks of material misstatements for each material class of transactions, account balance, and disclosure.

3.9 The basic information and considerations needed to design further audit procedures include:

- Nature of assessed risks;
- Use of tests of controls;
- Need for unpredictability; and

- Other basic or required audit procedures.

These are discussed as follows.

Nature of Assessed Risks

3.10 Audit attention should be directed in responding to those risks that have the highest potential for material misstatement. Considerations include:

- *How significant is the assessed risk?*

  What would be the impact if it occurred? This would relate to materiality.

- *How likely is the assessed risk to occur?*

  What is the likelihood or probability of the risk actually occurring?

- *What is combined assessment of impact and likelihood?*

- *What assertions are effected?*

  Consider the impact of the risk on each of the assertions (completeness, existence, accuracy, and valuation) relevant to the account balance, class of transactions, or disclosure.

- *Is it a "significant risk"?*

  Significant risks require separate attention and response by the auditor. Planned audit procedures should directly address these risks.

- *What is management's response?*

  Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Are the controls:

  - Routine in nature (occur daily) or periodic such as monthly?
  - Designed to prevent or detect and correct errors?

  - o Manual or automated?

- *Are there any unique characteristics?*

  Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures. Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

  Use of tests of controls

  The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In the case of very small entities, there may not be many control activities that could be tested. In this case, the further audit procedures are likely to be primarily substantive.

  There are two matters to consider when determining whether the response to assessed risks should include testing the operating effectiveness of internal control.

- *Is it efficient to test internal control?*

  Where internal control exists and is expected to operate effectively, consider:

  - o Whether testing controls would achieve an effective response to the assessed risk of material misstatement for a particular assertion; and

  - o What substantive testing could be reduced by performing tests of controls.

Even in a very small entity, there are often well-designed and effective controls over revenues that, if tested, could reduce the extent of substantive procedures required.

If testing the operating effectiveness of internal control would not be effective or efficient, it will then be necessary to perform substantive procedures that respond to assessed risks for specific assertions. No credit can be taken for the effective operation of controls that have not been tested.

- *Are there assertions that can only be effectively addressed by tests of controls?*

  In some cases, suitable substantive procedures (to obtain evidence for a particular assertion) may not be available, so tests of controls will be necessary. An example of this would be highly automated systems with little or no paper trail available. If such internal control is not considered reliable (controls are not likely to operate effectively) or is absent, the auditor will have to determine whether it is possible at all to obtain sufficient appropriate audit evidence.

Need for unpredictability

3.11 Based on the nature of the assessed risks, consider whether some of the planned procedures should be unannounced, changed from prior years, or performed at unpredictable times.

Other basic or required audit procedures

3.12 A number of specific further audit procedures may be required (regardless of the assessed risks) to comply with the SAs and local requirements. Examples might include attending the inventory count, external confirmations, and subsequent events.

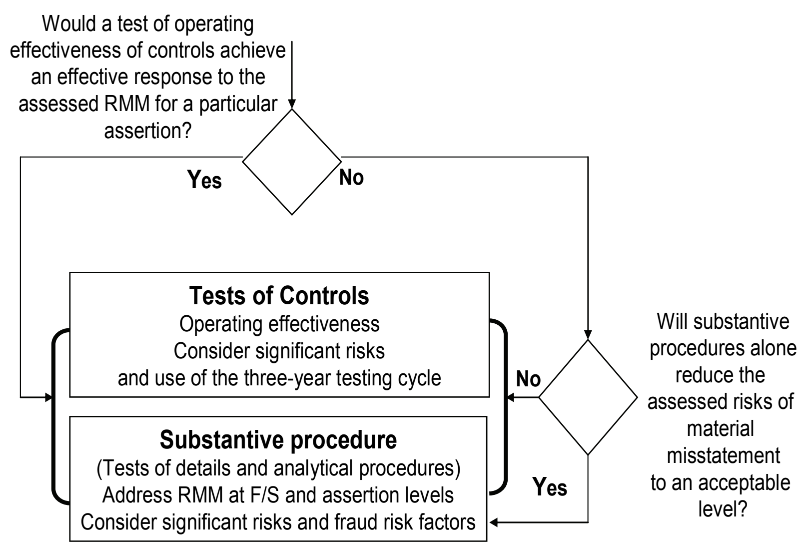
Design of Audit Procedures

3.13 The auditor can respond to assessed risks through the design of further audit procedures. These procedures usually involve elements such as inspection, observation, inquiry, confirmation, recalculation, re-performance, or analytical procedures. There are three major categories:

- Risk assessment procedures;
- Tests of the operating effectiveness of internal control; and
- Substantive procedures. This includes tests of detail and substantive analytical procedures.

3.14 An appropriate response to assessed risks may contain a combination of procedures such as tests of controls and substantive procedures.

3.15 The following outlines some of the considerations in developing the appropriate response.



Factors to Consider in Designing the Nature of Procedures	
Nature of Assertions	Certain audit procedures may: · Be more appropriate for addressing some assertions than others. Evidence for completeness of sales may best be obtained through a test of controls, whereas evidence to support the valuation of inventory will probably be obtained with substantive procedures; and · Provide more reliable evidence for an assertion. A confirmation of receivables to determine existence may provide better evidence than simply examining invoices or performing some analytical procedures.
Assessed Level of Risk	The higher the risk of misstatement, the more reliable and relevant is the audit evidence required. This may affect both the types and the combination of different types of audit procedures to be performed. For example, to ensure the existence of high value inventory, a physical inspection may be performed in addition to examining the supporting documents.
The Reasons for Risk	The underlying reasons for the risk should be considered in the design of both tests of controls and substantive procedures. This will include the characteristics of the financial statement area (inherent risks) and the internal control in place (control risk). If the assessed risk is low because of good internal control, tests of controls may reduce the need for or extent of substantive procedures.
Source of Information	If non-financial information produced by the entity's information system is used in performing audit procedures, evidence should be obtained about its accuracy and completeness. For example, the number of rental units in a high-rise apartment could be multiplied by the monthly apartment rental to compare with the total revenues recorded.

Factors to Consider in Designing the Nature of Procedures	
Dual Purpose Tests	Where efficient, a test of internal control could be performed concurrently with a test of details on the same transaction. An invoice could be examined for approval (tests of controls) and to substantiate the transaction (tests of detail). If the test of details reveals a misstatement not caught by the internal control system, it might be indicative of a material weakness in internal control. Such weaknesses should be communicated to management and to those charged with governance, and the need for additional audit procedures considered. This will include updating the risk assessment and developing an appropriate audit response.

Timing of Procedures

3.16 Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.

Before or at the Period End?

3.17 In most instances (particularly with small entities), audit procedures will be carried out at the period end and later. In addition, the higher the risks of material misstatement, the more likely it would be for substantive procedures to be performed nearer to, or after, the period-end.

3.18 In some situations though, there can be some advantages to performing audit procedures before the period end. For example:

- Helping to identify significant matters at an early stage. This provides time for the issues to be addressed and further audit procedures to be performed;
- Balancing the audit firm's workload by shifting some busy season procedures to a period when there is more time; and
- Performing procedures unannounced or at unpredictable times.

3.19 The following outlines the factors to consider when determining whether to perform procedures at an interim date.

	Factors to Consider
Should Audit Procedures be Performed Before the Period End?	· How good is the overall control environment? Performing a roll forward between an interim date and the period end is unlikely to be effective if the general control environment is poor. · How good are the specific controls over the account balance or class of transactions being considered? · Is the required evidence available to perform the test? Electronic files may subsequently be overwritten or procedures to be observed may occur only at certain times. · Would a procedure before the period end address the nature and substance of the risk involved? · Would the interim procedure address the period or date to which the audit evidence relates? · How much additional evidence will be required for the remaining period between the date of procedure and period end?

After Period End

3.20 Certain audit procedures can be performed only at, or after, the period-end. This would include cutoff procedures (where there is minimal reliance on internal control), period-end adjustments, and subsequent events.

Extent of Procedures

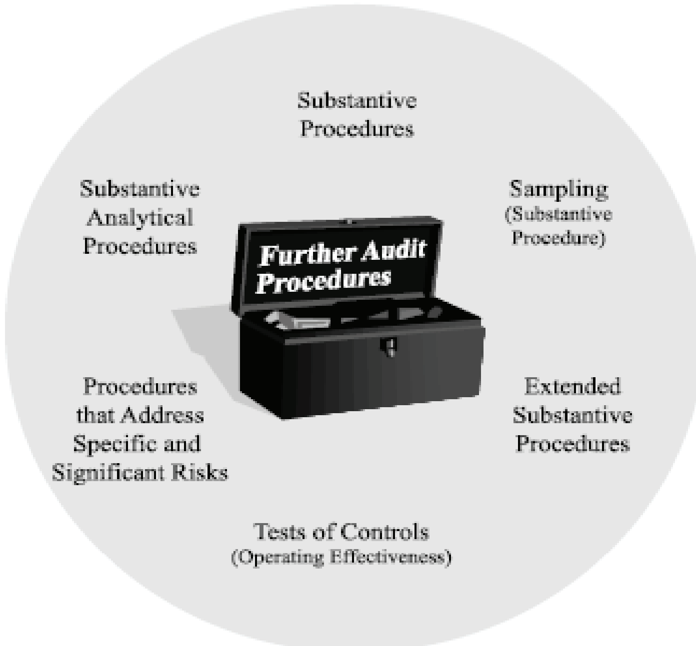
3.21 Extent relates to the quantity (sample size) of a specific audit procedure to be performed. The general rule is that as the risks of material misstatement increase, so should the sample size. However, this will only be effective if the procedure is relevant to the assessed risk.

The Audit Toolbox

3.22 As stated earlier, the objective of the detailed audit plan is to respond appropriately to the assessed risks and thereby reduce the audit risk to an acceptably low level.

3.23 The most effective approach would be to consider each assessed risk and then design an appropriate audit response in the form of further audit procedures. What is not appropriate is to use a standard ("one size fits all") audit program that may address each assertion, but has not been tailored in any way to address the assessed risks.

3.24 In developing the detailed plan, there are a number of different types of procedures that can be considered. An effective audit program will be based on an appropriate mix of procedures that collectively reduce audit risk to an acceptably low level. For the purposes of this Guide, the different types of audit procedures available to the auditor have been categorized as illustrated below.



Substantive Procedures

3.25 These include those procedures that would always be performed regardless of the risks of material misstatement (RMM) identified. Where the RMM is very low, these procedures alone might be sufficient for a specific area or assertion. Where the RMM is high, these basic procedures should be expanded in response to the assessed risks. A typical example would be obtaining a list of the items that make up the period-end balance, comparing this year's balance to that of last year, and performing some cut-off procedures.

Substantive Sampling

3.26 Where a basic procedure (such as confirmation of accounts receivable balances selected by a judgmental sample) is not sufficient to reduce audit risk to an acceptable level, additional confirmations may be selected using statistical sampling techniques.

Extended Substantive Procedures

3.27 These are basic substantive procedures that have been extended or tailored to address an assessed risk such as management override. For example, a basic substantive procedure would include confirming selected accounts receivable balances. Under the basic procedure, the confirmations obtained would be compared to the account balances. An extended procedure designed to address fraud risk would go a step further to include further work such as checking the telephone directory to establish that the company actually exists at the address provided.

Tests of Controls

3.28 Based on the understanding of internal control and the walk-through procedures, certain key controls may be identified (controls that address more than one assertion) that are expected to operate effectively. Testing of these controls may be the most effective audit procedure and will reduce the extent of other substantive procedures required.

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

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

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

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

3.31 In designing and performing tests 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; and

  (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.

3.32 The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs below, in order to provide an appropriate basis for the auditor's intended reliance.

Purpose

3.33 Tests of controls are tests designed to obtain audit evidence about the operating effectiveness of controls. Controls can prevent material misstatements at the assertion level from occurring altogether, or detect and then correct them after they occurred. The controls selected for testing would be those that provide necessary audit evidence for a relevant assertion.

Consider Point

3.34 A walk-through procedure to determine whether a control has been implemented is not a test of control. It is a risk assessment procedure, the results of which may determine whether tests of controls would be useful and, if so, how they would be designed.

Consideration of test of controls

3.35 Tests of controls are considered by the auditor when:

- The risk assessment is based on an expectation that internal control operates effectively; or
- Substantive procedures alone will not provide sufficient appropriate audit evidence at the assertion level. This might apply where sales are made over the Internet and no documentation of transactions is produced or maintained, other than through the IT system.

3.36 Tests of controls are designed to obtain audit evidence about:

- How internal control procedures were applied throughout or at relevant times during the period under audit. If substantially different controls were used at different times during the period, each control system should be considered separately;
- The consistency with which internal control procedures were applied; and
- By whom or by what means controls were applied.

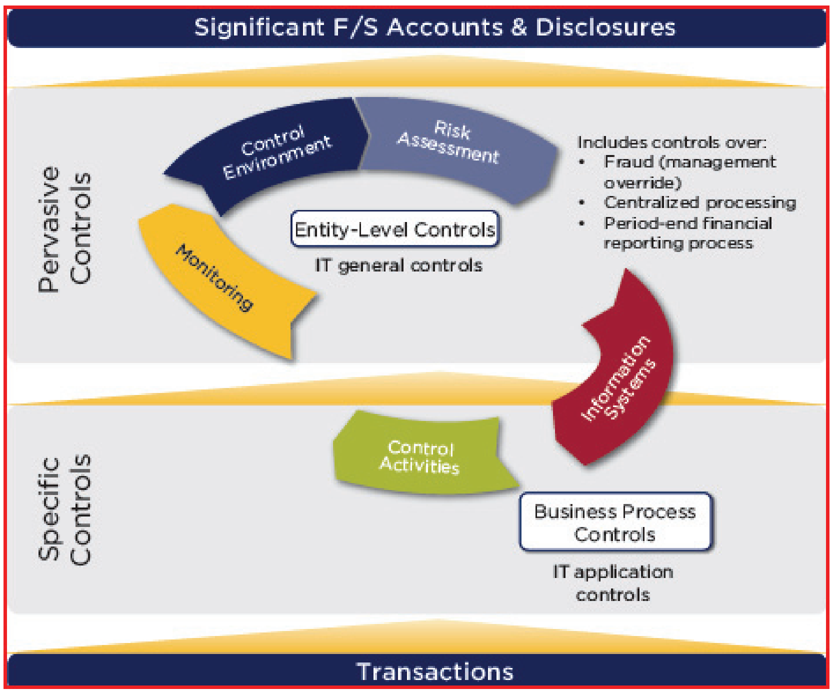
Consider Point

3.37 When auditing smaller entities, auditors often plan to perform substantive procedures on the assumption that tests of existing control activities would not be practical due to limited segregation of duties, etc. Before jumping to that conclusion, consider:

- The strength of the control environment and other elements of internal control;
- Existence of control activities over assertions where it would be more efficient to gain evidence through tests of controls; and
- Assertions where substantive procedures alone will not reduce the risks of material misstatement to an acceptably low level. For instance, this may be the case for the completeness of revenues.

Designing Tests of Controls

3.38 Tests of controls are used to gain evidence about the operating effectiveness of controls included in any of the five elements of internal control. See the exhibit below and on each of the five internal control elements.



3.39 Specific controls (such as control activities) directly address the prevention or detection and correction of misstatements, whereas pervasive controls provide the foundation for the specific controls and influence their operation.

3.40 In smaller entities, some pervasive controls (such as the control environment) may also serve to address specific risks of misstatement for a relevant assertion (for example, where senior management is directly involved in supervising and approving day-to-day transactions). In this case, if the pervasive controls were tested and found to operate effectively, there would be no need to test other controls (such as control activities) related to the particular risks involved.

Consider Point
3.41 Domination of management by a single individual does not mean that internal control is weak or does not exist. In fact, the involvement of a competent owner-manager in the detailed day-to-day operations would be an important control environment strength. The opportunity for management override of internal control still exists, but can be reduced to some extent (in virtually any size of entity) by implementing some simple anti-fraud controls.

3.42 In other cases, the link between pervasive and specific controls may be more direct. For example, some monitoring controls may identify control breakdowns in specific (business process) controls. If the auditor tested these monitoring controls for effectiveness, the need for testing more specific controls might be reduced (but not eliminated).

3.43 Tests of pervasive controls (often referred to as entity-level and general IT controls) tend to be more subjective (such as evaluating the commitment to integrity or competence) and therefore more difficult to document than specific internal control at the business process level (such as checking to see if a payment was authorized). As a result, the testing of entity-level and IT general controls are often documented with memorandums to the file explaining the approach taken and the action steps (for example, staff interviews, assessments, review of employee files, etc.), along with supporting evidence.

3.44 This approach is illustrated in the following example.

Testing Entity-Level Control

Control Component = Control Environment

Risk Addressed No emphasis is placed on need for integrity and ethical values.

Controls Identified Management requires all new employees to sign a form stating their agreement with the firm's fundamental values and understanding of the consequences for non-compliance.

Control Design Read the form to be signed by employees and ensure it does address integrity and ethical values.

Control Implementation Review one employee file to ensure there is a signed form and consider what evidence exists (such as discipline) that employees actually practice the values. This could be based on a short interview with an employee.

Test of Control Effectiveness Select a sample of employee files and ensure there are agreement forms on file and they are signed by the employee. This could be supplemented by asking some employees what are the entity values.

Documentation Provide details of the employee files selected and any interview notes along with the conclusions reached.

3.45 Some key factors for the auditor to consider in designing tests of controls are listed below.

Address - Description

What Risk of Material Misstatement and Assertion is being Addressed - Identify the risk of material misstatement and the related assertion that would be addressed by performing tests of controls. Then consider whether audit evidence about the relevant assertion can best be obtained by performing tests of controls or through substantive procedures.

Reliability of the Controls - As a general rule, it is not worth testing controls that may prove to be unreliable. This is because the small sample sizes commonly used for testing controls are based on finding no exceptions.

3.46 If any of the following factors are significant, it may be more effective to perform substantive procedures (if possible):

- Any history of errors?
- Any changes in the volume or nature of transactions?
- Are the underlying entity-level and general IT controls weak?
- Can controls be (or have been) circumvented by management?
- Frequency at which the control operates? (e.g., daily, weekly or monthly?)
- Any changes in personnel or competence of people performing the control?
- Is there a significant manual element in the control that could be prone to human error?
- Complexity of operation and major judgments involved with its operation?

3.47 *Existence of Indirect Controls*: Does control depend on the effective operation of other controls? This dependency or inter-relationship could include non-financial information produced by a separate process, the treatment of exceptions and management's periodic reviews of reports.

3.48 *Nature of Test to Meet Objectives:* Tests of control usually involve a combination of the following:

- Inquiries of appropriate personnel;
- Inspection of relevant documentation;
- Observation of the company's operations; and
- Re-performance of the application of the control.

3.49 Note that inquiry alone would not be sufficient evidence to support a conclusion about the effectiveness of a control. For example, to test the operating effectiveness of internal control over cash receipts, the auditor might observe the procedures for opening the mail and processing cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor would supplement the observation with inquiries of the entity's personnel and inspection of documentation about the operation of such internal control at other times.

> ***Consider Point***
>
> 3.50 Determine what constitutes a control deviation.
>
> When designing a test of control, spend time to define exactly what constitutes an error or exception to the test. This step will save time spent by audit staff in determining whether a seemingly minor exception (such as an incorrect telephone number) is, in fact, a control deviation.

Automated Controls

3.51 There may be some instances where control activities are performed by a computer and supporting documentation does not exist. In these situations, the auditor may have to re-perform some controls to ensure the software application controls are working as designed.

3.52 Another approach is to use computer assisted audit techniques (CAATs). One example of a CAAT is a software package that can import an entity's data file (such as sales or payables), which can then be tested. Such programs can analyze client data to provide the audit evidence needed. In addition, they provide the potential to perform much more extensive testing of electronic transactions and account files. Some possible uses of CAATs are outlined below.

Use of CAATs

3.53 Typical Types of Procedures

- Select sample transactions from electronic files.
- Sort transactions with specific characteristics.
- Extract records based on specified criteria.
- Test an entire population instead of a sample.

- Find gaps and duplicates (numeric, text and date).
- Add files and check extensions such as pricing.
- Stratify, summarize and age information.
- Match data across files.

Consider Point

3.54 Smaller entities often use off-the-shelf packaged accounting and other relevant software without modification. However, many software packages actually contain proven application controls that could be used by the entity to reduce the extent of errors and possibly deter fraud. Auditors might want to ask their clients whether these controls are being used and, if not, whether there would be value to using them.

Timing of Tests of Controls

3.55 The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs below, in order to provide an appropriate basis for the auditor's intended reliance.

3.56 If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

(b) Determine the additional audit evidence to be obtained for the remaining period.

3.57 If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

3.58 Tests of controls may provide evidence of effective operation:

- At a particular point in time (i.e., a physical inventory count); or

- Over a period of time such as the period under audit.

3.59 When the tests of controls take place before the period end, the auditor would consider what additional evidence may be required to cover the remaining period. This evidence may be obtained by extending the tests to cover the remaining period or testing the entity's monitoring of internal control.

Factors to Consider

3.60 Gap between the Tests of Controls and Period End

- Significance of assessed risks of material misstatement at the assertion level.
- Specific controls that were tested during the interim period.
- Degree to which audit evidence about the operating effectiveness of those controls was obtained.
- Length of the remaining period.
- Extent to which the auditor intends to reduce further substantive procedures based on the reliance on internal control.
- The control environment.
- Any significant changes in internal control, including changes in the information system, processes and personnel that occurred subsequent to the interim period.

Consider Point

3.61 Where efficient, consider performing tests on the operating effectiveness of internal controls at the same time as evaluating the design and implementation of these controls.

Using Audit Evidence Obtained in Previous Audits

3.62 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.

3.63 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. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit.

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods.

3.64 If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.

Rotational Testing of Controls

3.65 Assuming internal control has not changed since the controls were last tested, the tests of operating effectiveness may only need to be performed (with certain exceptions such as outlined below) once every third audit. The actual period of reliance will be based on professional judgment but cannot exceed two years.

3.66 When there are a number of controls where evidence could be used from prior audits, the reliance should be staggered so that some testing of internal control is performed during each audit. Testing at least a few controls each period also provides collateral evidence about the continuing effectiveness of the control environment.

3.67 Before audit evidence obtained in prior audits can be used, the continuing relevance of such evidence needs to be established each period. This will include confirming the understanding of those specific controls through:

- Inquiry of management and others; and
- Observation or inspection (walkthroughs) of the internal control.

3.68 Reliance on evidence obtained in previous audits would not normally be applicable in the following situations:

Reliance on Prior Years' Audit Evidence

3.69 Use of control testing performed in prior years is not permitted when:

- Reliance is required to mitigate a "significant risk";
- Internal control has changed;
- A weak control environment exists;
- The ongoing monitoring of internal control is poor;
- There is a significant manual element to the operation of relevant controls;
- Personnel changes have occurred that significantly affect the application of the control;
- Changing circumstances indicate the need for changes in the operation of the control; and/or
- There are weak or ineffective general IT controls.

3.70 In general, the higher the risks of material misstatement or the greater the reliance placed on internal control, the shorter the time period should be between tests of controls.

Procedures that address specific and significant risks

3.71 These audit procedures would respond directly to a specific assessed risk. This would include audit procedures that respond directly to significant risks identified.

Substantive analytical procedures

3.72 There are substantive analytical procedures that could be used to predict the total of a transaction stream such as sales.

Documenting the Audit Plan

3.73 When the detailed plan has been determined, the results can be documented in the form of an audit program that outlines the nature and extent of procedures and the assertion(s) being addressed. Space can then be provided to record details about who performed each step and the findings is illustrated below.

3.74 A typical audit program (excluding the details of each specific audit step) might look as follows.

Note: This illustration includes all types of procedures, whereas there may be just one or two types of procedures required for a particular account balance or class of transactions.

Receivables – Audit Procedures

BASIC PROCRDURES

Analytical Procedures…
Balance listing…
Allowance for doubtful accounts, cut-off, reconciliations etc.,
Accounting policies

SAMPLING (i.e. confirmation of balances, etc.)

TESTS OF CONTROLS ON SALES

SUBSTANTIVE ANALYTICAL PROCEDURES

EXTENDED SUBSTANTIVE PROCEDURES

Accounts receivable confirmation – fraud risk…

SPECIFIC PROCEDURES TO ADDRESS SPECIFIC/ SIGNIFICANT RISKS

FINANCIAL STAEMENT PRESENTATION AND DISCLOSURE

Assert-ions addressed	**Work complet-ed by (Initials)**	**W/P ref.**	**Comm-ents**
CEA			
C			
VAE			
A			
E			
A			
EC			
EA			
EV			
CEAV			

Audit Conclusions

a) These procedures (including tests of controls, where applicable) have been tailored (as necessary) to respond to the assessed risks of material misstatement at the financial statement and assertion level.

b) The risks of material misstatement in the accounts receivable balance have been reduced to an acceptable level.

c) All relevant assertions have been addressed.

	Date	**Initials**
Prepared by		
Reviewed by		

Communication of the Plan

3.75 An ongoing dialogue with management and those charged with governance can play an important role in the audit planning process. Communicating various aspects of the overall audit strategy may also be helpful to those charged with governance in understanding the role of the auditor and for discharging their responsibilities.

Accounting Estimates

3.76 The section contains audit procedures relating to the audit of accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements.

Exhibit

Overview

3.77 The objective when auditing the accounting estimates is to obtain sufficient appropriate audit evidence about whether:

- Accounting estimates, including fair value accounting estimates in the financial statements, whether recognized or disclosed, are reasonable; and
- Related disclosures in the financial statements are adequate.

3.78 Some financial statement items cannot be measured precisely and therefore have to be estimated. Such accounting estimates range from the straightforward (such as net realizable values for inventory and accounts receivable) to the more complex (such as calculating revenues to be recorded from long-term contracts and future liabilities on product warranties and guarantees). Estimates can often involve considerable analyses of historical and current data and the forecasting of future events such as sales transactions.

3.79 The measurement of accounting estimates may vary based on the requirements of the financial reporting framework and the financial item involved. For example, the measurement objective of an estimate may be to:

- Forecast the outcome of one or more transactions, events or conditions that gave rise to the accounting estimate; or
- Determine the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. This would include fair value measurements.

3.80 The degree of misstatement in an accounting estimate is more difficult to assess than other types of misstatement. This difficulty results from the following:

- The complexity and subjectivity involved in preparing estimates;
- The availability and reliability of data;
- The nature and extent of assumptions required; and
- The degree of uncertainty of future events.

3.81 A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Risk Assessment

3.82 For smaller entities, the amount of work involved in preparing estimates will be less complex as their business activities are often limited and transactions are less complex. Often a single person, such as the owner-manager, will identify the need for accounting estimates and the auditor may focus the inquiries accordingly.

3.83 *How is the Need for an Estimate Identified?* This could result from the financial reporting framework being used or from transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In addition, the auditor would make inquiries of management about changes in circumstances that give rise to new, or the need to revise existing, accounting estimates.

3.84 *Management's Process for Making Estimates:* Review and evaluate management's estimation processes including the development of the underlying assumptions, reliability of data used and any internal approval or review process. Where applicable, this could also include the use of an expert.

3.85 *Outcomes of Estimates Prepared in Previous Periods:* Review the outcome of the previous period's estimates and understand the reasons for differences between prior period estimates and the actual amounts. This will help to understand:

- Effectiveness (or not) of management's estimation process;
- Existence of any possible management bias;
- Existence of pertinent audit evidence; and
- Extent of estimation uncertainty involved, which may be required to be disclosed in the financial statements.

3.86 *Extent of Estimation Uncertainty Involved:* Consider the following:

- Extent of management's judgement involved;
- Sensitivity to changes in assumptions;
- Existence of recognized measurement techniques that mitigate the uncertainty;
- Length of the forecast period and relevance of data used;
- Availability of reliable data from external sources;
- Extent estimate is based on observable or unobservable inputs; and
- Susceptibility to bias.

3.87 *Significance of the Estimates:* In assessing the risks of material misstatement, consider:

- Matters addressed above in this table;
- Actual or expected magnitude of the estimate; and
- Whether the estimate creates a significant risk.

Responses to Assessed Risks

3.88 In smaller entities, there is likely to be active management involvement in the financial reporting process, which includes accounting estimate preparation. As a result, controls over the estimating process may not exist, or if they do exist, may operate informally. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature.

3.89 *Have Estimates been Prepared Appropriately?* Do the estimates comply:

- With the applicable financial reporting framework?
- Were methods used for making the estimates appropriate and applied consistently?
- How reliable is the Supporting Evidence?
- Review events subsequent to the period end to ensure they support management's estimates.
- Test the information, controls (if any), methods and assumptions used.
- Establish an independent point estimate or zone of reasonableness. Based on available evidence and discussions with management, develop an independent point estimate or zone of reasonableness for comparison with the entity's estimate. The amount by which management's estimate differs from the point estimate or falls outside the zone of reasonableness would be considered as a misstatement.

Possible Management Bias

- Consider the cumulative effect of bias in the preparation of management's accounting estimates. This could occur where estimates consistently lie at one boundary of the zone of reasonableness or move from one boundary to the other in successive periods.

3.90 Where the estimate is complex or involves specialized techniques, the auditor may determine it is necessary to use the work of an expert.

3.91 Where insufficient appropriate evidence is available or the evidence refutes management's estimates, the auditor would discuss the findings with management and consider the need to change the risk assessment and perform further audit procedures.

Reporting

3.92 The final step is to determine whether the disclosures in the financial statements about the estimates:

- Are in accordance with the requirements of the applicable financial reporting framework; and
- Adequately disclose their estimation uncertainty, if they give rise to significant risks.

Written Representations

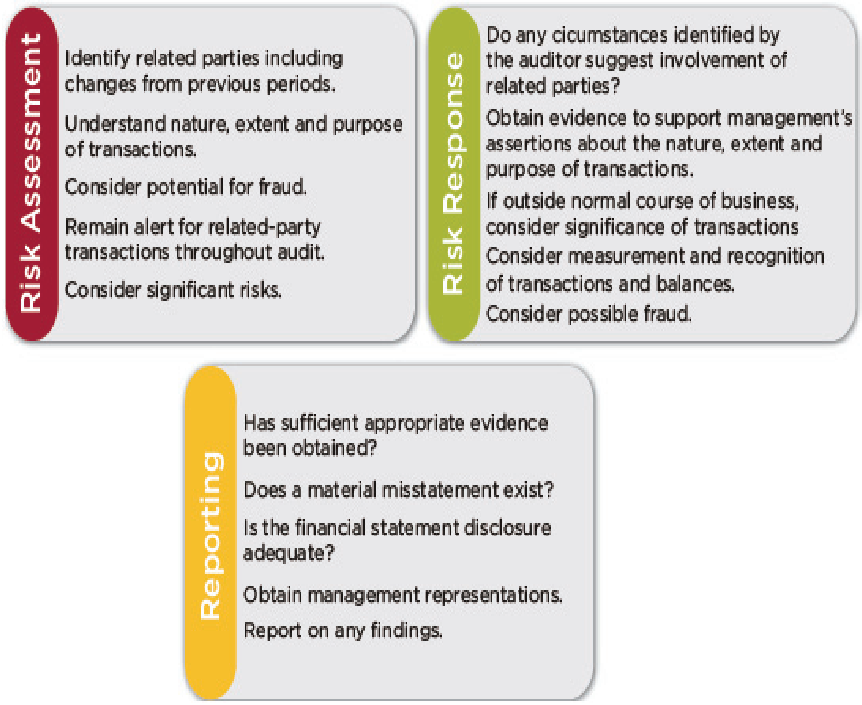
3.93 The auditor would obtain written representations from management regarding:

- The reasonableness of significant assumptions; and
- Whether the assumptions appropriately reflect management's intent and ability to carry out specific courses of action relevant to any fair value measurements or disclosures.

Related Parties

3.94 Audit procedures regarding related parties and transactions with such parties.

Exhibit



Overview

3.95 As related parties are not independent of each other, there may be higher risks of material misstatement in related-party transactions than transactions with unrelated parties. Consequently, financial reporting frameworks often contain accounting and disclosure requirements regarding related-party transactions. These disclosures are intended to provide financial statement users with an understanding of the nature of these transactions and the actual or potential effects.

3.96 Some of the potential risks with regard to related-party transactions are set out below.

Overly complex transactions: Related parties may operate through an extensive and complex range of relationships and structures.

Relationships and transactions not identified: The entity's information systems may be ineffective at identifying or summarizing transactions and outstanding balances between the entity and its related parties.

Not conducted in the normal course of business: Related-party transactions may not be conducted under normal market terms and conditions such as above, below fair values or even with no exchange of consideration at all.

3.97 Management is responsible for the identification and disclosure of related parties and transactions. This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements. In smaller entities, these procedures are likely to be less sophisticated and informal.

3.98 The auditor is responsible to maintain alertness for related-party information when reviewing records or documents during the audit. This includes the inspection of certain key documents but does not require an extensive investigation of records and documents to specifically identify related parties.

Risk Assessment

3.99 To identify the risks of material misstatement associated with related-party relationships and transactions, the auditor would consider the matters set out below.

Address Existence/Nature/Impact of Related Parties and Transactions: Inquire about the identity of related parties, including changes from prior period.

- Understand controls (if any) that management has established to identify, authorize, approve account for and disclose related parties and transactions, including those outside the normal course of business.
- Determine nature of related-party relationships and extent of type and purpose of transactions.

Consider Possible Fraud: Discuss among the engagement team the susceptibility of financial statements to material misstatement due to fraud or error resulting from related-party relationships and transactions. If fraud risk factors are identified, an appropriate audit response would also be developed.

Remain Alert when Inspecting Records or Documents: Engagement team members should always remain alert to undisclosed related-party relationships or transactions when inspecting records or documents, including:

- Bank and legal confirmations;
- Minutes of meetings of shareholders and of those charged with governance; and
- Significant transactions outside the entity's normal course of business.

Always share information obtained about possible related parties with other team members.

Identify Significant Risks: Significant related-party transactions outside the normal course of business would normally give rise to significant risks.

Consider Point

3.100 In smaller entities, the identification of related-party transactions can often be difficult. If the client uses a standard software package to record transactions, consider obtaining an electronic copy of transactions and then importing them into an electronic spreadsheet. Using the sort features and configuring some selection criteria, the auditor can usually readily identify unusual patterns in customers / suppliers and high-value transactions.

Risk Response

3.101 In response to the identified risks of material misstatement associated with related party relationships and transactions, the auditor would consider the matters set out below.

When Related Parties are Identified by the Auditor

- Determine whether there are underlying circumstances and confirm their existence;
- Promptly communicate this information to engagement team;
- Request management to identify all related-party transactions;
- If a related party was not previously identified, ask why. Consider:
  - Failure of any related-party identification controls, and
  - Fraud (non-disclosure by management appears intentional);
- Reconsider the risk that other undisclosed related parties or significant related party transactions may exist and perform further audit procedures as necessary; and
- Perform appropriate substantive audit procedures.

Transactions Outside Normal Course of Business

- Inspect underlying contracts or agreements, if any, and evaluate whether:
  - Rationale suggests possible fraudulent financial reporting or concealment of misappropriated assets,
  - Terms are consistent with management's explanations, and
  - Transactions are accounted for and disclosed in accordance with the applicable financial reporting framework; and
- Ensure transactions have been appropriately authorized and approved.

Management's Assertions: Obtain sufficient appropriate audit evidence about management's assertions about the nature and extent of related party transactions.

Reporting

3.102 In forming an opinion on the financial statements, the auditor would consider the following matters with regards to related parties and transactions.

Determine if the Audit Opinion Needs to be Modified: Modify the auditor's report if:

- It is not possible to obtain sufficient appropriate audit evidence concerning related parties and transactions; or
- Management's disclosure in the financial statements (as required by the financial reporting framework) is not considered adequate.
- Obtain a Management Representation: Obtain written representations from management (and those charged with governance) that:
- All related parties and transactions have been disclosed; and
- Such relationships and transactions have been appropriately accounted for and disclosed in the financial statements.

Document and Report

- Document the names of the identified related parties and the nature of the related-party relationships; and
- Communicate with those charged with governance any significant matters arising during the audit in connection with related parties.

Subsequent Events

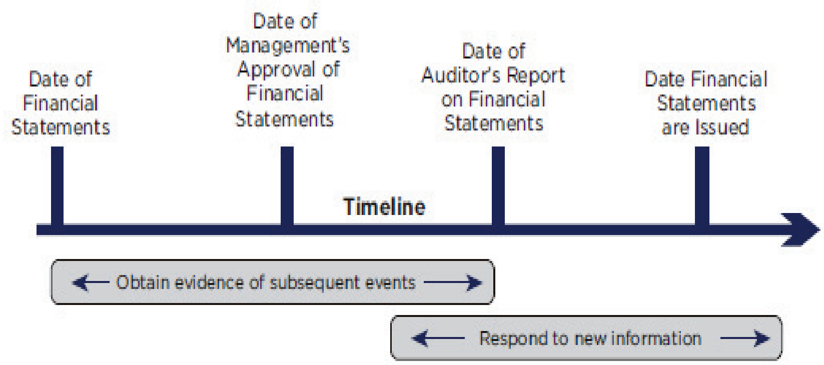
3.103 The section contains auditor's responsibility regarding subsequent events.

Overview

3.104 This standard provides guidance on the auditor's responsibility regarding subsequent events.

3.105 Subsequent events occur after the date of the financial statements (the period-end date). Other key dates in the preparation and release of financial statements are outlined in the exhibit below.

Exhibit



3.106 In determining the existence of subsequent events and assessing their impact, the auditor would carry out the steps set out below.

3.107 *Do Subsequent Events Exist?* Perform audit procedures to identify any subsequent events that would require adjustment of, or disclosure in, the financial statements. This would include:

- Understanding management procedures (if any) to identify subsequent events;
- Making inquiries of management (and those charged with governance) about subsequent events such as:

  - New commitments, borrowings or guarantees,
  - Planned / actual acquisition / sale of assets,
  - Appropriation or destruction of assets,
  - Business acquisitions or divestitures,
  - Increases in capital or debt instruments,
  - Litigation, claims and contingencies,
  - Unusual accounting adjustments made or contemplated,
  - Validity of the going-concern assumption or other accounting policies,
  - Events that affect the measurement of estimates or provisions made in the financial statements, and
  - Events relevant to the recoverability of assets.
- Reading minutes, if any, of the meetings (management and those charged with governance) held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available; and
- Reading financial reports produced after the period end, if any.

Obtain a Management Representation: Request a written representation that all subsequent events have been adjusted or disclosed in the financial statements.

3.108 *An Event Occurs after Date of Auditor's Report but before Financial Statements are Issued*

- Discuss the matter with management (and those charged with governance).
- Determine whether the financial statements need amendment and, if so:

- Inquire how management intends to address the matter in the financial statements,
- Perform any further audit procedures required, and
- Issue a new auditor's report on the amended financial statements. This could also include dual dating of the report, restricted to the amendment or inclusion of an emphasis of matter paragraph

• Where management does not amend the financial statements, the auditor would issue a modified auditor's opinion.

• If the auditor's report has already been released, notify management (and those charged with governance) not to issue the financial statements or the auditor's report to third parties.

• If the financial statements are released despite the notification, take appropriate action (after consulting with legal counsel) to prevent reliance on the auditor's report.

3.109 *An Event Occurs after the Financial Statements are Issued*

• Discuss the matter with management (and those charged with governance).

• Determine whether the financial statements need amendment and, if so, inquire how management intends to address the matter in the financial statements.

• If management amends the financial statements:

- Extend the subsequent event audit procedures to the date of the new auditor's report unless the auditor's report is amended to include an additional date restricted to a particular amendment,
- Perform any further audit procedures required,
- Review management's actions to ensure anyone in receipt of the previously issued financial statements

and auditor's report thereon is informed of the situation,

- ○ Provide a new auditor's report on the amended financial statements, and
- ○ Issue a new or amended auditor's report that includes an "Emphasis of Matter" paragraph.

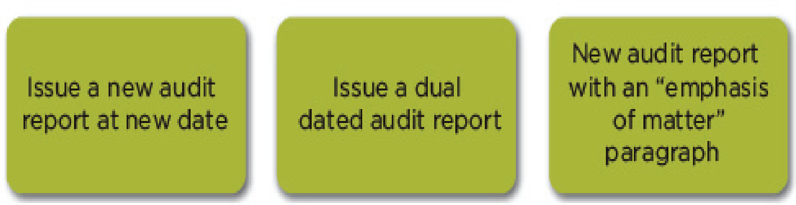
- If management does not take steps to ensure anyone in receipt of the previously issued financial statements is informed of the situation:
  - ○ Notify management (and those charged with governance) that the auditor will take appropriate action to seek to prevent reliance on the auditor's report.
- If, despite such notification, management (or those charged with governance) does not take the necessary steps, take appropriate action (such as consulting with legal counsel) to prevent reliance on the auditor's report.

Consider Point

3.110 It is in the interests of both the auditor and the client to complete the work necessary to issue the auditor's report on a timely basis. This will minimize the extent of work involved to identify, assess and possibly disclose subsequent events in the financial statements.

Amending Audit Reports

3.111 There are three methods of amending an audit report to address an amendment to the financial statements.



Dual Dating

3.112 Where the auditor's report is amended to include an additional date restricted to a particular amendment (that is, a subsequent event occurring after the date of the auditor's report), the original date of the auditor's report is retained. A new date is added to inform readers that the auditor's procedures subsequent to the original date were restricted to the subsequent amendment. Typical wording for an auditor's report originally dated September 15, 20xx and a Note Y where the audit work was completed on December 3, 20xx would be as follows:

- "September 15, 20xx except as to Note Y, which is as of December 3, 20xx."

Emphasis of Matter Paragraph

3.113 An Emphasis of Matter paragraph refers to a note in the financial statements that more extensively discusses the reason for the amendment to the previously issued financial statements and auditor's report.

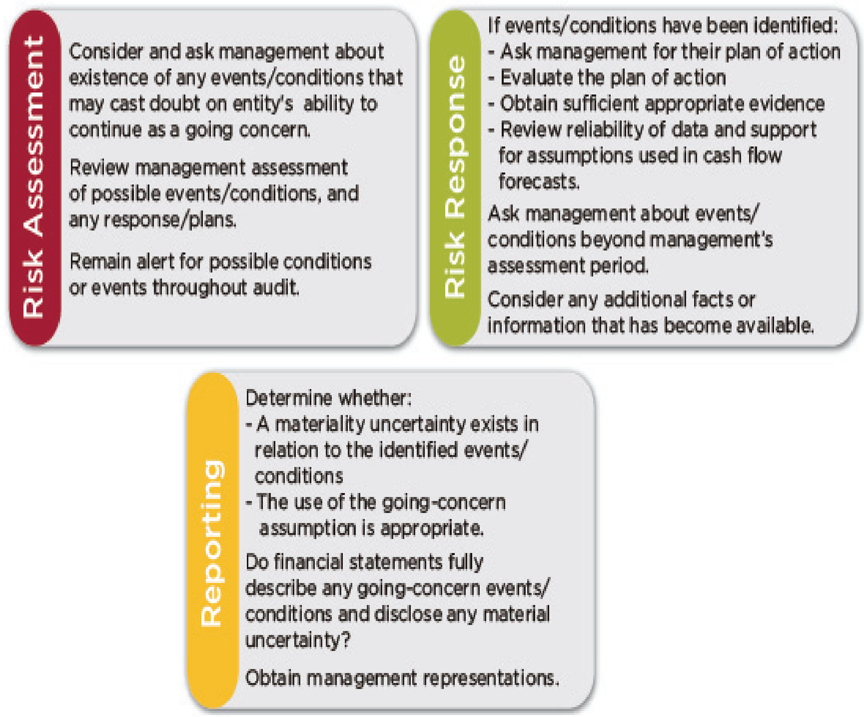
For example:

- "We draw attention to Note X to the financial statements, which describe the uncertainty related to the outcome of the lawsuit filed against the company by XYZ Company. Our opinion is not qualified in respect of this matter."

Going Concern

3.114 The section contains auditor's responsibility with respect to the going-concern assumption and management's assessment of the entity's ability to continue as a going concern.

Exhibit



Overview

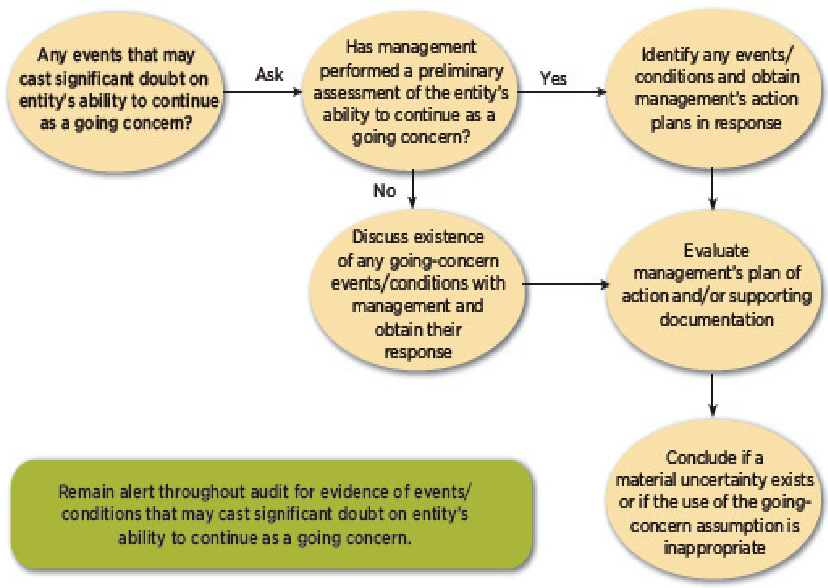
3.115 The going-concern assumption is a fundamental principle in the preparation of financial statements.

3.116 This standard provides guidance on the auditor's responsibility in the audit of financial statements with respect to the going-concern assumption and management's assessment of the entity's ability to continue as a going concern.

3.117 Under the going-concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, 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.

Risk Assessment Procedures

3.118 The requirements can be summarized as set out below.



3.119 Examples of some events or conditions that, individually or collectively, may cast significant doubt about the going-concern assumption are set out below.

Financial

- 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

- Management's intentions to liquidate the entity or to cease operations.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments. 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

- Non-compliance with capital or other statutory requirements.
- 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.

3.120 The significance of the above events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Evaluating Management's Assessment

Evaluating Management's Plans in Smaller Entities

3.121 Management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern. They may rely instead on their in-depth knowledge of the business and anticipated future prospects.

3.122 The auditor's typical evaluation procedures would include:

- Discussing medium and long-term financing with management;
- Corroborating management's intentions with the understanding of the entity obtained and documentary evidence;
- Satisfying the requirement for management to extend its assessment period to at least 12 months through discussion, inquiry and inspection by the auditor as to their feasibility or otherwise substantiated and the supporting documentation. For example, a prediction of future sales revenues could be supported by potential sales orders or sales contracts, which could be evaluated; and
- Inquiring if management has knowledge of events / conditions beyond the period of management's

assessment that would cast significant doubt on the entity's ability to continue as a going concern.

3.123 Where a small entity is largely financed by a loan or loan guarantees from the owner-manager (or other related parties such as family members), a withdrawal or major alteration in the terms of these funds could cast significant doubt on the entity's ability to continue as a going concern.

3.124 *Documentary Evidence Available:* Document:

- Terms of any loans provided to the entity;
- Details of subordinated loans to a third party such as the bank; and
- Details of financing by third parties based on guarantees or personal assets pledged as collateral.

3.125 *Is Additional Support Available?* Evaluate the ability of the owner-manager or other related parties to:

- Provide the necessary additional support such as loans or guarantees; and
- Meet the obligations under the support arrangements.

3.126 *Written Confirmations*: Request written confirmation of the:

- Terms and conditions of the financial support being provided; and
- The owner-manager's intentions or understanding in respect of the support being provided.

Risk Response — When Events are Identified

3.127 Where the auditor identifies going-concern events / conditions, the next step is to perform additional procedures (including consideration of mitigating factors) to determine whether or not a material uncertainty exists.

Material Uncertainty

3.128 A material (significant) 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 considered necessary in the financial statements.

3.129 Management's action plans to address going-concern issues typically include one or more of the following strategies:

- Liquidating assets;
- Borrowing money or restructuring debt;
- Reducing or delaying expenditures;
- Restructuring operations, including products and services;
- Seeking a merger or acquisition; or
- Increasing capital.

3.130 *Asking for Management's Assessment and Plan:* If not already provided, request management to make an assessment of the entity's ability to continue as a going concern.

Evaluating Management's Plans of Action: Evaluate management's future actions to address the going-concern assessment. Address:

- Will outcome of plans improve the situation?
- Are the plans feasible in the circumstances?
- How reliable are the profit / cash flow forecasts and what support is there for the assumptions used?
- Identifying, discussing and obtaining evidence for other factors that may affect the entity's ability to continue as going concern such as:
    - Poor recent operating results,

  - Breaches in terms of debentures and loan agreements,
  - References in meeting minutes to financing difficulties,
  - Existence of litigation / claims and estimates of financial implications,
  - Existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties,
  - Financial ability of related and third parties to provide additional funds or loan guarantees,
  - Other subsequent events, and
  - Indicators of fraud such as management override, fictitious transactions or concealment of material facts.
- Continued existence, terms and adequacy of borrowing facilities.
- Reports on regulatory actions.
- Adequacy of support for any planned disposals of assets.

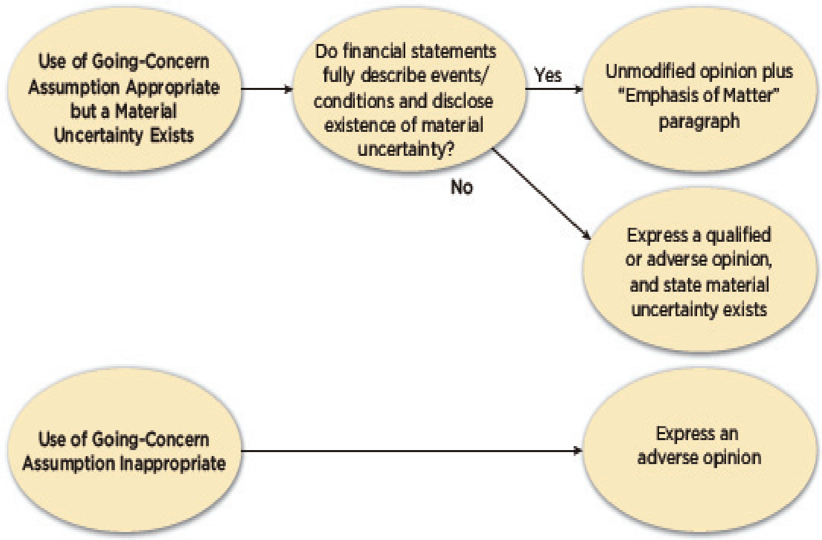
3.131 Also consider the impact of any additional facts or information since the date management made its assessment and plans.

Obtaining Written Confirmations: Request written representations from management (and those charged with governance) regarding their plans for future action and feasibility.

Reporting

3.132 The final step is to determine the impact of identified events / conditions on the audit report and communicate the decision to management and those charged with governance, where applicable.

3.133 The following exhibit summarizes the requirements.



Part D
Appendices

Appendix 1
Examples

Example 1

Background

Based on the preliminary cut off procedures done, the auditors noted that the invoices are being raised without despatching goods, where the policy for recognising revenue is based on despatches before year end.

Analysis

Sales booked in the current year is overstated.

Assertions

Cut off Procedures not adhered for Revenue

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Sales, Account receivable

Audit Procedures

The following procedures may ensure correct recognition of sales in line with the accounting policy:

- While performing substantive procedures for revenue account balance, ensure verification of despatch slip like lorry receipt/ security register/airway bill etc.
- While observing inventory count, check for goods invoiced not despatched logged separately.
- Meet with the company's inventory chain manager, and obtain written responses to our inquiries regarding the validity of the selected invoices.
- Discuss the impact of exceptions of such items with the client.

Example 2

Background

During the process of extracting the exception reports, the auditors noted numerous purchase entries without valid purchase orders.

Analysis

In terms of percentage, about 40% of purchases were made without valid purchase orders and also few purchase orders were validated after the actual purchase. Also there was no reconciliation between the goods received and the goods ordered.

Assertions

Validity of purchases

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Purchases, Account Payable

Audit Procedures

The following procedures may address the validity of the account balance:

- Make a selection of the purchases, review correspondence with the vendors, purchase requisitions (internal document) and reconciliations of their accounts.
- Review Vendor listing along with the ageing details. Follow up the material amounts paid before the normal credit period and analyse the reasons for exceptions.
- Meet with the company's Purchase officer, and obtain responses to our inquiries regarding the purchases made without purchase orders.
- Discuss the summary of such issues with the client.

Example 3

Background

Based on the enquiry made to the management of a large manufacturing company about current changes to the ERP environment the auditors noted migration of accounting system live during the year.

Analysis

On a preliminary review of the ERP implementation, the opening balances were not fed in to the database properly. The auditors noted material differences in the opening balance fed in to the system as compared to the previous year audited figures.

Assertions

Validity of financial statements

Pervasive/Account Balance Level

Pervasive

Account Balance(s) affected

Balance sheet accounts

Audit Procedures

The following procedures may address the validity of the financial statements generated from the new ERP:

- Discuss and obtain responses to our inquiries regarding the validity of the financial statements which are generated by ERP.
- Review opening balances account balance wise and also analyze the impact of the same in the current financial statements.
- Use of CAAT (Computer Aided Auditing Technique) may be done for generating exception reports, and evaluate the built in checks say, approvals or reconciliation etc.

- Discuss the summary of the testing and exceptions noted with the client in charge.

Example 4

Background

The company is a distributor of high-tech IT equipments; it also involved in the services equipment selling of that involves sales of replacement parts as well as labour. Because of rapid technological development for some of the equipment and the necessity to have a stock of replacement parts in order to service all of the equipment, the obsolescence provision presents a problem each year. The issue is particularly sensitive because the inventory is a security for a significant loan (maximum loan set at 75 percent of the net inventory), and management has historically tended to understate the obsolescence provision.

Analysis

Because there is a history of valuation problems, there is a specific risk with respect to misstatement of the obsolescence provision.

Assertions

Valuation

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Inventory, Provision for obsolescence.

Audit Procedures

Develop an independent range of reasonable estimates and determine whether management's estimate falls within this range. The focused procedures might include :

- Review management's procedures to identify obsolete inventory, including identification of such items at the inventory count. Review compliance with these procedures, as well as noting items that appear obsolete but are not identified as obsolete by the client.

- Test market value of items noted as obsolete by the client (and by us at the inventory count). Compare to recorded costs in order to assess adequacy of provisions.
- Compare the prior year listing of obsolete items to the final inventory listings of the current year to determine that items written down have not been re-instated.
- Interview sales and service personnel to determine if significant lines or items have been discounted or have become obsolete or if excessive quantities are on hand.
- Review perpetual inventory records to determine if significant lines or items with low usage have been omitted from the obsolescence evaluation.
- Consider sales analyses and forecast trends in sales *Vis-a-Vis* quantities in inventory. Evaluate results, and review the same with management.

Example 5

Background

Based on the enquiry made to the management of a large construction company about significant claims and related adjustments to subcontracts signed during the year the following is noted :

"Because of economic problems and tough competition, it has become increasingly common for subcontractors to present cost tenders in order to get the contract, knowing that they will prepare additional claims for cost overrun "

Analysis

Because of the above and a high volume of subcontracts, there were many claims by subcontractors during the year. Consequently, there is a risk of misstatement of job costs and accruals recorded in the books at the end of the year with respect to subcontractors.

Assertions

Completeness and valuation of job costs and accruals related to claims for "cost overrun"

Pervasive/Account Balance Level

Account Balance level

Account Balance(s) affected

Job costs and accruals for claims.

Audit Procedures

The following procedures (though do not address the job cost system audit as a whole) address only the completeness and valuation of the subcontractor claims:

- Make a selection of subcontractor claims; review correspondence relating to the subcontractors' claims and reconciliations of their accounts. Meet with the contract director and the relevant project director to discuss the claims and to evaluate the amounts claimed and completeness of amounts accrued.
- Review approved outstanding orders for which no invoices have been received. Follow up material amounts to ensure that the related goods and/or services have not been delivered or rendered prior to the year-end and that they are therefore valid exclusions from job cost accruals.
- Meet with the company's in-house legal advisors, and obtain written responses to our inquiries regarding the legal validity of the selected subcontract claims.
- The audit in charge should discuss the summary of such claims with the Chief Executive Officer.

Appendix 2

Case Study

A case study has been developed to accompany this Guide. The purpose of the case study is to illustrate how certain sections of the SAs can be applied in practice. The following provides background information about the fictional company, ABC furniture ltd.

Readers may note that this case study is purely illustrative. The data, analysis and commentary do not represent all of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise his professional judgment.

ABC Furniture Ltd

ABC Furniture ltd. is a family-owned furniture manufacturing company. It produces various kinds of wooden household furniture, both ready-made and custom built. ABC Furniture ltd has an excellent reputation for producing quality products.

The company has three major product lines *i.e.*, bedroom sets, dining room sets, and tables of all sorts. Standard pieces of furniture can also be customized for specific needs. Recently, the company supplied a very unique dining room set to a local celebrity and, as a result, received a lot of press coverage. Amid a lot of excitement (and concern) by family members, they recently set up a web page where people can buy furniture directly and pay through a credit card. During the last year, the company shipped custom orders as far as 900 kilometres away.

The manufacturing facility is located on an acre of land adjacent to owner Suraj Dephta's house. An addition on the west side of Suraj's home acts as ABC Furniture ltd. Major decisions are often made around the dining room table (which is the first table that Suraj and his father built together). He likes the symbolism of sharing a meal on the product that produces his family's money for food.

Industry Trends

The furniture industry is expanding due to:

A growing economy (more people can afford good furniture);

Availability of skilled labour;

Government policies that encourage business development; and

Local lumber mills that can now produce raw materials at a competitive rate.

Because of this growth, the furniture industry is attracting new players and there is some consolidation of smaller manufacturers by larger, more profitable manufacturers. Retailers are placing larger orders but only in exchange for lower prices. This demand is driving production in assembly-line style factories that have a few standard product lines. As a result, the market for traditional, handcrafted furniture, for which the region was known, is beginning to dwindle.

Governance

The company was started in 1952 by Suraj's father, Jeewan Dephta. Jeewan first made wooden spindles and banisters with one lathe in a small workshop next to the family home.

The company does not have a formal governance structure. Jeewan and Suraj prepare a business plan each year and then meet regularly (once a month) with a successful local businessman, Ravi Jain, to review their progress against the plan. They also pay Ravi to comment on the practicality of their new dreams and ideas for the business, review the operating results and provide advice on how to deal with any specific issues that have arisen.

Ravi's daughter, Parvin (a lawyer by training) usually accompanies her father to the meetings with Suraj and Jeewan. Parvin does offer some legal advice, but her true passion lies in marketing and promotion. It was Parvin's idea that Dephta Furniture should expand its boundaries and start selling their products on the Internet. She also pushed for expansion outside their local region and even to neighbouring countries. Although Jeewan is somewhat skeptical about expanding beyond local boundaries, Suraj sees this as an opportunity to expand the business and become more profitable.

Employees

ABC furniture ltd has a full-time staff of 19 employees. Over eight of these employees are related in some way to the family. However, during busy periods extra people are hired to fulfill larger orders when an order deadline exists. Some weeks there is no need for temporary workers, but at other times as many as three to seven temporary workers may be employed. A few of the temporary workers return regularly but because of low pay and lack of security, the turnover is quite high, a situation which makes training a high priority.

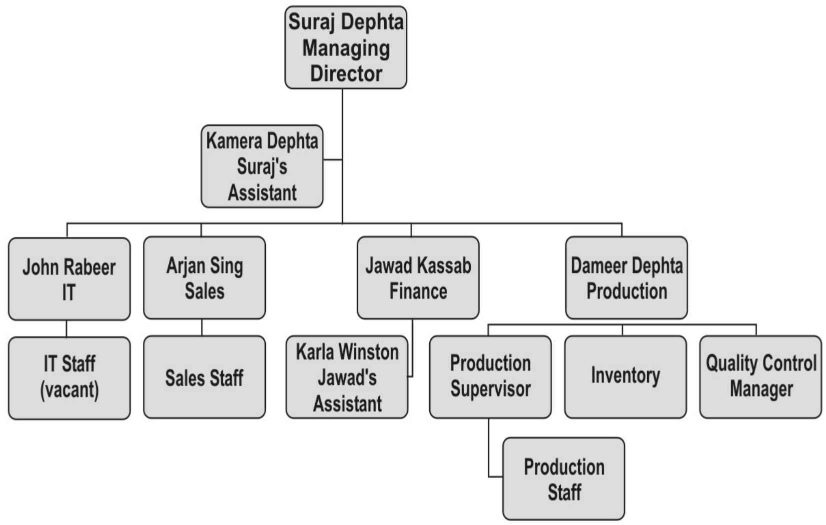
Suraj Dephta is the managing director. He oversees all aspects of the business with the help of his assistant, Kamera, who is his daughter-in-law.

Arjan Sing is in charge of sales and he is assisted by full-time sales people.

Dameer, Suraj's brother, looks after production, which includes ordering raw materials and managing the inventory. There are also a production supervisor and a person in charge of quality control. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process and so they share the task of supervising the staff.

Jawad Kassab (a cousin of Suraj) is in charge of the finance function and John Rabeer is in charge of information technology (IT).

Organizational Chart



At present the production supervisor is also responsible for inventory. Most of the full-time employees live close by. They either walk or take the bus to work. During busy periods, Suraj provides accommodation for temporary workers in some old buildings on his land. He supplies his workers with lunch each day as a benefit and also so that they can spend the maximum time working at the factory.

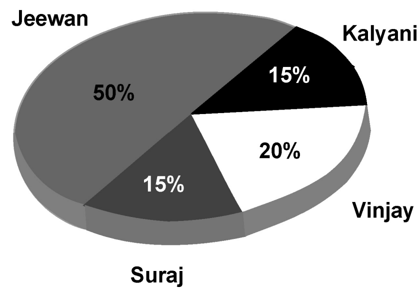
Ownership

Jeewan is the principal shareholder with a 50% interest in the company. He has plans to start transferring the shares to his son, Suraj, as long as Suraj continues to manage the company full-time and the company remains profitable as a result. Suraj and his sister Kalyani both hold a 15% interest respectively.

The remaining 20% is held by a family friend, Vinjay Sharma. Vinjay is a wealthy investor who has provided much of the capital needed to grow the company. He also provided Dephta with a 100,000Є loan to finance some new equipment needed for the larger orders. The loan bears annual interest of 12% and is repayable over 10 years, commencing January 1, 2001. The debt would be convertible to equity in case the company ever default in repaying either the interest and/or the principal on the loan.

Last year, Vinjay (63 years of age) expressed disappointment that Dephta did not accept a larger manufacturer's very generous offer to buy the company. Jeewan had totally rejected the offer, stating that this was a family company and it was not for sale. Vinjay saw this as a missed opportunity for the family to make money.

Ownership



Kalyani is a well-known singer and she travels extensively. She is not involved in the operations of the company and totally relies on her father and brother to look after her interests.

In June of each year, Jeewan organizes a more formal business meeting. The shareholders meet in the morning (primarily to review the financial statements) and, later in the afternoon, hold a party for all staff. Suraj uses this occasion to tell the staff how well the business is doing and what the plans are for the future.

Operations

The company started out manufacturing chairs, tables and spindles for railings and banisters, but has since expanded into making simple household furniture such as dressers, wardrobes and cabinets. ABC Furniture ltd has grown considerably through strategies such as :

- Providing quality products at fair prices to local customers;
- Accepting larger furniture orders from national retailers. These large orders come with a firm delivery deadline (there are major penalties for late delivery) and the profit margins are much tighter than those for custom-made furniture;

- Being the first company in the region to sell (limited products) over the Internet; and
- Manufacturing parts such as spindles and round table legs for other local furniture manufacturers. This has enabled the company to purchase expensive lathes and specialized tools that other companies cannot afford.

ABC Furniture Ltd. Dephta also sells scrap furniture and wood (pieces rejected in the quality control process) at the factory for cash only.

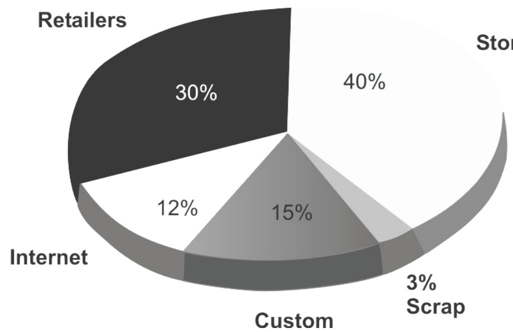
New initiatives being considered include :

- Exporting their furniture to neighbouring countries. ABC Furniture Ltd. recognizes that this will mean higher shipping costs, dealing with customs, foreign currency exchange risk and the potential for damage during transport. However, Parvin is very well connected. She knows many people in local government and thinks she can facilitate the extra paperwork involved.
- Re-designing some of its tables, chairs and cabinets so they can be assembled with screws, rather than relying on dove-tailing, glue and dowels. This will enable the company to sell and ship the furniture in parts for assembly later on.

Sales

The sales breakdown is approximately:

• Standard furniture (catalogue) from sales that are negotiated in person at the store:	40%
• Sales to furniture retailers:	30%
• Internet sales:	12%
• Made-to-order (custom-built) furniture:	15%
• Scrap sales from factory:	3%
	100%



Arjan Sing is a great dealmaker. He is very persistent when negotiating with customers and usually gets the sale, although the profit margins on these deals are sometimes very slim. Arjan loves to work hard, but he also likes to spend money. He recently bought a beautiful house overlooking the valley and a brand new Range Rover.

- **Notes on the sales system**
  - Sales contracts are prepared for retail and specialized orders. Deposits of 15% of the order are required on all custom orders, which are recorded as sales revenue when received. Two of the large retailers require ABC Furniture Ltd. to keep 30 days of inventory on hand so that orders can be shipped quickly to the stores when needed. These contracts also have provisions for inventory to be returned to ABC Furniture Ltd if it doesn't sell within a specified time period.
  - Sales orders are manually filled at the time of sale, except for furniture sold directly from the shop or other small items on hand. All orders over 500Є, or where the sales price is below the minimum sales price, must be approved by Arjan. Invoices are prepared when the items are shipped and sent to the customer.

- For all sales out of the shop, invoices are prepared at the time of sale and entered into the accounting system, which automatically numbers after the each sale transaction and provides an order receipt if requested.

- A summary of the day's internet sales is downloaded from the website. Details of the items ordered are prepared and given to the production department. An invoice is prepared at the same time and recorded into revenue since the item has already been paid for by the customer's credit card. An invoice marked "paid in full" accompanies each Internet order that has been shipped.

- Arjan rarely performs credit checks on customers. He knows most of them. Customers used to pay cash upon delivery but credit is granted today to match the terms that their competitors are providing. As a result, ABC Furniture Ltd. requires a line of credit from the bank. Each year, the number of bad debts seems to be growing.

- At the end of each month, Suraj reviews the sales and accounts receivable listing. He ensures that there are no obvious mistakes and he personally calls every customer whose account is over due by 90 days.

- Each member of the sales staff (including Arjan) receives a commission of 15% on each sale in addition to a minimum base salary. To motivate the sales people, their base salary is well below the salaries of most of the other employees. The computer system tracks sales made by each sales person. Jawad prints off a report each month and prepares a listing of commissions that will be paid on the following week's payroll. Either Suraj or Dameer reviews the listing of commissions and the sales to ensure the staff are paid the correct amount. Arjan receives by far the most sales commissions.

Information Technology

John oversees the company's computer system and IT operations. The system consists of six PCs and a server which is used for hosting the Internet site. The internal system is mainly used for email, order taking and accounting.

The son of one of Jawad's friends, Remal, helped with the basic set-up of the system and installation of the programs. John ensures the PCs are well-maintained, helps users with problems and runs weekly backups of the accounting system on an external hard drive that is kept in the safe next to the computer room. Firewall protection and password protection have all been added by John in the last two years. Last year, several PCs were stolen from the office. John realized that although the factory area was well secured, the offices and computer systems were vulnerable. Access to the offices is now better secured, the PCs are chained to desks, and the server is locked in a separate and specially cooled office.

Internet sales are managed by John with oversight by Dameer. They have an agreement with the bank to process the credit cards before any order is approved for shipping. They pay the bank 7% on each order processed. The application program for internet sales provides the details of each sale, including the customer's name, address, and the items ordered. Internet transactions are downloaded daily from the website and sales orders are prepared and forwarded to the production department.

Human Resources

All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees. The company:

- Strives to hire the best talent it can find in the region and pays its full-time employees very competitive rates.

- Invests a considerable amount of time and money in training new employees. It holds training programs and has an informal mentoring process by which it requires newer employees to work with more experienced ones for a period of time.
- Posts many signs in the factory to remind workers about safety procedures. Last year, two temporary students were badly injured while using a lathe. This year, several new workers were disciplined for acting irresponsibly and endangering others.

Payroll

Employees are paid in cash at the beginning of each week. Jawad's assistant, Karla Winston, has a list of employees and calculates the payroll and deductions based on time card summaries that Dameer provides her. Suraj reviews payroll each Monday morning before instructing Karla to hand the envelopes to employees. All employees sign a list when they pick up their envelope. The company does not keep formal employee records.

Purchasing and Production

Dameer is responsible for purchasing and production. Because the inventory system is not very sophisticated, he tends to over-order some items, which often results in inventory sitting in the warehouse for long periods of time. This is considered better than under-ordering supplies, which results in production delays. He is also responsible for hiring enough workers to fulfill orders. Because estimating worker needs is not very scientific, many times there are either too many or too few workers.

- **Notes on the purchasing function**

  - At least two quotes must be obtained before purchases over 5,000€ are approved. The exception is wood supplied by the local wood mill where Dephta has negotiated a five year exclusive supply contract.
  - The company prepares purchase orders for all inventory or capital purchases over 1,000€.

- Dameer approves all new vendors and supplies the details to Jawad. Jawad then sets up the vendors in the system and enters details of invoices received.
- ABC furniture ltd maintains 5,000€ in cash on the premises at all times, as a number of the smaller vendors like to be paid cash-on-delivery for raw materials.

Finance

Jawad studied accounting at university and is well versed in accounting and financial matters. When he joined ABC furniture ltd two years ago, he quickly introduced the "Sound Accounting" software package by Onion Corp. with its integrated accounts payable, accounts receivable, and capital assets modules.

- **Notes on the accounting function**
  - At present, the company does not have a perpetual inventory system. Inventory is counted twice a year, once at year-end and once half way throughout the year. This ensures that profit margins on sales can be accurately calculated at least twice a year.
  - Jawad has been frustrated by the lack of controls over inventory. He had suggested to Suraj that inventory be counted at least four times per year to ensure that margins are reviewed throughout the year. Suraj had overridden his recommendation, stating that it would be too disruptive to count inventory so often and it could cause the company to miss deadlines.
  - Although ABC Furniture Ltd. has been profitable, the gross margins have been inconsistent. Jawad does not have an explanation as to why inventory costs are not tracked by product line. For example, one of the most time-consuming areas is making the intricate spindles for which ABC Furniture Ltd. is known. The spindles are used in both the

bedroom and dining room lines and are also sold to other manufacturers.

- Jawad has also been pushing for costs to be tracked individually for custom pieces, including company overhead allocations. When he presented his calculations, Suraj could not believe that custom orders were losing money and asked Jawad to do the analysis again.
- Suraj gets very annoyed at having to pay any form of income tax and usually pressures Jawad to ensure that accruals are "more than adequate".
- The following income statement and balance sheet were prepared by management. Notes to the financial statements or a cash flow statement have not been included. Excerpts from significant accounting policies, terms and conditions for the loan payable, and details of related-party transactions have been included in the case study material used in the illustrations.

Overall Audit Strategy - ABC Furniture Limited for recurring audits:

Once the decision is made to continue with the audit of ABC Furniture Ltd, the next step is to develop and document an overall plan and strategy for conducting the engagement. This can be documented by a memo or by completing some form of planning checklist, as illustrated in the example below.

ABC Furniture Ltd. Overall Planning Memo

Scope

The scope of the audit has not changed this year and we are required to audit the financial statements in accordance with [insert applicable accounting framework] as at year end.

Changes

The company is beginning to expand beyond the local area. As the unit expands its sales to foreign countries and makes sales in foreign currencies, managing foreign exchange risk will become more important. Internet sales are also increasing, so unit's IT capabilities will be stretched. Changes in the following applicable financial reporting framework will also need to be reflected in financial statement preparation. This company is renowned for squeezing profit margins of suppliers in exchange for giving large orders. They also require suppliers to maintain additional inventories of some products for instant delivery as required.

Internal Control Environment

Our assessment of risk at the financial statements level is low (refer to W/P Ref). Management is not particularly sophisticated but there is a strong commitment to competence, they have introduced a code of ethics and, in general, they have a good attitude toward internal control.

Based on our assessment of the internal control environment we should proceed as follows:

1. Materiality will be increased from 10,000 KINR to 15,000 KINR this year to reflect the growth in sales and profitability during the last year.
2. Use the same senior staff as last year and perform the work at the same time. This will provide continuity and audit efficiency. New junior staff will be used.
3. At our team planning meeting to be held on November 15,2008, we need to:
   i. Spend more time considering the susceptibility of the financial statements to fraud;
   ii. Emphasize the use of professional skepticism by our staff;
   iii. Consider the potential for employee fraud and management override. We have no specific reason for suspicion but profit margins have been fluctuating and no one seems to know why;

iv. Focus on the related-party transactions that have been growing.

4. Perform our risk assessment procedures at the end of July 2008. There are no plans to change systems unless the volume of new sales demands it.
5. Attend both the mid-year and year-end inventory counts due to the lack of ongoing inventory internal control procedures.
6. We must keep in touch with senior management to ensure we are informed on a timely basis of any dramatic increase in sales and production. This would cause us to perform additional risk assessment procedures to identify/assess the new risks and management's response to mitigate those risks.
7. Test the operating effectiveness of internal control over sales and payroll (in September 08) so that the extent of our substantive procedures can be reduced. This work will be rolled forward to cover the October–December period.
8. Our IT specialist needs to spend some time at Dephta this year to thoroughly assess the internal control over Internet sales and the general IT controls. As the company grows, IT general controls are becoming more critical and must keep pace.
9. We should expand our testing with regard to related-party transactions. This includes the process for identifying who is a related party and the terms and timing of such transactions.
10. Because of the recent changes in accounting standards and the growth potential in this company and associated risks, we should assign an engagement quality control reviewer to review the file this year.

Understand the Entity and Assess Risk:

ABC Furniture Ltd seems to be following the industry trends, as outlined below.

- The furniture industry is expanding due to a growing economy, availability of skilled labour, government policies that encourage business development, and local lumber mills that can now produce raw materials at a competitive rate.

- ABC Furniture Ltd has a five-year contract for the supply of lumber at fixed prices. The growing industry is also attracting new players and there is some consolidation of smaller manufacturers by larger more profitable manufacturers. ABC Furniture Ltd was approached by a larger company last year that wanted to buy the company. The offer was refused.

- The trend seems to be towards manufacturing standard (lower priced) pieces of furniture for larger retailers as opposed to the traditional practice of custom furniture sold directly to consumers. Retailers are asking for bigger orders but only in exchange for lower prices. This is driving assembly-line style factories with a few standard product lines. ABC Furniture Ltd has supplied two major retailers. There is risk here because the retailers can be very demanding. In the last year, three furniture companies went bankrupt by trying to produce and finance large quantities of goods and orders at slim profit margins.

Sales breakdown is as follows:

Product	**% Sales**
Standard furniture (from catalogue)	40%
Sales to furniture retailers	30%
Internet sales	12%
Made-to-order (custom-built) furniture	15%
Scrap sales from factory	3%

The analysis can be as follows:

- Understanding the laws and regulations applicable to an entity: Companies Act, Income tax Act, etc.

- Key customers : Tata systems ltd, Covansys Inc.

- Key suppliers : Woodies Ltd, Better furns & co., etc.
- Nature of entity—The company does not have a formal governance structure, but the top management prepare a business plan each year and then meet regularly (once a month) with successful local businessman, to review their progress against the plan. They pay local businessman to comment on the practicality of their new ideas for the business, review the operating results, and provide advice on how to deal with any specific issues that have arisen. The company feels that it pays too much in corporate taxes. By comparing actual results to the estimates made in previous years, we identified some instances of management bias. This matter has become a topic of discussion at the closing meeting in each of the last two years.
- Personnel—ABC Furniture Ltd Furniture Inc. has a full-time staff of 19 employees. Over eight of these employees are related in some way to the family. However, during busy periods extra people are hired to fulfill larger orders where a deadline for order completion exists. During some weeks, there is no need for temporary workers at all; at other times, there can be anywhere from four to eight temporary workers employed. A few of the temporary workers return regularly, but because of the lack of job security, the turnover is quite high.
- All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees. ABC Furniture Ltd has always strived to hire the best talent the company can find in the region and pays its full-time employees very competitive rates.
- Individual responsibilities are as follows :
    - Suraj is the managing director of ABC Furniture Ltd. He oversees all aspects of operations and

finances with the help of his assistant, Kamera, who is his daughter-in-law.

- Arjan Singh is in charge of sales and he is assisted by two full-time sales people.
- Dameer looks after production, which includes raw materials ordering and the inventory.
- There are eight full-time production staff members, which includes a production supervisor and one person in charge of quality internal control. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process and so they share the task of supervising the staff.
- Jawad Kassab (a cousin of Suraj) is in charge of the finance function.
- John Rabeer is in charge of IT.
- Management is very involved in the operations. Suraj and Dameer monitor operations and deal with issues as they arise. Job descriptions have been developed and roles and responsibilities are reasonably well defined.

- Key advisors—In addition to the bank manager and Ravi, Parvin (Ravi's daughter and a lawyer by training) usually accompanies her father to the meetings with Suraj and Jeewan. Parvin offers some legal advice, but also gets involved with strategy. It was Parvin's idea that ABC Furniture Ltd Furniture should expand its boundaries and start some Internet sales. She also pushed for expansion outside their local region and even to neighbouring countries.
- Financing—HGIQ Bank operating loan secured by receivables and inventory.
- Bonus plans—HGIQ Bank operating loan secured by receivables and inventory. Vinjay – unsecured loan at 12%

repayable over 10 years commencing January 1, 20x4. The debt is convertible to equity if there is ever a default in repaying either interest or the principal on the loan.

- Accounting policies—Revenue is recognized when the goods are shipped. The only exception is the non-refundable 15% deposit taken on large orders, which is recognized as revenue when the deposit is made. This amount has not been material in the last three years. Of more concern are the sales contracts that have provisions for inventory to be returned to ABC Furniture Ltd if it does not sell within a specified time period. This could result in a revenue recognition issue. The other significant accounting policies are as follows :
- Business objectives and strategies—The business plan calls for more expansion beyond local boundaries. This includes more sales to large retailers and marketing to attract Internet sales. Suraj sees this as a great new opportunity to grow the company and become more profitable.
- The implications of growth are :
  - An increased risk of bad debts;
  - A need for sound inventory management to ensure investment levels and obsolescence are minimized;
  - A potential squeeze on working capital;
  - An increased risk of damage in transport;
  - An increased cost of returned merchandise;
  - A need for foreign currency exchange risk management;
  - A need for additional fixed assets;
  - A need for additional craftsmen; and
- **Performance measures**

Suraj watches the gross margin levels very closely. However, because inventory management is not strong, some of the calculated margins may be higher than reality. This has been the subject of a communication to management in the past. Based on our research of the industry, the current margin levels are reasonable.

Risk Table

#	*Account Affected*	*Risk*	*Potent-ial Error* **	*Audit Response* *	*Specific Procedures*
	Pervasive risks				
1	All Accounts	Lack of Working capital	NA	• Consider the need for heightened professional skepticism when examining certain documentation or corroborating significant management representations.	# Analyse the nature of use of current working capital - Long term or short term. # Understand the borrowing powers of the entity and relationship with bankers
2	Income/ Expense	Addition-al crafts-men	NA	• Consider the need to use people with specialized skills/ knowledge.	Understand the availability of skilled labour, possibility of mechanising the operations. Also analyse the impact of Going concern in case of non availability of skilled labour

#	*Account Affected*	*Risk*	*Potent -ial Error* **	*Audit Response* *	*Specific Procedures*
3	Inventory	Techno-logy Obsole-scence	NA	• Consider the need to use people with specialized skills/ knowledge.	Assess the stock in hand for impairment and also impact of going concern for lack of market for the goods produced.
4	Expenses	Foreign Currency Risk mana-gement	NA	• Consider the need to use people with specialized skills/ knowledge.	Since the INR currency is strengthening against the US Dollar, cash flow from revenue has a shortfall. Hence measures can be taken to hedge the risk, say use of derivative instruments.
5	Fixed Assets/ Long term Funds	Capital outflow - Fixed Assets addition-al require-ment	NA	• Introduce an element of unpredictability in the selection of audit procedures. For example, perform procedures on	Analyse the formal budgets in place, impairment of the existing assets and source for the additional requirement.

#	***Account Affected***	***Risk***	***Potent-ial Error *****	***Audit Response ****	***Specific Procedures***
				selected account balances and assertions not otherwise tested, adjust the timing of audit procedures, use different sampling methods, or perform procedures on an unannounced basis.	Understand the impact of the capex requirement in the Financial statements.
	Specific risks				
6	Debtors	Risk of Bad debts	Validity	• Request additional information in external confirmations. For example, on a receivables confirmation, the auditor could ask for confirmation on the details of sales agreements,	# Circulate confirmations for the debtors balance, preferably at an interim date and analyse the responses. # Analyse the reconciliations of various customer balance.

#	Account Affected	Risk	Potent-ial Error **	Audit Response *	Specific Procedures
				including date, any rights of return and delivery terms.	
7	Revenue	Increase sales return	Validity, Cut off	• Change the nature, timing, and extent of the auditing procedures to address the risk.	# Perform Cut off testing procedures (at the balance sheet date) and ensure revenue is recognised as per the accounting policy in the appropriate period.

* Choose from the procedures from Appendix 6 separately given for pervasive and specific risks.

* No potential errors can be addressed to pervasive risks.

Appendix 3

Overall Audit Strategy

Client :	**Prepared by :**	**Date :**
Year :	**Reviewed by :**	**Date :**

Overall Audit Strategy

The overall audit strategy can be established after considering the following :

1. Organise a planning meeting with the clients staff to update our understanding the entity and their accounting process.

   Description :

   Work Paper ref :

2. Consider environmental and industry factors which might identify specific potential risk and document our observation.

   Description :

   Work Paper ref :

3. Perform preliminary analytical procedures and identify any unusual or unexpected balances, and or, relationship which may indicate potential misstatement of the financial statements.

   Description :

   Work Paper ref:

4. Determine planning materiality after assessment of the specific circumstances of the client.

   Description :

   Work Paper ref :

5. Decide whether Involvement of experts is necessary, and any additional risk assessment procedures required for the engagement.

   Description :

   Work Paper ref :

6. Where changes during the year are significant or where factors indicate potential risks, document the details and our specific observations.

   Description :

   Work Paper ref:

7. Prepare debriefing notes on audit including carry forward points of last year. It includes the following:

   - Any audit areas that might require additional or less attention in the future;
   - Any planned changes that will affect future engagements such as an acquisition, new product or service, or the installation of a new accounting system; and
   - Where additional assistance could be provided by the entity such as analysis of certain accounts.

   Description :

   Work Paper ref :

8. Document the assertions that cannot be addressed by substantive tests alone, if any.

   Description :

   Work Paper ref :

9. Assess the need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, and so forth)

Description:

Work Paper ref:

10. Ensure special attention required for any significant risks is given duly while framing the overall audit strategy.

    Description:

    Work Paper ref:

Appendix 4
Understanding the Entity

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Understanding the Entity

During an audit engagement, the below mentioned may be used for understanding the business:

A. External factors:

- Assess the Industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Understand the regulatory environment, including the applicable financial reporting framework.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

- Determine the specific risks arising from the nature of the business or the degree of regulation.

  Description :

  Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Determine the legal, political environment and environmental requirements affecting the industry and the entity.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific **(***Tick the appropriate box)*

- Existence of any laws or regulations that, if violated, could reasonably be expected to result in a material misstatement in the financial statements.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Document any other external factors, such as general economic conditions.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

B. Nature of Entity

- Briefly describe of nature of entity's operations

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Describe the ownership and governance, including owners, family members, those charged with governance and relationships between owners and other people or entities.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific **(***Tick the appropriate box)*

- Enquire about types of investments (acquisitions, equipment, people, new products, locations, R&D, etc.) that the entity is making and plans to make.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Understand the entity structure (locations, subsidiaries, etc.). Existence of complex structures may give rise to risks of material misstatement such as:

  - Allocation of goodwill and its impairment; and
  - Accounting for investments.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Understand the process in place for identifying related party transactions.

  Description :

  Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ascertain the nature/mode of financing the entity is adopting and also assess the cost for the same.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ensure the accounting policies appropriate for the business and are in line with industry requirements/ financial reporting framework.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ascertain the system in place for proper recording of significant and unusual transactions.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Assess whether any significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. If so, consider the effect of using such policies.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Check for any changes in the entity's accounting policies during the period. (This includes new financial reporting standards/regulations.) If so :
  - Document the reasons and consider appropriateness; and
  - Consider consistency with requirements of the applicable financial reporting framework.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ensure adequate disclosure of material matters in the financial statements. Consider form, arrangement and content of the financial statements and footnotes, classification of items, amount of detail provided and basis of amounts set forth.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

C. Entity Objective and strategies

- Obtain a copy of any mission, vision or values statement produced by the entity (such as in promotional or web-based materials) and consider its consistency with the entity's strategy and objectives. In smaller entities, this information will not often be documented but could possibly be obtained through discussions with management and observation of how they respond to such matters.

  Description :

  Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Identify and document the entity's strategies (that is, operational approaches by which management intends to achieve its objectives).

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Identify and document the entity's current objectives (that is, its overall plans for the entity both short term and long term). In smaller entities, this information will likely be obtained through inquiry of management and observation of how they respond to such matters.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Based on the understanding obtained about mission, vision, business strategies and objectives, identify and document the related business risks.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific **(***Tick the appropriate box)*

- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies or through the setting of inappropriate objectives and strategies.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

D. Measurement of financial performance

- Identify the key measures used by management to assess the entity's performance and achievement of objectives.

  Description :

  Risk Identified:

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Are there external parties that measure and review the entity's financial performance (regulators, franchisors, lending institutions, and so forth)? If so, consider whether copies of such reports should be obtained from the entity (for example, credit rating agency reports).

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Enquire whether performance measures exist to motivate management to take action to:

  - Improve the business performance;
  - Heighten risk by taking aggressive actions to achieve objectives;
  - Meet personal goals such as achieving a bonus threshold;
  - Highlight any unexpected results or trends;

- Indicate trends or results consistent with the industry as a whole.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

- Ensure performance measures based on reliable information and precise enough to be used as a basis for analytical procedures.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

Appendix 5

Understanding the Information System

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Understanding the Information System

The following aspects may be understood and details gathered for risks assessment.

- The IT Governance structure.
- How IT risks are identified, mitigated & managed.
- The Information Plan, strategic plan & budget.
- IT policies, procedures, and standards.
- The organizational structure and segregation of duties
- Acquisitions, configurations, integration, and maintenance of IT infrastructure.
- Delivery of information services to users.
- Management of third-party providers.
- Use of system software, security software, database management systems, and utilities.
- Incident tracking, system logging, and monitoring functions.
- Security of passwords.
- Internet firewalls and remote controls.
- Date encryption and cryptographic keys.
- User accounts and access privilege controls.
- User profiles that permit or restrict access.

- Revoking employee passwords and user IDs when employees resign or are terminated.
- Acquisition and implementation of new applications.
- System development and quality assurance methodology.
- The maintenance of existing applications including controls over program changes.
- Policies and procedures regarding the IT system and reporting that ensure that it is aligned with business requirements.

The information system (which includes the accounting system) consists of the procedures and records established to initiate, record, process, and report the entity's transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. The following insights may be helpful to understand the business.

1. Obtain Information from the following sources:

- Understand the classes of transactions in the entity's operations that are significant to the financial statements.
- Understand transactions that originate within the entity's business processes.
- Determine the related accounting records (whether electronic or manual), supporting information and specific accounts in the financial statements, in respect of initiating, recording, processing, and reporting transactions.
- Ascertain how the information system captures events and conditions other than classes of transactions that are significant to the financial statements.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

2. Analyse the means of processing of Information:

- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Methods adopted by the entity to communicate financial reporting roles, responsibilities, and significant matters relating to financial reporting.
- Ascertain the risk of material misstatement associated with inappropriate override of controls over journal entries.
- Understand the procedures adopted by management used to:
    - Initiate, record, process, and report significant and non-standard transactions in the financial statements (such as related party transactions and expense reports);
    - Transfer information from transaction processing system to general ledger or financial reporting system;
    - Capture information relevant to financial reporting for events and conditions other than transactions (such as, the depreciation/amortization of assets and changes in the recoverability of accounts receivables);
    - Record and control the use of standard and non-standard journal entries; and
    - Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

- Determine the resolve mechanism in place for incorrect processing of transactions. This could be automated or require manual intervention.
- Determine whether automated controls can be suspended in any circumstances and effects if they fail to operate.
- Process of exceptions reported and their disposal.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

3. Uses of Information produced

- Understand the range of reports regularly produced by the information system and use to the management.
- What information is provided by management to those charged with governance and to external parties, such as, regulatory authorities.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

Impact of Information Technology Controls

The auditor should obtain an understanding of how the entity has responded to risks arising from IT. This IT controls in place is very relevant for designing procedures for risks identified.

<u>Analysis of IT Controls and Risks Associated with them</u>

4. Examine the predefined business rules and complex calculations involved in processing large volumes of transactions or data.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

5. Ascertain the timeliness, availability, and accuracy of information.

   Description :

   Risk Identified :

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

6. Determine the ability of the Information system in place to facilitate the additional analysis of information.

   Description :

   Risk Identified:

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

7. Determine the ability to monitor the performance of the entity's activities and its policies and procedures.

   Description :

   Risk Identified :

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

8. Assess for any risk in the internal control that may be circumvented.

   Description :

   Risk Identified :

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

9. Assess the ability to achieve effective segregation of duties by implementing security internal control in applications, databases, and operating systems.

   Description :

   Risk Identified:

   Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

10. Assess the degree of Reliance on systems or programs that may be inaccurately programmed, processing inaccurate data, or both.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

11. Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions particular risks may arise where multiple users access a common database).

    Description :

    Risk Identified:

    Nature of risk: □ Pervasive □ Account balance specific (*Tick the appropriate box)*

12. Assess the possibility of IT personnel gaining privileges beyond those necessary to perform their assigned duties.

    Description:

    Risk Identified:

    Nature of risk: □ Pervasive □ Account balance specific (*Tick the appropriate box)*

13. Ensure no unauthorized changes to data are made in master files.

    Description :

    Risk Identified:

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

14. Ensure no unauthorized changes are made to systems or programs.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

15. Determine failure to make necessary changes to systems or programs.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

16. Ascertain for any chances of inappropriate manual intervention.

    Description :

    Risk Identified :

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

17. Enquire for any potential loss of data or inability to access data as and when required.

    Description :

    Risk Identified:

    Nature of risk : □ Pervasive □ Account balance specific (*Tick the appropriate box)*

Appendix 6

Risk Assessment Procedures

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Risk Assessment Procedures

<u>A. Inquiries with Management</u>

The processes in place for identifying and responding to the risks of fraud and error in the financial statements.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Management communication in place to employees regarding its views on business practices, adherence to policies and procedures, and ethical behavior.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Ascertain the potential for management override of controls in place.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Inquire whether there is a history of fraud happenings or there is any suspected fraud.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Assess the strength of financial statement preparation and review process.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

B. Analytical Procedures

Develop expectations about plausible relationships among the various types of information that could reasonably be expected to exist. Seek to use independent sources of information (that is, not internally generated) where possible.

Such financial and non-financial information could include:

Financial statements for comparable previous periods;

Budgets, forecasts, and extrapolations, including extrapolations from interim or annual data; and

Information regarding the industry in which the entity operates and current economic conditions.

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Compare expectations with recorded amounts or ratios developed from recorded amounts and summarize below:

Description :

Risk Identified:

Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

<u>C. Observation/Inspection</u>

Inspect documents such as:

- Business plans and strategies;
- Accounting policies and records;
- Internal control manuals;
- Reports prepared by management (such as interim financial statements); and
- Other reports such as minutes from meetings of those charged with governance, reports from consultants, etc.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

Test of Controls

Assess the necessity for testing internal control during the engagement. Where internal control exists and is expected to operate effectively, consider:

- Whether testing controls would achieve an effective response to the assessed risk of material misstatement for a particular assertion; and
- What substantive testing could be reduced by performing tests of controls.

  Even in a very small entity, there are often well-designed and effective controls over revenues that, if tested, could reduce the extent of substantive procedures required. If testing the operating effectiveness of internal control would not be effective or efficient, it will then be necessary to perform substantive procedures that respond to assessed risks for specific assertions. No credit can be taken for the effective operation of controls that have not been tested.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

- Identify whether any assertions that can only be effectively addressed by tests of controls.

  In some cases, suitable substantive procedures (to obtain evidence for a particular assertion) may not be available, so tests of controls will be necessary. An example of this would be highly automated systems with little or no paper trail available. If such internal control is not considered reliable (controls are not likely to operate effectively) or is absent, the auditor will have to determine whether it is possible at all to obtain sufficient appropriate audit evidence.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

Substantive Procedures

Data Reliability

- Assess whether data obtained from sources within the entity or from independent sources outside the entity (Independent sources are generally more reliable).

  Description :

  Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(Tick the appropriate box)

- Assess whether data from sources within the entity developed by persons not directly responsible for its accuracy (If so, consider further procedures to check on accuracy).

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(Tick the appropriate box)

- Ensure reliability of data developed with adequate internal control.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(Tick the appropriate box)

- Determine whether broad industry data comparable for use within the entity is available.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(Tick the appropriate box)

- Ascertain whether the data subject to audit testing in the current or prior periods and tailor the procedures.

Description :

Risk Identified :

Nature of risk : □ Pervasive □ Account balance specific
(Tick the appropriate box)

- Ensure that the auditor's expectations regarding recorded amounts developed from a variety of sources.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific *(Tick the appropriate box)*

Timing, Extent of Procedures

Determine the Timing, Extent of Procedures after considering the following:

- Purpose of the test and assertions will be addressed;
- The experience (if any) in performing similar tests in previous periods;
- Population of items to be tested be defined;
- Sampling technique to be used;
- Disposal of deviation in the sample;
- Specific (substantive) items that could be excluded from the sample and evaluated separately;
- Subgroups within the defined population that could be tested separately;
- Level of confidence is required from the test;
- Maximum deviation rate that is tolerable.

  Description :

  Risk Identified :

  Nature of risk : □ Pervasive □ Account balance specific (Tick the appropriate box)

Conclusions drawn from such procedures corroborate the conclusions formed during the audit of individual components or elements of the financial statements

Description :

Appendix 7

Risk Table

Client : **Prepared by :** **Date :**

Year : **Reviewed by :** **Date :**

Risk Table

No.	*Account Affected*	*Risk (Refer Appendix 6)*	*Potential Error*	*Overall Audit Response (Refer Appendix 9)*	*Specific Proce-dures*	*Wkp Ref.*
	Pervasive risks					
1						
2						
3						
4						
5						
	Specific risks					
6						
7						
8						
9						
10						

Appendix 8

Steps for Risk Identification

Assess the significance of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.

Determine the likelihood for assessed risk to occur and its impact on our auditing procedures.

Document the assertions that are effected.

Consider the impact of the risk on each of the assertions (completeness, existence, accuracy, validity, valuation and presentation) relevant to the account balance, class of transactions, or disclosure.

Identify the degree of Significant risks that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.

Enquire and document the management's response.

Consider the nature of the internal control system in place and its possible effectiveness in mitigating the risks involved. Ensure the controls :

- Routine in nature (occur daily) or periodic such as monthly.
- Designed to prevent or detect and correct errors.
- Manual or automated.

Consider any unique characteristics of the risk.

Consider the existence of any particular characteristics (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures. Examples could include high value inventory, complex contractual agreements, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

Possible potential misstatements - Indicators
> Completeness
Transactions not identified.
Source documents not prepared.
Source documents not captured.
Rejected source documents not represented.
> Existence
Fictitious or unauthorised transactions entered on source documents.
Source documents overstated.
Transactions duplicated on source documents.
Capture of source documents duplicated.
Invalid source documents captured on subsidiary ledgers.
> Recording
Source documents captured inaccurately.
Processing of transactions is inaccurate.
Inaccurate adjustments made in subsidiary ledgers.
> Cut-Off Procedures
Transactions that occur in one period are recorded in another period.

Appendix 9

Overall Responses Relating to the Financial Statements in General

- **Pervasive Risks Exist at the Financial Statements Level**
  - Consider the need for heightened professional skepticism when examining certain documentation or corroborating significant management representations.
  - Consider the need to use people with specialized skills/knowledge, such as information technology (IT).
  - Introduce an element of unpredictability in the selection of audit procedures. For example, perform procedures on selected account balances and assertions not otherwise tested, adjust the timing of audit procedures, use different sampling methods, or perform procedures on an unannounced basis.
- **Specific Responses Relating to Risks at the Assertion Level**
  - Change the nature, timing, and extent of the auditing procedures to address the risk. Examples include the following:
    - Obtain more reliable and relevant audit evidence or additional corroborative information to support management assertions.
    - Perform a physical observation or inspection of certain assets.
    - Observe inventory counts on an unannounced basis.

- Perform further review of inventory records to identify unusual items, unexpected amounts and other items for follow-up procedures.
- Perform further work to evaluate the reasonableness of management estimates and the underlying judgments and assumptions.
- Increase sample sizes or perform analytical procedures at a more detailed level.

o Use Computer-Assisted Audit Techniques (CAATs).

- Gather more evidence about data contained in significant accounts or electronic transaction files;
- Perform more extensive testing of electronic transactions and account files;
- Select sample transactions from key electronic files;
- Sort transactions with specific characteristics, and
- Test an entire population instead of a sample.

o Request additional information in external confirmations. For example, on a receivables confirmation, the auditor could ask for confirmation on the details of sales agreements, including date, any rights of return and delivery terms.

o Change the timing of substantive procedures from an interim date to near the period end. If a risk of intentional misstatement or manipulation exists, audit procedures to extend audit conclusions from an interim date to the period end would not be effective.

Risks Related to Management Override

Review of Journal Entries

- Identify, select, and test journal entries and other adjustments based on the following:
    - An understanding of the entity's financial reporting process and design/implementation of internal control;
    - Characteristics of fraudulent journal entries or other adjustments;
    - Presence of fraud risk factors that relate to specific classes of journal entries and other adjustments; and
    - Inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity.

Estimates

- Review estimates relating to specific transactions and balances to identify possible biases on the part of management. Further procedures could include the following:
    - Reconsidering the estimates taken as a whole;
    - Performing a retrospective review of management's judgments and assumptions related to significant accounting estimates made in the prior year; and
    - Determining whether the cumulative effect of the bias amounts to a material misstatement in the financial statements.

Significant Transactions

- Obtain an understanding of the business rationale for significant transactions that are unusual or outside the normal course of business;

  This includes an assessment as to whether:

  - Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction;
  - The arrangements surrounding such transactions appear overly complex;
  - Management has discussed the nature of and accounting for such transactions with those charged with governance;
  - The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit;
  - Transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance; and
  - There is adequate documentation.

Risks Related to Management Override

Revenue Recognition

- Perform substantive analytical procedures. Consider Computer-Assisted Audit Techniques to identify unusual or unexpected revenue relationships or transactions;
- Confirm with customers relevant contract terms (acceptance criteria, delivery, and payment terms) and the absence of side agreements (right to return the product, guaranteed resale amounts, and so forth).

3

Implementation Guide to Materiality in Planning and Performing An Audit

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Foreword

Standards on Auditing are an important instrument in bridging the expectation gap existing between the society and the auditors regarding the expectations of the society from the auditors with regard to the audits of financial statements. It, therefore, becomes essential that the auditors properly understand and implement the Standards on Auditing in their audit engagements.

Implementation Guides to Standards on Auditing are an important tool for the auditors to appropriately understand the requirements of these Standards and help them implement the Standards in an appropriate manner to meet the objectives of these standards. The Implementation Guides also provide solutions to the practical problems in implementing these standards in the real life situations being faced by the auditors in their audit engagements.

I am happy to note that the Auditing and Assurance Standards Board is issuing a number of Implementation Guides on new / revised Standards on Auditing issued during the last 3-4 years for the benefit of the members. This Implementation Guide to Standard on Auditing (SA) 320, 'Materiality in Planning and Performing an Audit' is one such Guide. I am sure the Implementation Guide would be able to address the apprehensions, concerns and difficulties, if any, being faced by the auditors regarding this Standard on Auditing.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives in bringing out guiding literature on Standards on Auditing and other technical literature on auditing for the benefit of the members. I also eagerly look forward to more such Implementation Guides and other technical publications from the Auditing and Assurance Standards Board.

February 2, 2012
New Delhi

CA. G. Ramaswamy
President, ICAI

Preface

Materiality is an important concept in the context of preparation and presentation of financial statements as well as the audits of financial statements. Financial reporting frameworks across the world recognize the concept of materiality in the preparation and presentation of financial statements. Materiality is a vital factor as to the nature and extent of audit coverage and procedures required in conducting an audit. In other words, the question of materiality has a direct bearing in deciding the nature, timing and extent of audit procedures as well as actual performance of audit for conducting an audit effectively.

The Institute of Chartered Accountants of India had issued a Standard on Auditing dealing with audit materiality as back as in 1997. The Standard was revised in 2007 under the Clarity Project. The Revised Standard deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

As a part of its efforts to create awareness among the members about the various Standards on Auditing issued under the Clarity Project, the Auditing and Assurance Standards Board has been bringing out Implementation Guides to these Standards on Auditing. This Implementation Guide to SA 320, 'Materiality in Planning and Performing an Audit' is one such Guide in the series. The Guide provides practical implementation guidance on various aspects relating to audit materiality in an easy and lucid language. It covers matters such as concept of materiality, determining materiality when planning the audit, revision of materiality during performance of audit, evaluating the results of audit procedures etc.

I am grateful to CA. Paratha S De, Kolkata for preparing the preliminary draft of the Implementation Guide. I am also extremely grateful to CA. Ganesh Balakrishnan, Hyderabad and his team, *viz.*, Ms. Swati Naik, Mr. Sriraman Parthasarthy and Mr. T.S. Venkateswaran for squeezing time out of their pressing professional and personal preoccupations for reviewing and giving the Implementation Guide its final shape.

At this juncture, I also wish to express my sincere thanks to CA. G. Ramaswamy, President, ICAI as well as CA. Jaydeep N. Shah, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, *viz.*, CA. Rajkumar S Adukia, Vice Chairman, CA. Amarjit Chopra, CA. Naveen N.D. Gupta, CA. Sanjeev K. Maheshwari, CA. M. Devaraja Reddy, CA. Rajendra Kumar P., CA. J. Venkateswarlu, CA. Sumantra Guha, CA. Anuj Goyal, CA. Pankaj Tyagee, CA. Jayant P. Gokhale, CA. S. Santhanakrishnan, CA. Mahesh P. Sarda, CA. Vijay Kumar Garg, CA. V. Murali, CA. Nilesh S. Vikamsey and the Central Government nominees, Shri Prithvi Haldea and Smt. Usha Sankar and also to the co-opted members at the Board, *viz*., CA. David Jones, CA. Sanjay Vasudeva, CA. Raviprasad, CA. P.R. Vittel, CA. C.N. Srinivasan, CA. Ramana Kumar B., for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, *viz*., CA. Vinod Chandiok, Prof. A. Kanagaraj, CA. Amit Roy, Shri Sunil Kadam, CA. Raj Agrawal, CA. Bhavani Balasubramanian, CA. K. Rajasekhar, CA. Harinderjit Singh, CA. N. Venkatram, CA. B. Padmaja, CA. L. Kamesh for their support to the Board. I also wish to place on record my thanks to CA. Puja Wadhera, Secretary, Auditing and Assurance Standards Board and her team, *viz.,* CA. Rajnish Aggarwal, Education Officer and Mrs. P. Anitha, Steno-typist for their efforts in giving the Implementation Guide its final form.

I am sure that the members and other interested readers would find this Implementation Guide useful. I also eagerly look forward to the feedback of readers on the publication.

February 2, 2012
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
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Contents

Foreword

Preface

Snapshot of Revised SA 320 and SA 450 391

Chapter 1: Concept of Materiality 409

Chapter 2: Determining Materiality When Planning the Audit 424

Chapter 3: Evaluating the Results of the Tests of Details 443

Appendices

Appendix 1: Text of Revised SA 320, "Materiality in Planning and Performing an Audit" 448

Appendix 2: Text of SA 450, "Evaluation of Misstatements Identified during the Audit" 462

Snapshot of Revised SA 320 and SA 450

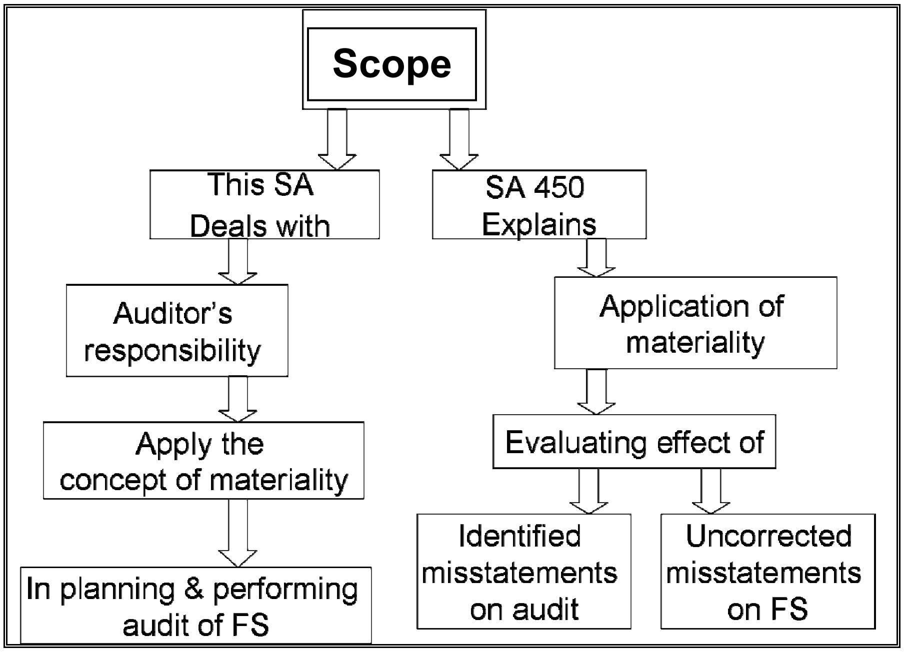
Revised SA 320

Materiality in Planning and Performing an Audit

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

Overview of SA 320

- **Introduction**
  - Scope
  - Materiality in the Context of an Audit
  - Effective Date
- **Objective**
- **Definition**
- **Requirements:**
  - Determining Materiality and Performance Materiality when Planning the Audit
  - Revision as the Audit Progresses
  - Documentation
- **Application and Other Explanatory Material on these aspects**



* FS – Financial Statements

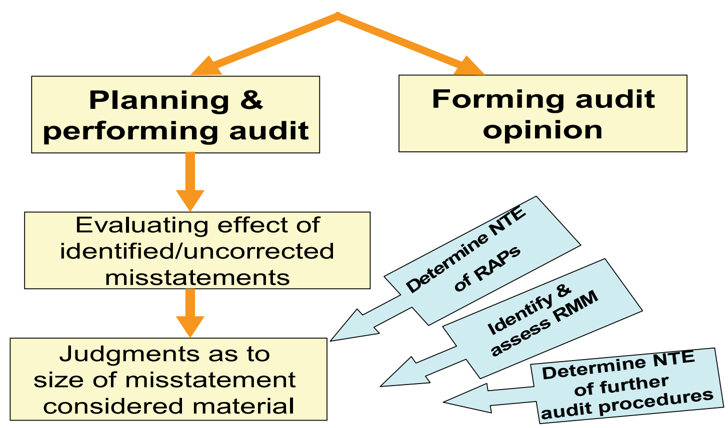
Materiality in the Context of an Audit

- FRFs normally discuss "materiality" in context of preparation & presentation of FS:
  - Misstatements are material if in aggregate/ individually may influence economic decision of users.
  - Judgments on materiality made in the light of surrounding circumstances.
    - Affected by size/nature of misstatements or both.
  - Judgments on matters material for FS users are based on common financial info needs as a group:
    - Not specific needs.

* FRF – Financial Reporting Framework

- Determination of materiality is matter of professional judgment:
  - Affected by auditor's perception of info needs of FS users.
- Auditor may assume that users:
  - Have:
    - Reasonable knowledge of business & economic activities & accounting.
    - Willingness to study FS with reasonable diligence.
  - Understand that FS are prepared, presented & audited to levels of materiality.
  - Recognise inherent limitations in accounting estimates, judgments & consideration of future events.
  - Make reasonable economic decisions based on info in FS.

Consideration of Materiality



Materiality and Audit Risk:

- Materiality and audit risk are considered throughout audit, in particular, when;
  - 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 FS and in forming the opinion in the auditor's report.

\# NTE = Nature, Timing and Extent
RAPs = Risk Assessment Procedures

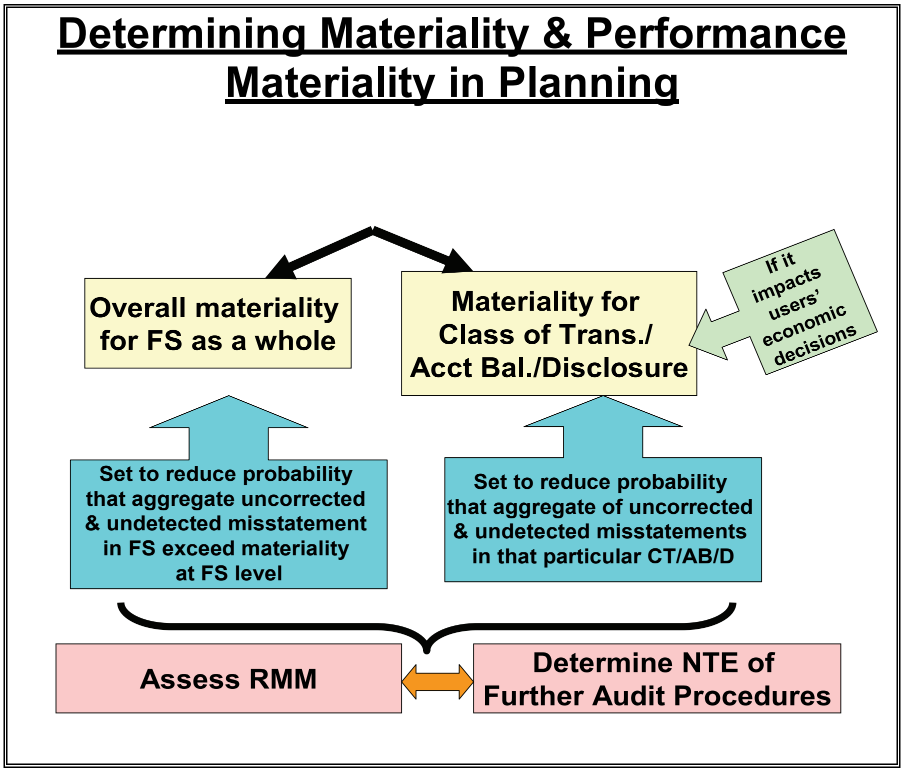
Auditor's Objective

- Apply the concept of materiality.
- Appropriately in planning and performing the audit.

Definition

- **Performance materiality:**
  - Amount(s) set by auditor at less than materiality for FS as a whole.
  - To reduce to an appropriate low level.
  - Probability that aggregate of uncorrected & undetected misstatements exceeds materiality for FS 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.



- Materiality determination is done while establishing the overall audit strategy.
- Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the FS to be materially misstated, and leaves no margin for possible undetected misstatements.
- Determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by:
    - Auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and
    - Nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

\# RMM = Risk of Material Misstatements

Using Benchmarks to Determine Materiality at FS level

- Involves use of professional judgment.
- Starting point - a percentage often applied to a chosen benchmark.
- For less/ more than 12 month FS period, materiality relates to whole of that period.
- Chosen benchmarks ordinarily include:
  - Prior period financial results & State of Affairs (SoA).
  - Period to date results & SoA.
  - Budgets & forecasts (adjusted for significant changes).
  - Changes in the industry/economic environment of entity.

- Factors affecting identification of an appropriate benchmark include:
  - Elements of FS.
  - Items of focus for users of FS.
  - Nature of the entity.
  - Industry & economic environment.
  - Ownership & finance structure.
  - Relative volatility of benchmark.
- Chosen Benchmark:
  - For example, when, as a starting point, the materiality at FS level is determined for a particular entity based on a percentage of Profit before Tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality at FS level is more appropriately determined using a normalised Profit before Tax from continuing operations figure based on past results.

Materiality for Classes of Transactions/ Account Balances/ Disclosures

- Factors that may indicate need to set such materiality level:
  - L&R or FRF affect users' expectations regarding measurement/ disclosure of certain items.
  - Key disclosures wrt industry in which entity operates.
  - Focus on particular aspects of entity's business that is separately disclosed in FS.

- In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, auditor may find it useful to obtain an understanding of views and expectations of TCWG and management.

\# L&R = Laws and Regulations

Revision as Audit Progresses

- Revise materiality if auditor becomes aware of information during audit :
  - That would have caused him to have determined a different amount initially.
- If materiality level requires lowering, determine:
  - Need to revise performance materiality.
  - Appropriateness of Nature, Timing and Extent (NTE) of further audit procedures.

- Materiality 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.
  - A change in auditor's understanding of entity and its operations as a result of performing further audit procedures.
  - For example, if during audit it appears as though actual financial results are likely to be substantially different from anticipated period end financial results that were used initially to determine materiality for FS as a whole, auditor revises that materiality.

Documentation

- Include following amounts & the factors considered in their determination:
  - Materiality for FS as a whole.
  - Materiality level for
    - Class of Transactions
    - Account Balance
    - Disclosures
  - Performance materiality.
  - Any revision to any of above.

SA 450

Evaluation of Misstatements Identified During the Audit

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

Overview of SA 450

- **Introduction**
  - Scope
  - Effective Date
- **Objective**
- **Definitions**
- **Requirements**
  - Accumulation of Identified Misstatements
  - Consideration of Identified Misstatements as the Audit Progresses
  - Communication & Correction of Misstatements
  - Evaluating the Effect of Uncorrected Misstatements
  - Written Representation
  - Documentation
- **Application and Other Explanatory Material on these aspects.**

Scope

- **Auditor's responsibility to evaluate effect of:**
  - Identified misstatements on audit; and
  - Uncorrected misstatement (if any) on FS.
- Auditor's opinion as per Revised SA 700 influenced by evaluation of impact of uncorrected misstatements on FS as per SA 320.

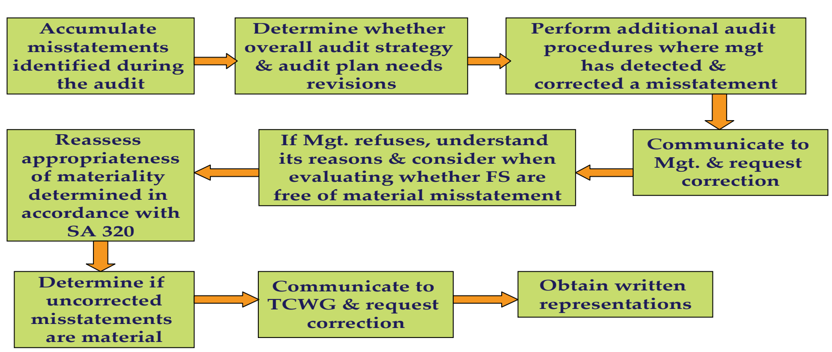
Auditor's Objective

- Evaluate:
  - Effect of identified misstatements on audit; and
  - Effect of uncorrected misstatements (if any) on FS.

Definitions

- **Misstatement:**
  - Difference between:
    - Amount/classification/presentation/ disclosures of reported FS item *vis-à-vis*
    - Requirements of FRF.
  - Includes adjustments as are necessary, in auditor's judgment, to provide True & Fair view.
  - Can arise from fraud/ error.
- **Uncorrected Misstatements:**
  - Misstatements accumulated by auditor during the audit; and
  - That have not been corrected.
- **Misstatements may result from:**
  - An inaccuracy in gathering or processing data from which FS are prepared.
  - An omission of an amount or disclosure.
  - An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts.
  - Judgments of management concerning accounting estimates that auditor considers unreasonable or selection and application of accounting policies that auditor considers inappropriate.
  - Examples of misstatements arising from fraud are provided in Revised SA 240.

Basic Flow of the Audit Process



Accumulation of Identified Misstatements

- Accumulate misstatements identified during the audit:
  - Except those clearly trivial.
- Types of misstatements:
  - Factual.
  - Judgmental.
  - Projected.

- Concept of Clearly Trivial:
  - Clearly trivial does not mean not material. These are matters that are:
    - Wholly smaller than that determined in accordance with Revised SA 320; and
    - Are clearly inconsequential, individually or in aggregate and by any criteria.
  - If there is an uncertainty whether one or more items are clearly trivial, the matter is not considered clearly trivial.
- To assist auditor in evaluating the effect of misstatements accumulated during audit and in communicating misstatements to management and TCWG, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.
  - **Factual misstatements -** Misstatements about which there is no doubt.
  - **Judgmental misstatements** - Differences arising from:
    - judgments of management concerning accounting estimates that auditor considers unreasonable, or
    - selection or application of accounting policies that auditor considers inappropriate.
  - **Projected misstatements -** Auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

Consideration of Identified Misstatements as the Audit Progresses

- Determine need to revise overall audit strategy & audit plan if:
  - Nature of identified misstatements & circumstances of occurrence indicate existence of other (possibly material) misstatements; or
  - Aggregate of misstatements accumulated during audit approaches materiality determined as per SA 320 (Revised).
- Perform additional procedures, if at auditor's request:
  - Management has examined a CoT/AB/D and
  - Corrected misstatements that were detected to determine if misstatement remain.

- A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.
- If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised), there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.
- Auditor may request management to examine a class of transactions, account balance or disclosure to understand the cause of a misstatement identified by auditor, perform procedures to determine the amount of actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to FS. Such a request may be made, for example, based on auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication & Correction of Misstatements

- Communicate:
  - On timely basis.
  - All misstatements accumulated during the audit.
  - To appropriate level of Mgt.

  Unless prohibited by law/ regulation.

- Request Management to correct misstatements.
- If Management refuses correction:
  - Understand its reasons; and
  - Take that into account when evaluating whether FS as a whole are free from material misstatements.

- **Timely communication** is important because it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. **Appropriate Level of Management** is one that has responsibility and authority to evaluate misstatements and to take the necessary action.
- **Prohibition by L & R:**
  - L&R may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act.
  - In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.
- Correction of all misstatements, including those communicated by auditor, enables management to:
  - Maintain accurate accounting books and records; and
  - Reduces risks of material misstatement of future FS because of cumulative effect of immaterial uncorrected misstatements related to prior periods.

Evaluating the Effect of Uncorrected Misstatements

- Reassess appropriateness of materiality determined as per SA 320(R) in context of entity's actual financial results.
- Determine if uncorrected misstatements are material, individually or in aggregate. Factors to consider:
  - Size & nature of misstatements.
  - Particular circumstances of occurrence of misstatement.
  - Effect of uncorrected misstatements related to prior periods.

- This assessment is to be done prior to evaluating effect of uncorrected misstatements. The auditor's determination of materiality in accordance with SA 320 (Revised) is often based on estimates of entity's financial results, because actual financial results may not yet be known. Therefore, prior to auditor's evaluation of effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 (Revised) based on the actual financial results.

- Consider each misstatement to evaluate its effect.
- A material misstatement is unlikely to be offset by other misstatements.
- May offset immaterial misstatements within the same AB/CoT:
  - But consider risk of existence of further undetected misstatements.
- Determining whether a classification misstatement is material involves evaluation of qualitative considerations.
- The circumstances related to some misstatements may cause the auditor to evaluate them as material, even if they are lower than the materiality for the financial statements as a whole.

- Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
- If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the FS as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses.
- Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as:
  - Effect of the classification misstatement on debt or other contractual covenants, and
  - Effect on individual line items or sub-totals on the effect on key ratios.
- SA 240 (Revised) explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of misstatement is not material in relation to the FS.

- Evaluation whether a misstatement is material also affected by L&R and additional responsibilities for the auditor to report other matters, including, for example, fraud.
- Issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature.
- The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements.

Communication with TCWG

- Communicate:
  - Uncorrected misstatements (Identify material uncorrected misstatements individually), and
  - Impact (individually/aggregated) on audit opinion,

Unless prohibited by Laws and Regulations

- Request correction of uncorrected misstatements.
- Also communicate effect of Uncorrected misstatements of prior periods.

- Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate:
  - Number and overall monetary effect of uncorrected misstatements rather than details of each individual uncorrected misstatement.
  - The auditor may discuss with TCWG the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representations

- From Management or TCWG (where appropriate):
  - Whether they believe effects of uncorrected misstatements are immaterial, individually/in aggregate, to FS as a whole:
    - Summary of such items to be included/ attached to Written Representations

- Where, Mgt./ TCWG do not believe that certain uncorrected misstatements are misstatements, they may want to add to their written representation words such as: "We do not agree that items and constitute misstatements because [description of reasons]". Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

\# TCWG = Those Charged With Governance

Documentation

- Include:
  - Amount below which misstatements would be regarded as clearly trivial.
  - All misstatements accumulated during the audit and whether they have been corrected.
  - Auditor's conclusion as to:
    - Whether uncorrected misstatements are material, individually or in aggregate, and
    - Basis for that conclusion.

- Auditor's documentation of uncorrected misstatements may take into account:
  - The consideration of the aggregate effect of uncorrected misstatements.
  - The evaluation of whether the materiality level or levels for a particular classes of transactions account balances or disclosures, if any, has been exceeded.
  - The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (e.g., debt covenants).

Chapter 1

Concept of Materiality

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

1.2 Financial reporting frameworks across the globe mention the concept of materiality in the context of the preparation and presentation of financial statements. The term materiality has been referred in various pronouncements on the preparation of the financial statement and reporting thereof.

- **Paragraph 30 of the "Preface to the Accounting Standards"** issued by ICAI dealing with "Qualitative Characteristic of Financial Statements", states as under: -

  "The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful."

- **'Guidance Note on terms used in Financial Statements'** issued by ICAI defines materiality as *"an accounting concept according to which all relatively important and relevant items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements".*

- **AS 1 "Disclosure of Accounting Policies"** requires materiality as one of the consideration in the selection of accounting policies as under: -

  "Financial statements should disclose all 'material' items i.e. items the knowledge of which might influence the decisions of the users of the financial statements".

- **'Guidance Note on Accrual Basis of Accounting'** issued by ICAI provides under headline: para 6 *concept of materiality* as mentioned below: -

  Concept of Materiality in the Context of an Audit

  The aspects of materiality is a vital factor as to the nature and extent of audit coverage required in conducting an audit i.e. the question of materiality has a direct bearing in shaping an audit programme aiming to conduct an audit effectively.

- **IAS 1 "Presentation of Financial Statements"** requires each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only which are individually immaterial.

- **IAS 34 "Interim Financial reporting"** requires materiality should be assessed in relation to the interim period financial data. Interim measurements may rely on estimate to a greater extent than measurements of annual financial data.

- **Materiality Concept as per RBI guidelines based on N.D. Gupta Committee**

  "In his approach to audit, the auditor should keep in mind the concept of 'materiality'. Items that do not materially affect the views presented by the financial statements may be ignored. While suggesting any changes due to wrong classification or mistakes in grouping or wrong head of account, through the Memorandum of Changes, the branch auditor has to be guided by the materiality concept. In case of some banks, Head Office circular indicates the

quantum of materiality to be considered by the branch auditor. The concept of materiality is fundamental to the reporting of information. Materiality depends on the size, nature and circumstances. Hence, the branch auditor has to decide on the materiality taking into account the amount involved and the impact of the financial statement. If there is a basic mistake in the accounting principle, then such transactions may be reported through Memorandum of Changes even if the amount involved is not material."

- **Kohler's Dictionary for Accountants defines materiality as follows**

  "The relative importance, when measured against a standard of comparison of any item included in or omitted from books of account or financial statements or of any procedure or change of procedure that conceivably might affect such statement. Certain items become material through law, administrative regulation and directors' resolution or other fiat. Other items are regarded a material because of convention, custom or current social emphasis and after the only means of determining relative. Importance are based on such factors as the relative size and general characteristic of item and assumed responsibilities of the management to shareholders, employees and the public. Moreover, the factors of importance today may be of greater or less importance tomorrow. Financial statements as representations of corporate management can be prepared have been well developed. Unimportant items are merged with other items of the same general class or may perhaps be omitted altogether (e.g. minor accruals or pre-payments), important items may require varying degrees of disclosure, a separate listing, a footnote, or parenthetical mention. Some accountants have endeavored to establish standard of materiality by rules of thumb as by requiring that any item or item class, the money amount of which is 5% or more of total assets or 10% or more of net income as an integral of financial statement. Such a rule however, leaves

unsolved the problem of smaller amounts whose disclosure may be essential regardless of their size and where certain items now of minor importance may develop into major items with the passage of time or upon the happening of events now contingent or even unknown ……...."

Concept of Materiality needs to be applied in the preparation of financial statements and reporting thereof. Financial Statements are prepared and presented for the users or stakeholders. They take the economic decision on the basis of financial statements. Thus, the financial statements should disclose all material items i.e. the items knowledge of which might influence the decisions of the users.

Considerations in Preparing and Presenting Financial Statements

Users of Financial Statements

1.3 The basic consideration in the preparation and presentation of general purpose financial statements is the common financial information need of the users or stakeholders and not of any specific individual users.

Generally accepted accounting principles on the basis of which the financial statements are prepared

1.4 This includes: -

- Accounting principles commonly accepted and used and those pronounced in the Framework and Accounting Standards issued by the relevant standard setting body.
- selection of accounting policies for the disclosure of all material items (the knowledge of which might influence the decisions of the users of the financial statements).
- Disclosure of accounting policies, viz.:

- ○ All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed and should form part of the financial statements.
- ○ Any change in the accounting policies which has a material effect should be disclosed along with the amount by which any item in the financial statements is affected by such a change. If such amount is not ascertainable fully or any part thereof, the fact should be disclosed with reason therefor.
- ○ Principles of consistency and conservatism are also to be complied with while preparing and presenting the financial statements. Under principle of consistency, the same accounting policies and principles need to be followed from one period to the next. Under the principle of conservatism, while preparing the financial statements, management should recognise all possible expenses/ losses but should not account for any probable income/ gains.

Accrual Basis of Accounting

1.5 As explained in the Accounting Standard on Disclosure of Accounting Policies (AS-I) issued by the ICAI, revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate, i.e., the concept of accounting on accrual basis.

1.6 The accrual basis of accounting or mercantile basis of accounting is method of recording transaction by which revenue, costs, assets and liabilities are reflected in the accounts in the period in which they accrue. This includes considerations relating to: -

- deferrals,
- allocations,

- depreciation and
- amortization

1.7 The recording of a transaction is made on the following basis: -

- on accrual and not at the line of occurrence of actual flow of money.
- income is accounted for when earned.
- expenses or payments are accounted for when due and payable.
- All known losses are accounted for in the accounting period in which these are determinable.

1.8 This, however, does not necessarily imply that detailed calculations are required to be made in respect of even smallest and immaterial amounts of revenue and expenditure. Thus it may not be improper to write off items of lower value even through it is expected to be used for more than one year. However ascertaining whether an amount is lower or higher is a relative consideration and is based on the size of the entity.

1.9 An individual item should be judged to be material if the knowledge of that item could reasonably be deemed to have influence on the users of financial statements. 'Statement on Auditing Practices' issued by the Institute of Chartered Accountants of India states that the recommendation contained in the statements apply primarily to items which are material and significant in relation to the affairs of the company.

Concept of True and Fair View

1.10 The concept of 'true and fair' view also recognises that the concept of materiality must be given due importance in the preparation and presentation of financial statements.

1.11 Section 209(3) of the Companies Act, 1956, requires that every company has to keep the books of account in such a manner that they give a 'true and fair view' of its state of affairs and that the books are maintained on the accrual basis of accounting.

1.12 Materiality, thus, is a crucial factor for the statutory auditor in forming or expressing an opinion mainly based on judgment in respect of certifying the financial statements as to their 'true and fair' presentation or whether the financial statements are 'presented fairly'.

Factors for Determining Materiality

1.13 An amount is not material solely by reason of its size. Other factors including those set out below need to be considered in making decisions as to materiality.

1.14 The nature of the item, i.e., whether it is: -

a) a factor entering into the determination of net income.

b) unusual or extraordinary.

c) contingent upon an event or condition.

d) determinable based upon existing facts and circumstances.

e) required by statute or regulation, the amount itself, in relation to:

   i) the financial statement taken as a whole.

   ii) the total of the accounts of which it forms, or should form a part.

   iii) related items.

   iv) the corresponding amount in previous years.

   v) expected amount in future years.

1.15 The question of materiality is, therefore, particularly relevant in respect of: -

- Profit (or Loss) before taxation
- Turnover

- Net Tangible Assets
- Net Current Assets
- Current Liabilities
- Income or expenditure of an exceptional or non-recurring nature
- Trends in turnover and profits before taxation

1.16 In a trend analysis for assessing materiality, transactions which are exceptional, unusual or non-recurring in nature are to be excluded as those items tend to distort the actual state of affairs of the business in terms of turnover, profits and returns on capital employed.

Performance Materiality

1.17 A new term "Performance Materiality" has been introduced in Standard on Audit (SA) 320, Materiality in Planning and Performing an Audit". Paragraph 11 of SA 320 requires that for the purpose of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures auditor shall determine "Performance Materiality". The term "Performance Materiality" has been defined in paragraph 9 of SA 320 as follows:

"For purposes of the SAs, 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."

1.18 Further, paragraph A12 of SA 320 explains that:

"Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may: -

- *cause the financial statements to be materially misstated; and*
- *leaves no margin for possible undetected misstatements.*

Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period."

1.19 The underlying concept of performance materiality, which is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole, is not new as in para 5 of the erstwhile SA 320 (i.e., AAS 13, "Audit Materiality") it was already stated that,

"The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices. The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transaction……………………………………………………"

1.20 But the term "Performance Materiality" is new and is considered as the primary benchmark for the auditor to assess the nature, timing and extent of risk assessment procedures and plan and perform associated audit procedures to mitigate those risks.

1.21 For example auditor's verification of individual accounts of customers may reveal error in discount allowed/credited that may be immaterial at the level of an individual customer but if aggregated as a whole for the company this may exceed the level of materiality. The auditor, therefore, while planning the audit should consider the effect of such aggregated impact based on his understanding of the entity updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

1.22 Examples of application of performance materiality:

- Variation between 5 to 10 % of current year and previous year income and expenditure
- Cost of repairs and maintenance in relation to the fixed assets
- Closing stock valuation *vis-à-vis* production, consumption and sales.
- Cost of assets as additions during the year in relation to loans/internal funds applied for financing such assets.

1.23 Materiality may have to be judged on a single item in relation to the group of assets and liabilities, e.g., for a single item of assets in the context of total assets and for a single item of liability in the context of total liability.

1.24 Normally, the same monetary precision has to be applied both in respect of profit and loss account items and balance sheet items because the materiality has to be judged for an item in profit and loss account which has a corollary effect on the balance sheet also. For example, when examining the overstatement of sundry debtors, the auditor will have to relate this to the over statements of sales also. Similarly, the reasonableness as to the provision for bad debts and for doubtful debts must be linked with sundry debtors as well as to sales. Similarly, when profit before tax is low in comparison to the turnover, the focus will be on turnover as well as on the co-relationship of different nature of expenditures, particularly, 'cost of sales' (or Cost of Goods Sold).

1.25 In assessing materiality in connection with the above significant aspects of financial statements, the question of monetary precision also has to be set out. Since ultimately, misstatements and materiality in financial statements boils down to monetary impact.

1.26 In the context of materiality in financial statements for audit of accounts, the monetary precision may based on the maximum amount of misstatement that could probably occur which may not make the financial statements misleading. Professional judgment is a crucial factor for deciding on materiality in financial statements.

1.27 In respect of materiality, the auditor's judgment is based on monetary precision, i.e., deciding on what the amount which is likely to be material to the financial statements – maximum amount by which the financial statement would be misleading.

1.28 The form and content is based on the concept of materiality in the context of preparation and presentation of financial statement. Schedule VI to the Companies Act, 1956 has been framed taking into account the concept of materiality. The revised Schedule VI also takes into account the materiality concept, for the purposes of presentation and disclosures of financial statement information.

Misstatement

1.29 A "misstatement" is the 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.

1.30 When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

Uncorrected Misstatements

1.31 "Uncorrected misstatements" refers to misstatements that the auditor has accumulated during the audit and that have not been corrected.

Determine the Threshold for Clearly Trivial Misstatements

1.32 Auditor may designate an amount below which Misstatements would be clearly trivial and would not need to be accumulated because he expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material." Matters that are clearly trivial are of a wholly different (smaller) order of magnitude than materiality, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

1.33 Up to 5 percent of materiality is often considered as clearly trivial. The auditor may determine, based on the facts and circumstance of the entity and the audit engagement, that a lower level is appropriate. Factors such as the nature of the entity, history of misstatements, and number of locations may affect the actual threshold of what the auditor may consider as clearly trivial. If it is anticipated that the accumulated Uncorrected Misstatements might approach the amount deducted from materiality when determining Performance Materiality, the auditor may decide to apply a lower percentage to determine the actual threshold of what would be considered clearly trivial.

Illustrative Factors for Consideration of Materiality

1.34 Whether or not the knowledge of an item would influence the decisions of users of financial statements would depend on a particular facts and circumstances of each case. It is not possible to lay down precisely, either in terms of specific items or in terms of amounts, what could be considered as material in all circumstances.

Factors for consideration	Illustration
Materiality to users is based on common financial need of users of group and thus possible effect of misstatement on specified individual user whose need may vary widely need not be considered.	Paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by ICAI in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".
Apart from the size (or magnitude) of an item, its nature is also an important factor in determining whether or not it is material in the facts and circumstances of a case.	If the discovery of an illegal payment, even of a small amount could result in the closure of an enterprise, the item is material. Similarly, inadequate or improper description of an accounting policy would be material if it is likely to mislead the users of the

	financial statements.
Materiality can be judged only in a relative context.	In a small business, Rs.1000 may be material amount, whereas in a giant undertaking, even Rs.10,000 may not be considered material.
An item of information is material, if its omission or misstatement can influence the economic decisions of the users of the information.	If fake sales of significant amounts are recorded in the books of account of a company, it would result in over-statement of sales and profit as shown by the financial statements. A potential investor may be induced by the figure of profit shown in the financial statements to invest in the shares of the company.
What is material depends upon the particular facts and circumstances of each case.	For example, omission of sale invoice of Rs.10000/- in an enterprise with turnover of say Rs.1000 crores, may not normally be material. However the omission could become material if the turnover of the enterprise were say Rs.5 lacs.

Determining Performance Materiality

Example 1

1.35 Materiality for entity AA has been set at Rs. 5,000,000 for the current period audit and the engagement team is about to determine performance materiality next. Entity AA is an IT consulting firm and there have been no significant changes in the entity's business, internal control, risks of material misstatement or management. The entity has been an audit client for the last five years and the uncorrected misstatements have been in the region of 20% - 30% of materiality during the client relationship. Last audit's uncorrected misstatement amounted to Rs. 1,034,280 (none of which carry over to this period).

The engagement team determined performance materiality to be Rs. 3,500,000.

Example 2

1.36 For the following audit of entity AA, materiality has been set to Rs. 5,000,000 again. The uncorrected misstatements in the previous audit were Rs. 1,243,257. There have been no significant changes in the entity's business, internal control or risks of material misstatement but the entity has partly new management starting a few months into the current period. In planning meetings with management they declared that they intend to correct all identified misstatements, unless clearly trivial.

Considering the above circumstances, the engagement team determined performance materiality to be Rs. 4,500,000.

Example 3

1.37 Materiality for entity BB has been set at Rs. 900,000 for the current period audit. Entity BB is an importer of fine Italian wine and food and has been an audit client for two years. There have been no significant changes in the entity's business, internal control, risks of material misstatement or management. Last audit's uncorrected misstatement amounted to Rs. 421,853 with two of the misstatements carrying over and reversing in the current period to an amount of Rs. 171,853. The engagement team's best estimate of this period's uncorrected misstatements is to be similar to the prior period.

Considering the last period's uncorrected misstatements and the carry over effects of these misstatements, the engagement team determined performance materiality to be Rs. 650,000.

Chapter 2

Determining Materiality When Planning the Audit

2.1 As per paragraph 10 and 11 of SA 320 (Revised), one of the requirements is to determine materiality and performance materiality when planning the audit.

2.2 Further, paragraph 11 of SA 200 (Revised),"Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states as follows:

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

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

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

2.3 SA 200 (Revised), paragraph 17 states as follows:

"To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion."

2.4 SA 200 (Revised), paragraph 13(c) defines the Audit Risk as follows:

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

2.5 As per Revised SA 320, the objective of the auditor is to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Impact of Materiality in Planning an Audit

2.6 SA 315 states that 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.

2.7 Once the risk of material misstatements at both the financial statement level and assertions level are identified and assessed, the auditor is responsible to design and implement the related responses in accordance with SA 330, "The Auditor's Responses to Assessed Risks"*.* This includes determination of the nature, extent and timing of further audit procedures in response to these risks.

2.8 While establishing the overall audit strategy in keeping with the requirements of SA 300 (Revised) 'Planning an Audit of Financial Statements', the auditor needs to consider the materiality for the financial statements as well as carry out preliminary identification of significant components and material classes of transactions, account balances and disclosure which he plans to examine.

2.9 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.

2.10 The auditor takes into account the materiality, while determining the sample size, for testing the account balances. Materiality forms the basis for determination of audit scope and the levels of testing the transactions.

Determination of Materiality

2.11 Whether or not the knowledge of an item would influence the decisions of users of financial statements would depend on a particular facts and circumstances of each case. It is not possible to lay down precisely, either in terms of specific items or in terms of amounts, what could be considered as material in all circumstances. The auditor has to use his judgment to determine whether a particular item is material or not in a given situation. However, the following general considerations may be useful to an auditor in forming this judgment.

2.12 Materiality can be judged only in a relative context. In a small business, Rs.1000 may be material amount, whereas in a giant undertaking, even Rs.10000 may not be considered material.

2.13 In many cases, percentage comparisons may be useful in determining the materiality of an item. For example, Revised Schedule VI to the Companies Act, 1956 requires that the following items are required to be disclosed separately in the Profit and Loss Account besides others: -

- Other expense exceeding 1 percent of the revenue from operations of the company or Rs.100,000 whichever is higher.
- As additional information:
  - Total value of all imported raw materials, spare parts and components consumed during the financial year.
  - Total value of all indigenous raw materials, spare parts and components consumed during the financial year.
  - The percentage of each to the total consumption.

2.14 Thus, the law recognises that even items which are of small value individually should be considered as material if they are so numerous as to constitute more than a cutoff point. Percentages as indicators of materiality, other than those specified by law, should be used with care and only as a rule of thumb because many other factors also affect the materiality of an item, apart from its relative amount or quantity.

2.15 The relative significance of an item has to be viewed from many angles while judging its materiality. For example, an item in the Profit and Loss Account would be considered material from the perspective of its impact on the overall figure of profit and loss. Thus, if the item affect the profit or loss figure significant, it will be a material item. Another indicator would be its impact on the total of the category of the expenditure or income to which it pertains. Thus, a particular amount received as dividend will be material if it considerably affects the total amount of income from investment. Another angle to judge the materiality of the item can be to compare it with the corresponding figure in the previous year. Suppose the item is of a low amount in the current year, whereas in the previous year, it was of a much higher amount, it becomes material. Materiality of an item can be judged (a) by considering the impact that it has on the profit and loss, or on the balance sheet, or in the total of the category of items to which it pertains, and (b) on its comparison with the corresponding figure for the previous year.

2.16 In many circumstances, even small amounts may be considered material. Thus, if there is a statutory requirement of disclosure of amounts paid as sitting fee to directors, the amounts so paid should be disclosed precisely and separately. Similarly, a payment of Rs.10000 to directors as remuneration in excess of the statutory limits may be material. A small inaccuracy may be considered material if it converts a loss into a profit or *vice versa*. Similarly, if it creates or eliminates a margin of solvency in the balance sheet, it will be a material item.

2.17 In offsetting and aggregating items, care should be taken to ensure that material items of different nature are not setoff against or aggregated with each other.

Benchmark in Determining Materiality for the Financial Statements and Using Thereof

2.18 Basically, materiality determination involves the exercise of professional judgment. But a percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

2.19 Factors affecting identification of an appropriate benchmark includes the following:

Factors	Consideration/Attributes/Example
Elements of the financial statements	Assets, Liabilities, Equity, Revenue, Expenses
Need to focus item of attention of the users of a particular entities' financial statements	For example, for the purpose of evaluating financial performances users may tend to focus on profit revenue or net assets
The nature of 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 its funding pattern	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
Relative Volatility of the Benchmark	
Appropriateness of the example of benchmark	Circumstances of the entity which includes categories of reported income: ➢ Profit before tax (PBT) ➢ Total revenue ➢ Gross profit ➢ Total expenses ➢ Total equity/net asset value (NAV)

For profit oriented entities	Profit before tax from continuing operation is used
In case of entities where PBT is volatile	Other benchmarks may be more appropriate such as gross profit or total revenues
In relation to the chosen benchmark	Relevant financial data ordinarily includes: ➢ Prior period financial results and financial position ➢ The period to-date financial results and financial position ➢ Budgets or forecasts for the current period ➢ Adjusted for significant changes in the circumstances of the entity (Example a significant business acquisition) ➢ Relevant changes of conditions in the industry or economic environment in which the entity operates (For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalised profit before tax from continuing operations figure based on past results.)

2.20 Materiality relates to the financial statements prepared for that financial reporting period on which the auditor is reporting. What benchmarks and to which extent these will be applied are assessed with professional judgment. There is a relationship between the percentage and the chosen benchmark. A percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

Example

2.21 The auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent 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.

Consideration Specific to Small Entities

Features	Benchmark
➢ Owner managed business ➢ PBT from continuing operation is consistently nominal ➢ Owner takes much of the PBT in the form of remuneration	PBT may be more relevant

Consideration Specific to Governments (Central & State) and Related Government Entities (Agencies, Board, Commission)

Features	Benchmark or the determination of materiality for the financial statement as a whole if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the

	financial statements of those entities may therefore be influenced by
➢ Legislators and regulators are often primary user of the financial statements ➢ Financial statements may be used to make decision other than the economic decision	➢ Legislative and Regulatory requirement ➢ Financial information need of the Legislator Public in relation to public utility programs/projects (like Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities).

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures

Factors indicating the existence of	**Consideration Of The Auditor**
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 reasonably and expectedly to influence the economic decisions of users taken on the basis of the financial statements	
➢ Whether law, regulations or the applicable financial reporting framework affect	To obtain an understanding of the views and expectations of those

users' expectations regarding the measurement or disclosure of certain items (for example, 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 (for example, a newly acquired business).	charged with governance and management.

Revision As the Audit Progresses

2.22 The auditor needs to revise materiality in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures).

2.23 The need of revisit may arise as a result of a change in circumstances as stated above and that occurred during the audit.

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.

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

Examples of Determining Materiality

Example 1

2.25 The engagement team of entity A is in the process of determining materiality for the current period's audit. The entity is a listed entity in the publishing business. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.26 Engagement risk has been determined as normal. Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 7.5% to be applied to the chosen benchmark.

2.27 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 335,060,000. Applying the chosen percentage, 7.5%, to the benchmark amount, Rs. 335,060,000, gives Rs. 25,129,500.

2.28 The engagement team consequently determines materiality for entity A to be Rs. 25,000,000.

Example 2

2.29 The engagement team of entity B is about to determine materiality for the entity which is a listed entity that develops and sells computer games. The entity's management has informed the engagement team that there are strong indications that the entity will be acquired within the next 12 month by one of the country's largest media groups. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.30 There have been no significant changes in the entity's business, management or internal control. Using professional judgment, based on knowledge of the users of the entity's financial statements and considering the fact that the entity is likely to be acquired during or shortly following the period under audit, the engagement partner has chosen 5% to be applied to the chosen benchmark.

2.31 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 147,350,000. Applying the chosen percentage, 5%, to the benchmark amount, Rs. 147,350,000, gives Rs. 7,367,500.

2.32 The engagement team consequently determines materiality for entity B to be Rs. 7,500,000.

Example 3

2.33 Entity C is a listed entity that manufactures and sells office supplies. The entity has been an audit client for a number of years and the engagement risk has been determined as normal. The entity has had a slow but steady growth in revenue and dividends. It has inconsequential external debt and finances most investments by internally generated funds. The entity has a history of few identified misstatements and the engagement team has assessed its internal control as very effective. There have been no significant changes in the entity's business, management or internal control during the period. The engagement partner has determined that due to the fact that the entity is listed the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.34 Due to the entity's low external debt and knowledge of the entity as having effective internal control and accurate financial reporting, the engagement partner has chosen 10% to be applied to the chosen benchmark.

2.35 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 833,250,000. Applying the chosen percentage, 10%, to the benchmark amount, Rs. 833,250,000, gives Rs. 83,325,000.

2.36 The engagement team consequently determines materiality for entity C to be Rs. 83,000,000.

Example 4

2.37 Entity D is a listed entity that leases high value machinery to the construction industry. The entity has been an audit client for a number of years and the engagement risk has been determined as normal. The entity has very little external debt and finances most investments by internally generated funds. The entity has a history of few identified misstatements and the engagement team has assessed its internal control as effective. There have been no significant changes in the entity's business, management or internal control during the period. It is a well-known fact that the key performance indicator for entities in this industry is net assets and the engagement partner has therefore determined that this is the most appropriate benchmark to use in determining materiality.

2.38 Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 2% to be applied to the chosen benchmark.

2.39 The engagement team has estimated net assets for the current period to be Rs. 412,538,000. Applying the chosen percentage, 2%, to the benchmark amount, Rs. 412,538,000, gives Rs. 8,250,760.

2.40 The engagement team consequently determines materiality for entity D to be Rs. 8,250,000.

Example 5

2.41 Entity E is a listed entity that provides environmentally sustainable garbage disposal. The entity has experienced profit and losses alternatively in the past years. It has been investing heavily in fixed assets over the past years and this has been financed ongoing through borrowing. The main focus of the readers of the entity's financial statements is net assets and the engagement partner has therefore determined that this is the most appropriate benchmark to use in determining materiality.

2.42 Using professional judgment, based on knowledge of the users of the entity's financial statements, the engagement partner has chosen 2% to be applied to the chosen benchmark. The engagement team has estimated net assets for the current period to be Rs. 35,702,000. Applying the chosen percentage, 2%, to the benchmark amount, Rs. 35,702,000, gives Rs. 714,040.

2.43 The engagement team consequently determines materiality for entity E to be Rs. 725,000.

Example 6

2.44 Another engagement team is in the process of determining materiality for entity F. The entity is a privately owned entity in the forestry business. Both revenue and profit before tax varies significantly between years due to the fact that the optimal timing for harvesting the trees depends both on the current market price of timber and related products and the availability of appropriately mature trees for harvesting. The entity has significant external debt. Due to these circumstances, the engagement partner has determined that the most appropriate benchmark to use in determining materiality is net assets.

2.45 Engagement risk has been determined as normal. Using professional judgment the engagement partner has chosen 3% to be applied to the chosen benchmark.

2.46 The engagement team has estimated net assets for the current period to be Rs. 12,850,000. Applying the chosen percentage, 3%, to the benchmark amount, Rs. 12,850,000, gives Rs. 385,500.

2.47 The engagement team therefore determines materiality for entity F to be Rs. 400,000.

Example 7

2.48 Entity G is a non listed entity that sells high-end clothing in three different stores located in the same city. The brand is well established since several years back. Some control deficiencies have been identified in the past but the engagement team has assessed its internal control as effective overall. There have been no significant changes in the entity's business, management or internal control during the period. The entity has some external debt and engagement risk has been determined as normal. Since the entity is a profit-oriented entity the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.49 Using professional judgment, based on knowledge of the users of the entity's financial statements it, the engagement partner has chosen 10% to be applied to the chosen benchmark.

2.50 The engagement team has estimated profit before tax from continuing operations for the current period to be Rs. 5,600,000. Applying the chosen percentage, 10%, to the benchmark amount, Rs. 5,600,000, gives Rs. 560,000.

2.51 The engagement team consequently determines materiality for entity G to be Rs. 560,000.

Example 8

2.52 Entity I deal in antiquities. Goods are acquired through purchases of estates, attending auctions and people bringing items to the store. Sales are made through the entity's store, website and at antiquity fairs. The business is privately owned and managed by the owner. The entity has considerable values tied in its inventory, which is partly very slow moving. Revenue and profit has been relatively stable throughout the years. The entity has some external debt but is primarily financed through retained earnings. Engagement risk has been determined as normal and there have been no significant changes in the entity's business, management or internal control. Since the entity is profit-oriented, profit or revenue could be relevant benchmarks in determining materiality for the entity. Due to the significance of the entity's inventory, net assets could also be a relevant benchmark. Using professional judgment, based on these circumstances and knowledge of the users of the entity's financial statements, the engagement partner has decided to consider all these benchmarks in determining materiality.

2.53 The engagement team estimated revenue, profit before tax from continuing operations and net assets for the current period and made the following calculations:

- Profit before tax from continuing operations: 10% of Rs. 460,000=Rs. 46,000
- Revenue: 0.026 x Rs. 5,880,000=Rs. 152,880 (factor applied based on professional judgement)
- Net assets: 3% of Rs.2,000,000=Rs. 60,000
- The average of the three criteria above is Rs. 86,293.

2.54 Considering the amounts calculated above and using professional judgment the engagement partner sets materiality to be Rs. 80,000.

Example 9

2.55 Entity J is a wholly owned subsidiary of an entity which is an audit client and is subject to statutory audit. The entity functions as a sales channel for products manufactured by other group entities. All financing and debt of the entity is provided by the parent and the parent has confirmed in writing that there is no intention of disposing of entity J. Engagement risk has been determined as normal, the entity has a history of few misstatements and the engagement team has assessed its internal control as effective. Being a profit-oriented entity the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations.

2.56 The engagement team has estimated the profit before tax from continuing operations for the current period to Rs. 62,350,000. In determining which percentage to apply to the chosen benchmark the engagement partner considers that the entity has the characteristics that allows the engagement partner to apply a larger percentage to the benchmark amount and knowledge of the readers of the entity's financial statements and decides to apply 15% to the benchmark amount. Applying the chosen percentage, 15%, to the chosen benchmark, Rs. 62,350,000, gives Rs. 9,352,500.

2.57 The engagement team therefore determines materiality for entity J to be Rs. 9,250,000.

Example 10

2.58 Subsidiary K of the same group as entity J above has the same main characteristics with the exception that it is financed through external debt that is not guaranteed by the parent entity, as well as share capital. As for entity J, the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations. However, due to the external debt, the engagement partner decides to apply a lower percentage, 7.5%, to the benchmark amount.

Example 11

2.59 Entity L is an entity for which the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations (and applies 5% to this benchmark). Due to entity L's very long production cycle, and dependence on few large products, the entity's profit varies significantly between periods. The engagement partner has, therefore, determined a need to normalise the benchmark amount by using an average of the current period and the four preceding periods.

2.60 The current period's estimated profit before tax from continuing operations is Rs. 11,000,000 and for the prior periods Rs. 907,782, Rs. 9,838,760, Rs. 635,361 and Rs. 7,099,304. The engagement team did not identify any trends to consider in normalising the benchmark amount. 5% of the average benchmark amount of Rs. 5,533,129, is Rs. 276,656.

2.61 The engagement team therefore determines materiality for entity H to be Rs. 300,000.

Example 12

2.62 Entity M is an entity for which the engagement partner has determined that the most appropriate benchmark to use in determining materiality is profit before tax from continuing operations (and applies 8% to this benchmark). The estimated profit before tax from continuing operations for the period is Rs. 20,000,000. This amount includes Rs. 5,000,000 which entity M was awarded in damages in a court case. Since the current period estimated profit includes an amount that significantly increases it and the amount is of an extraordinary nature, the engagement partner decides to normalise the benchmark amount by excluding the damages from the current period profit.

2.63 The normalised estimated profit before tax from continuing operations is Rs. 15,000,000. Applying 8% to the normalised benchmark amount gives Rs. 1,200,000.

2.64 The engagement team consequently determines materiality for entity M to be Rs. 1,200,000.

Example 13

2.65 Entity N is a listed entity providing cable, phone and internet services. 49% of the entity's shares are state-owned. Materiality has been set to Rs. 9,830,000 based on 7.5% of estimated profit before tax from continuing operations.

2.66 Due to recent media coverage of a competitor's failure to appropriately disclose salaries and benefits to management, the engagement partner expects users of entity L's financial statements to pay more attention to the disclosure of remuneration of management for the next couple of years than they have in the past. In preliminary discussions with a member of the audit committee a heightened interest in this disclosure was expressed. Due to this fact, the engagement partner determines to set materiality for the disclosure of remuneration of management to half of the materiality for the financial statements as a whole amount, Rs. 500,000.

Documentation

2.67 Audit documentation broadly refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

2.68 Working papers: -

- Aid in the planning and performance of the audit.
- Aid in the supervision and review of the audit work; and
- Provide evidence of the audit work performed to support the auditor's opinion.

2.69 As defined in paragraph 6(a) of SA 230(Revised), Audit Documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work-papers" are also sometimes used).

2.70 Paragraph 14 of SA 320(Revised) states as follows:

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

(a) Materiality for the financial statements as a whole;

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures;

(c) Performance materiality; and

(d) Any revision of (a)-(c) as the audit progressed."

2.71 Thus, the documentation is based on the consideration of the amounts and the factors in their determination. The consideration as pronounced in the Standard and discussed in the earlier paragraphs in connection with the planning the audit and meeting the requirements in connection with the following are to be kept for recording audit procedure performed, relevant audit evidence obtained, and conclusion the auditor reached in the commonly used terms as working papers.

Materiality for the Financial Statements as a Whole

2.72 The auditor determines materiality for the financial statements as a whole while establishing the overall audit strategy. The auditor should determine the materiality levels to be applied to particular classes of transaction, account balances, or disclosures for which misstatement of lesser amounts than the materiality of the financial statement as a whole could reasonably be expected to influence the economic decision of the users taken on the basis of financial statements.

2.73 The question of materiality arises at various stages during the course of an audit. Thus, the auditor is concerned with materiality when: -

- Determining the nature, timing and extent of audit procedures
- Evaluating the effect of misstatement in the measurement and classification of accounts; and
- Determining the appropriateness of presentation of financial information

2.74 The assessment of materiality is a matter of professional judgment. Judgments about materiality are taken in the light of the surrounding circumstances, and are affected by the magnitude or nature of a misstatement, or a combination of both. Therefore, consideration of materiality embeds the qualitative considerations along with the numerical attributes of the information.

Chapter 3

Evaluating the Results of the Tests of Details

Accomplishment of Test Objectives

3.1 After completing tests of details, the results are evaluated to determine if test objectives have been accomplished. Evaluation of results of the tests of details performed depends on:

- Whether Misstatements were detected; and
- The type of Tests of Details used by the auditor.

Quantitative Evaluation

3.2 The quantitative evaluation is primarily related to the amount of misstatement found or estimated to exist in the Population.

3.3 Auditor is required to accumulate misstatements identified during the audit, other than those that are clearly trivial. As such, misstatements detected by a particular test of details which exceed the 'clearly trivial threshold' or are qualitatively significant, are accumulated.

3.4 A quantitative evaluation without due consideration of qualitative aspects may be meaningless if the qualitative evaluation indicates misstatements with suspicious or unusual aspects or misstatements that suggest a particular condition in a portion of the Population.

3.5 For example, if the qualitative evaluation indicates that some population items have different characteristics and, therefore, audit sampling would not be appropriate to test the Population as a whole.

Qualitative Evaluation

3.6 The qualitative evaluation may address the following issues:

- Do the discovered misstatements contain suspicious or unusual aspects that may indicate fraud or error?
- Is there a pattern of Misstatements that may indicate that the population ought to have been defined as two or more populations (e.g., there are misstatements in inventory items at one location, while inventory items at other locations are correct)?
- Has management confirmed that apparent misstatements are, in fact, misstatements and explained their causes?

Evaluating the Results of the Tests of Details

3.7 How an auditor evaluates the results of the Tests of Details performed depends on whether factual misstatements were detected when he examine and evaluate the evidence for items selected for the tests of details.

3.8 The type of tests of details used.

If factual misstatements were identified, the auditor is required to individually assess them, whether or not corrected by management, in order to obtain an adequate understanding of their nature and cause and their possible effect on the particular audit objective and on other areas of the audit. Based on his understanding of their nature and cause, he may need to reconsider audit evidence obtained and plan to perform further audit procedures in order to meet test objectives.

Tests of All Items in the Population

3.9 If an auditor used tests of all items in the population, the misstatement in the population is equal to the amount of factual misstatement that he detected while performing our tests of details.

Non-representative Selection

3.10 If an auditor used non-representative selection, the misstatement in the total population cannot be determined only from the non-representative selection. This is because, based on the Non-representative Selections, he can only form a conclusion with respect to that portion of the population to which those audit procedures were applied to. For that portion of the population, the Misstatement is equal to the amount of factual misstatement that he detected while performing those tests of details.

Audit Sampling

3.11 For tests of details, auditor shall project misstatements found in the sample to the population. An 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.

3.12 This projection is performed regardless of whether the audit sample was statistically based or not. The results of the examination of the sample items are evaluated in order to form a conclusion about the population as a whole.

3.13 The purpose of an audit sample is to draw inferences about the entire population based on the results of our tests of selected items. Therefore, if an auditor detect factual misstatements using Audit Sampling, he calculates a projection of the probable misstatements in the total population based on sample findings. This projection forms his best estimate of misstatement in the sampled population. He then subtracts the factual misstatements found in the audit sample from the projected misstatement to determine the extrapolated misstatement in the population tested.

3.14 A Factual Misstatement in an audit sample is not ordinarily an isolated, although by focusing on the type of misstatement, it may be possible to identify a portion of the population most likely to be subject to that type of misstatement and separately test and evaluate this portion of the population.

Anomalous Misstatements

3.15 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.

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

3.17 For example, an error caused by a computer breakdown that is known to have occurred on only one day during the period. In that case, the auditor assesses the effect of the breakdown (e.g., by examining specific transactions processed on that day) and considers the effect of the cause of the breakdown on audit procedures and conclusions.

3.18 For example, a misstatement that is found to be caused by use of an incorrect formula in calculating all inventory values at one particular branch. To establish that this is an anomaly, the auditor needs to determine whether the correct formula has been used at other branches.

Evaluating Results of Audit Sampling

3.19 Auditor is required to evaluate the results of the sample to determine whether the use of Audit Sampling has provided a reasonable basis for conclusions about the Population that has been tested.

3.20 For Tests of Details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further Audit Evidence that no material misstatement exists.

3.21 The projected misstatement plus anomalous misstatement, if any, is auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than his expectations of misstatement used to determine the sample size, he may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps him to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional Audit Evidence is obtained.

3.22 Tolerable misstatement may be the same amount or an amount lower than performance materiality. An auditor however typically set tolerable misstatement equal to performance materiality.

Appendix 1

SA 320(REVISED)

MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

Contents

Paragraph(s)

Introduction

Scope of this SA 1

Materiality in the Context of an Audit 2-6

Effective Date 7

Objective. 8

Definition 9

Requirements

Determining Materiality and Performance Materiality when Planning the Audit 10-11

Revision as the Audit Progresses 12-13

Documentation 14

Application and Other Explanatory Material

Materiality and Audit Risk A1

Determining Materiality and Performance Materiality when Planning the Audit A2-A12

Revision as the Audit Progresses A13

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Limited Revision Consequential to issuance of SA 320 (Revised), "Materiality in Planning and Performing an Audit"

Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of SAs and SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450[1], explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. 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.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.

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[1] SA 450, "Evaluation of Misstatements Identified during the Audit".

[2] For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".

4. 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.

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

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

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

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

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

   The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.[3]

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

9. For purposes of the SAs, 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.

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. 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. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

[3] SA 450, paragraph A16.

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)

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

Documentation

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

    (a) Materiality for the financial statements as a whole (see paragraph 10);

    (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);

    (c) Performance materiality (see paragraph 11); and

    (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

* * *

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.[4] The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level[5]. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk[6]. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement[7];

(b) Determining the nature, timing and extent of further audit procedures[8]; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report[9].

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, 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;

[4] SA 200 (Revised), paragraph 11.
[5] SA 200 (Revised), paragraph 17.
[6] SA 200 (Revised), paragraph 13(c)
[7] SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".
[8] SA 330, "The Auditor's Responses to Assessed Risks".
[9] SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

- 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); and
- The relative volatility of the benchmark.

A3. 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.

A4. 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. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent 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.

Considerations Specific to Small Entities

A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .

A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A10. 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 (for example, 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 (for example, a newly acquired business).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears 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.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.

2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may

be an appropriate benchmark. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained

Limited Revision Consequential to issuance of the Standard on Auditing (SA) 320 (Revised), "Materiality in Planning and Performing an Audit"

The amendments to the following Standards on Auditing (SAs) have been shown in track change mode.

SA 230 (Revised), "Audit Documentation"

A17. ….Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with SA 320(Revised)[10], assessed risks, significant matters noted during the audit, and conclusions reached.

SA 260 (Revised), "Communication with Those Charged with Governance"

A15. Communication regarding the planned scope and timing of the audit may:

(a) Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures …

A17. Matters communicated may include:

- The application of the concept of materiality in the context of an audit.

[10] SA 320 (Revised), "Materiality in Planning and Performing an Audit".

SA 300 (Revised), "Planning an Audit of Financial Statements"

Appendix

Considerations in Establishing the Overall Audit Strategy

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of ~~appropriate~~ materiality ~~levels~~ in accordance with SA 320 (Revised),[11] and, where applicable: ~~including:~~
  - ~~o setting materiality for planning purposes~~
  - ~~Setting~~ Determination of materiality for components and communication ~~g materiality for~~ thereof to component auditors ~~of components.~~
  - ~~o Reconsidering materiality as audit procedures are performed during the course of the audit.~~
  - Preliminary identification of ~~material~~ significant components and material classes of transactions, account balances and disclosures.

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment"

A1. The understanding establishes a frame of reference within which the auditor plans to audit and exercise professional judgment throughout the audit, for example, when: …

- ~~Establishing~~ Determining materiality in accordance with SA 320(Revised) ~~and evaluating whether the judgment about materiality remains appropriate as the audit progresses;~~[12] ~~…~~

SA 540 (Revised), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

A94. Ordinarily, a range that has been narrowed to be equal to or less than ~~the amount lower than the materiality level for the financial statements as a whole determined for purposes of assessing risks of material misstatement, and designing further audit procedures~~ performance materiality is adequate for the purposes of evaluating the reasonableness

[11] SA 320 (Revised), "Materiality in Planning and Performing an Audit".
[12] SA 320 (Revised), "Materiality in Planning and Performing an Audit".

of management's point estimate.

A122. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95 & A94).

Appendix 2

SA 450

EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

Contents

Paragraph(s)

Introduction

Scope of this SA **1**

Effective date 2

Objective 3

Definitions 4

Requirements

Accumulation of Identified Misstatements 5

Consideration of Identified Misstatements as the Audit Progresses 6-7

Communication and Correction of Misstatements 8-9

Evaluating the Effect of Uncorrected Misstatements 10-13

Written Representation 14

Documentation 15

Application and Other Explanatory Material

Misstatements A1

Accumulation of Identified Misstatements A2-A3

Consideration of Identified Misstatements as the
Audit Progresses A4-A6

Communication and Correction of Misstatements A7-A10

Evaluating the Effect of Uncorrected Misstatements A11-23

Written Representation A24

Documentation A25

Material Modifications to ISA 450, "Evaluation of Misstatements Identified during the Audit"

Standard on Auditing (SA) 450, "Evaluation of Misstatements Identified during the Audit" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," which sets out the authority of SAs and SA 200 (Revised), "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised)[1] deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320(Revised)[2] deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to evaluate:

(a) The effect of identified misstatements on the audit; and

(b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material

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[1] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraphs 10-11.

[2] SA 320 (Revised), "Materiality in Planning and Performing an Audit".

respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

(b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

(a) 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 (Ref: Para. A4)

(b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised). (Ref: Para. A5)

7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

Communication and Correction of Misstatements

8. 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[3].The auditor shall request management to correct those misstatements .(Ref: Para. A7-A9)

9. 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

[3] SA 260 (Revised), "Communication with Those Charged with Governance", paragraph A4.

understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A 10)

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 (Revised) to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

(a) 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 (Ref: Para. A13-A17, A19-A20)

(b) 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. (Ref: Para. A18)

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance[4] uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

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[4] In accordance with the paragraph 9 of SA 260 (Revised), "Communication with Those Charged with Governance," if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

Written Representation

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The audit documentation shall include: (Ref: Para. A25)

(a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);

(b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and

(c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. (paragraph 11)

* * *

Application and Other Explanatory Material

Misstatements (Ref: Para. 4(a))

A1. Misstatements may result from:

(a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(b) An omission of an amount or disclosure;

(c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and

(d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Examples of misstatements arising from fraud are provided in SA 240 (Revised).[5]

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[5] SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.

Accumulation of Identified Misstatements (Ref: Para. 5)

A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320 (Revised), and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530 (Revised)[6].

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320 (Revised), there may be a greater than an acceptably low level of risk that possible undetected

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[6] SA 530 (Revised), "Audit Sampling", paragraphs 14-15.

misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.[7]

A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

A7. 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. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

A9. The correction by management of all misstatements, including those communicated by the auditor, 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.

A10. SA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's

[7] SA 530 (Revised), paragraphs 5(c) and (d).

judgments[8], which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

A11. The auditor's determination of the materiality in accordance with SA 320 (Revised) is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 (Revised) based on the actual financial results.

A12. SA 320 (Revised) explains that, as the audit progresses, the materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially[9]. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with SA 320(Revised) (see paragraph 10 of this SA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures, are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate[10].

A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification

[8] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.
[9] SA 320 (Revised), paragraph 12.
[10] The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to re-assess the risk of material misstatement for that account balance or class of transactions.

misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Makes a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;

- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. SA 720[11] deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

  These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A17. SA 240 (Revised)[12], explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

A19. In the case of an audit of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the evaluation whether a misstatement is material may also be

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[11] SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".
[12] SA 240 (Revised), paragraph 35.

affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

Communication with Those Charged with Governance (Ref: Para. 12)

A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.[13]

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A23. SA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this SA).[14] The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representation (Ref: Para. 14)

A24. Because management and, where appropriate, those charged with governance are responsible for adjusting the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We

[13] SA 260 (Revised), paragraph 9.
[14] SA 260 (Revised), paragraph 12(c)(iii).

do not agree that items ………and ………….. constitute misstatements because [*description of reasons*].” Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A25. The auditor's documentation of uncorrected misstatements may take into account:

(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

Material Modifications to ISA 450, "Evaluation of Misstatements Identified during the Audit"

Deletions

Paragraph A19 of ISA 450 states that in the case of an audit of public sector entities, the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A19, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

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Implementation Guide to Standard on Auditing (SA) 530 Audit Sampling

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Foreword

Standards on Auditing are critical in ensuring and enhancing quality in audits of financial statements and thus bridging the expectation gap. It is therefore necessary that the auditors properly understand and implement these Standards in their audit engagements. Implementation Guides to Standards are an important tool in the hands of the practitioners to appropriately understand the exacting requirements of these Standards and help them implement the Standards in real life audit scenarios.

I am happy to note that the Auditing and Assurance Standards Board is conscious of the fact that the mission of convergence with the International Standards on Auditing having been already achieved, focus is now required on taking these Standards to the common practitioners through various proactive awareness initiatives such as conferences/ seminars, training workshops, and more importantly, technical publications such as Implementation Guides to Standards. This Implementation Guide to Standard on Audit (SA) 530, 'Audit Sampling' is one such Guide.

I complement CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board who has been actively driving these awareness initiatives. I also keenly look forward to more such Implementation Guides and other technical publications from the Auditing and Assurance Standards Board.

December 28, 2011 **CA. G. Ramaswamy**
New Delhi President, ICAI

Preface

Collection of audit evidence is an extremely crucial and sensitive phase of an audit since the ultimate opinion of the auditor hinges on the audit evidence obtained and auditor's evaluation thereof. Given the fact that it is neither possible nor practicable for an auditor to check each and every transaction or record or detail, especially, in contemporary modern businesses where the volume and geographical spread of transactions are incredibly enormous, test checking has been an acceptable method of evidence collection and evaluation all along.

Audit sampling is an established technique that removes *adhocism* and provides scientific and logical foundation and credence to the "test check" approach followed by the auditors in demanding situations. It allows the auditors to draw inference from testing a smaller sample and extrapolating the results to a much larger population.

The Institute of Chartered Accountants of India had issued a Standard on Audit dealing with audit sampling as back as in 1998. The Standard was revised in 2007 under the Clarity Project. The Standard deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.

As a part of its efforts to create awareness among the members on methods to further improve the quality of their audit by encouraging their understanding and compliance with the various Standards on Audit, the Auditing and Assurance Standards Board has been bringing out Implementation Guides on auditing standards. This Implementation Guide on SA 530, Audit Sampling is one such Guide. It provides practical implementation guidance on important aspects relating to audit sampling in an easy and lucid language, covering matters such as need for audit sampling, its appropriateness and sufficiency, sampling foundation and sampling process, sampling techniques, performing audit procedures and evaluating results of audit sampling, computerized audit sampling, etc.

I am extremely grateful to CA. Paratha S De, Kolkata for preparing the preliminary draft of the Implementation Guide. I am also grateful to CA. Ganesh Balakrishnan, Hyderabad and his team *viz.,* Ms. Swati Naik, Mr. Sriraman Parthasarthy and Mr. T.S. Venkateswaran for reviewing and giving the Implementation Guide its final shape.

At this juncture, I also wish to express my sincere thanks to CA. G. Ramaswamy, President, ICAI as well as CA. Jaydeep N. Shah, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, *viz.*, CA. Rajkumar S Adukia, Vice Chairman, CA. Amarjit Chopra, CA. Naveen N.D. Gupta, CA. Sanjeev K. Maheshwari, CA. M. Devaraja Reddy, CA. Rajendra Kumar P., CA. J. Venkateswarlu, CA. Sumantra Guha, CA. Anuj Goyal, CA. Pankaj Tyagee, CA. Jayant P. Gokhale, CA. S. Santhanakrishnan, CA. Mahesh P. Sarda, CA. Vijay Kumar Garg, CA. V. Murali, CA. Nilesh S. Vikamsey and the Central Government nominees, Shri Prithvi Haldea and Smt. Usha Sankar and also to the co-opted members at the Board, *viz*., CA. David Jones, CA. Sanjay Vasudeva, CA. Raviprasad, CA. P.R. Vittel, CA. C.N. Srinivasan, CA. Ramana Kumar B., for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, viz., CA. Vinod Chandiok, Prof. A. Kanagaraj, CA. Amit Roy, Shri Sunil Kadam, CA. Raj Agrawal, CA. Bhavani Balasubramanian, CA. K. Rajasekhar, CA. Harinderjit Singh, CA. N. Venkatram, CA. B. Padmaja, CA. L. Kamesh for their support to the Board.

I am confident that this Implementation Guide would be well received by members and other interested readers.

December 20, 2011
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing & Assurance Standards Board

Contents

Foreword

Preface

Chapter 1: Need of Audit Sampling, Its Appropriateness and Sufficiency 481

Chapter 2: Sampling Foundation and Sampling Process 485

Chapter 3: Sampling Techniques 492

Chapter 4: Performing Audit Procedures and Evaluating Results of Audit Sampling 512

Chapter 5: Computerised Audit Sampling 517

Appendices

Appendix 1: Stratification and Value-Weighted Selection 519

Appendix 2: Examples of Factors Influencing Sample Size for Tests of Controls 522

Appendix 3: Examples of Factors Influencing Sample Size for Tests of Details 525

Appendix 4: Sample Selection Methods 529

Chapter 1

Need of Audit Sampling, Its Appropriateness and Sufficiency

1.1 Auditors require reliable audit evidence from which they can draw robust conclusions. An auditor can apply sampling in carrying out both compliance procedures to review and evaluate the effectiveness of the internal Control System and substantive procedures to obtain evidence regarding the completeness, accuracy and validity of the data.

Need for Sampling

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

1.3 An auditor is required to formulate and express an overall opinion on financial statements based on an examination of the records of transactions and other relevant information. The audit evidence enables the auditor to form an opinion on the financial statements. In forming such an opinion, the auditor may obtain audit evidence on a selective basis by way of judgmental or statistical sampling.

1.4 It is often necessary to draw a sample of information from the whole population to enable a more focused examination to take place. For instance, if the auditor of a bank checks each of the transactions of the bank, it would not be feasible to do so without incurring enormous cost and expending lot of time.

1.5 Sampling is an important auditing technique since it enables the auditor to select some transactions out of a large mass of similar transactions data in a manner that results in drawing valid conclusions about the entire data after a thorough examination of the selected transaction.

1.6 In this back drop, the extent of checking has undergone a progressive change in favour of more focus on the principals and controls with a curtailment of non-consequential routine checking and with a shift in favour of formal internal control in the management of affairs of organizations, where the possibilities of routine error and frauds have greatly diminished.

1.7 **"**An effective sample test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);

(b) Selecting specific items.

1.8 The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.**"**

(Para A52 of SA 500 (Revised) Audit Evidence)

1.9 "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."

(Para A10 of SA 500 (Revised)) Audit Evidence)

Consideration in the Evaluation of Sample and Basic Categories of Sampling

1.10 The extent of checking to be undertaken is primarily a matter of judgment of the auditor. There are generally, no statutory requirements specifying what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. The ultimate objective of the auditor is to express his opinion and become bound by that.

1.11 Generally, the evaluation of a sample is based upon a "judgmental selection" of transactions for review, with little statistical foundation or mathematical reasoning behind the sample. For certain audit objectives, where statistically correct samples are impractical, this approach is acceptable as long as conclusions are fairly represented.

1.12 Audit sampling plays an important role in the auditor's ability to evaluate both internal control and account balances. Sampling techniques attempt to establish conclusions, or an inference, about a population of data based upon a smaller amount of information. The purpose of audit sampling is to obtain information or determine some characteristic about a population represented in an account balance or class of transaction types.

1.13 There are two basic categories of audit sampling i.e., statistical and non-statistical. The significance of the sample to an overall audit objective will affect the sample design, as will the auditor's knowledge of the area under consideration. For example, sampling could be used in substantive testing to collect evidence regarding account balances, transactions or disclosures. Samples can be selected non- statistically for known high-risk items or statistically for specific attributes or monetary coverage. Statistical sampling measures results with confidence intervals for sample reliability concerning the population. This foundation, free of bias, supports audit analysis grounded in mathematical principle.

1.14 As mentioned in SA 530 (Revised), an auditor may decide to use audit sampling in performing audit procedures. If it is so decided then SA 530 (Revised), Audit Sampling, applies. The SA 530 (Revised) deals with the auditor's use of statistical and non statistical sampling when:

- designing and selecting the audit sample,
- performing test of controls, test of details, and
- evaluating the results from the sample

Limitations of Sampling

1.15 Sampling can provide a valid, defensible methodology but it is important to match the type of sample needed to the type of analysis required. The auditor should also take care to check the quality of the information from which the sample is to be drawn. If the quality is poor, sampling may produce reliable results.

Chapter 2

Sampling Foundation and Sampling Process

Sampling Foundation

2.1 During audit planning for areas with a high number of transactions or large quantities of evidence for evaluation, the auditor should consider the use of sampling techniques. Since there are many variations to audit sampling, only a few common types are being discussed in this Implementation Guide along with the procedures for determining the right sample size to adequately represent the target population and develop conclusions. However, a discussion of sampling risks and concepts will precede the details of sampling types since this understanding is important for developing an appropriate sampling technique.

2.2 A risk is, no doubt, involved in selecting and checking only some items in order to reach a conclusion about all of them. Sampling risk arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion auditor would reach if the entire population were subjected to the same audit procedure.

2.3 Auditors should, therefore, be careful about extrapolating audit findings or drawing broad conclusions across a population of activities or transactions. Extrapolating results that exceed the statistical significance of judgmental sampling activities can unintentionally increase audit risk. Conclusions based upon judgmental sampling should be limited to those items actually examined since subsequent events could contradict the conclusions -- especially when performed using a non-statistical approach. Conversely, many variations of statistical sampling provide a strong basis for conclusions about audit evidence.

2.4 A sampling approach should be consistent with audit objectives and testing programmes including the accurate interpretation of results (evidential matter) as in any audit reporting. Substantiation of significant findings may rely upon the statistical grounding of the sampling approach. Simply put, audit sampling establishes the objectivity and credibility of audit results and gives more meaning to recommendations, particularly when a mathematical approach is incorporated.

2.5 **Sampling Risk** arises in carrying out both the compliance procedure and the substantive procedures. When an auditor evaluates an internal control system through compliance procedure, auditor assumes the risk of under reliance or over reliance on internal controls. Thus, the sample results may show the auditor should not rely on a particular internal control whereas the actual position might have warranted such reliance. This is termed as the risk of under reliance. In such a situation, the auditor would, on the basis of the result of his sample test, extend his substantive test even though the additional work was not required. The risk of over reliance on the other hand, is a risk that the sample results support the auditor's reliance on a particular control, when actually auditor should not have so relied. Risk of over reliance is more serious since by wrongly relying on the result of the sample, auditor may reduce the extent of substantive test and may thereby reach erroneous conclusion.

2.6 Judgmental and statistical sampling types include sampling risk and require professional judgment to minimize this risk. Inherent in every sampling procedure is the risk that the sample is not representative and that the auditor would have drawn different conclusions from procedures that include examining 100% of the population.

2.7 Regarding substantive test and tests of controls, there are two basic sampling risk attributes. First, the risk of incorrect acceptance occurs when the sample leads the auditor to conclude that there is no material misstatement when, in fact, there is. In tests of the related controls, the sample would suggest that control is effective since sample results indicate a lower deviation rate than actually exists in the true operating effectiveness of the control. Thus, the auditor has the risk of assessing control risk too low. In both instances, the sample does not detect the issues as intended by the related audit objective. On the other hand, a sampling error occurs when, for substantive tests, there exists a condition of incorrect rejection. In this situation, the sample leads the auditor to conclude that a material misstatement exists when, in fact, it does not. For tests of controls, the sample results indicate a greater deviation rate than actually exists, which leads to the risk of assessing control risk too high.

2.8 These erroneous conditions will have an impact on both the efficiency and effectiveness of the overall audit. The efficiency is compromised by performing more work than required because of incorrect rejection and assessing control risk too high. The effectiveness is compromised by not identifying misstated balances or ineffective controls because of incorrect acceptance and assessing control risk too low.

2.9 Auditors may be 90 or 95 per cent confident that a sample is representative of the population tested. As a corollary, the risk of not being correct, or sampling risk, would be 5% or 10% depending upon the confidence interval chosen. The risk of being ineffective + confidence level = 100%. The confidence level is the complement of the risk of sampling error.

Behind the Numbers

2.10 The probability theory is used to analyse events or processes with uncertain outcomes. Probability models quantify the risk of sampling error (the uncertainty caused by random chance in the selection process). In a random sample all data points should have the same probability of being picked. The value of statistical sampling is its ability to use probability theory to calculate the risk of sampling error.

2.11 One important assumption in understanding statistical sampling is that most populations follow a normal distribution on both sides of a mean or simple average. This type of distribution, if graphically represented, would be a **bell-shaped curve**. Although populations can be skewed representing a concentration of higher or lower values, most populations, statistically speaking, are measured around the standard deviation.

2.12 The **standard deviation** is a measure of how far items within a population are distributed from the central point or mean point. Statistical standards show that about 68% of items in a "normal" population will be one standard deviation from the mean and over 95% of the same population will be two standard deviations (+/-). Therefore, if one sample is taken at random from a large population with a known standard distribution, the probability can be estimated of the sample items falling between a certain ranges (i.e., 95% chance of falling in a range between plus/minus 1.96 standard deviations).

2.13 The **confidence level** describes the reliability of the sample results and expresses the probability of achieving accuracy in estimating the population value. The precision level expresses the accuracy of the sample to estimate the population (usually on both sides since the population value is to land in between). The precision level is commonly referred to as the error limits or upper and lower boundaries. Both of these measures are interdependent, relating (as opposites) the reliability and accuracy of a statistical sample. Together they describe the risk of sampling error.

2.14 Once a statistical sample is evaluated, the results are extended to generate an estimated value or point estimate of the actual population. This point estimate is the base for estimating error as a range, plus or minus. So, these two parameters used as guidelines accompanied with probability constants will allow an auditor to form the statistical inference statement. This statement describes a 'n%' probability that a particular attribute or monetary value either exists or falls within a range, respectively.

Reliability of a Sample

2.15 Statistical foundations assist auditors to prove that a sample is quantitatively representative of the population tested. Therefore, when testing large data sets, any auditor can subsequently conclude and report with confidence the results of audit objectives. In short, successful sampling techniques will result in technically supported conclusions and lend traction to auditor's recommendations for action.

2.16 Sampling, however, does not in any way reduce an auditor's liability. Auditor cannot use it as a cover for negligence. The auditor's responsibility for reasonable care and skill is applicable in all cases and one should see whether the extent of sampling was reasonable so as to enable the auditor to form an opinion. If the results of sampling indicate requirement of further probe, the auditor should consider modifying the nature, timing and extent of his audit procedures accordingly.

2.17 The need for more substantiated audit results, especially in high-risk and variable operations, can exert pressure on auditors performing reviews. It is of utmost importance that a complete record of the extent of the various tests carried out in reaching the audit conclusion and the supporting evidence is kept to justify the process and rationale behind it for any review in future.

Sampling Process

2.18 The sampling process comprises of:

- Defining the population
- Sample Design, Size and Selection of Items for Testing

Population Selection

2.19 Population in the context of an audit of financial statements could include:

- Whole mass of transactions
- Information contained in the accounting records underlying the financial statements and other information
- Other records or documents whether internal or external supporting the information contained in the accounting

records underlying the financial statements and other information

- Physical existence of tangible assets
- Existence of 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
- Authority or valid ownership of both tangible & intangible assets
- Confirmation obtained from external sources
- System and procedure for entering into and processing a transaction right from the beginning to the end
- System of internal control in the area of accounts and finance transaction or document
- Such others as relevant.

Sample Design, Size and Selection of Items for Testing

2.20 When designing an audit sample, the auditor should consider:

- the purpose of the audit procedure, and
- the characteristics of the population from which the audit sample will be drawn

2.21 For any sample design, deciding upon the appropriate **sample size** will depend on **key factors** discussed below. It is important to consider these factors together to achieve the right balance and ensure that the sample objectives are met.

(i) ***Margin of Error -*** No estimate taken from a sample is expected to be exact. Inference to the population will have an attached margin of error. The better the design, the less the margin of error and the tighter the precision but in most cases will require larger sample size.

(ii) ***Amount of Variability*** -The amount of variability in the population, i.e., the range of values or opinions, will also affect accuracy and, therefore, the size of sample required when estimating a value. The more the variability the less accurate the estimate and the larger the sample size required.

(iii) ***Confidence Level*** - The confidence level is the likelihood that the results obtained from the sample lie within the associated precision. The higher the confidence level, that is the more certain one wishes that the results are not atypical, the larger the sample size. Normally 95% confidence may be used to provide forceful conclusions. However, if one is only seeking an indication of the likely population value a lower level such as 90% may be acceptable.

2.22 **Population size** normally does not affect sample size. In fact, the larger the population sizes, the lower the proportion of that population that needs to be sampled to be representative. The effect is to slightly reduce the required sample size.

Chapter 3

Sampling Techniques

Statistical Sampling

3.1 It is important to understand that statistical sampling techniques do not replace the judgment of an auditor. They only enable the auditor quantify the degree of risk that he would take in a particular case. As the Committee on Statistical Sampling of the American Institute of Certified Public Accountants (AICPA) states:

> *"Although statistical sampling furnishes the auditor with a measure of precision and reliability, statistical techniques do not define for the auditor, the values of each to provide audit satisfaction. Specification of the precision and reliability necessary in a given test is an auditing function and must be based upon judgment in the same way as is the decision as to audit satisfaction required when statistical sampling is not used. The use of statistical sampling does not reduce the use of judgment by the auditor, but provides certain statistical measurements as to the results of audit tests, which measurements may not otherwise be available."*

3.2 How, then, does an auditor take a decision regarding the degree of risk that auditor can take in a given situation? This question is closely related to the basic objectives of the audit itself. All standard auditing procedures are designed to help the auditor in formulating a reasonable basis for an opinion on the propositions under examination. In an independent financial statement audit, for example, the auditor has to state whether the financial statements are fairly presented or not (in other words, give a true and fair view). As the AICPA Committee points out, "Materiality is implicit in the concept of fair presentation. Similarly, some degree of uncertainty is implicit in the concept of a reasonable basis for an opinion". This implies that the sample size should be such that the more material an item is the lower should be the sampling risk. Therefore, an auditor should first decide as to how material an item is. The auditor's decision as to the monetary amount or frequency of errors that would be considered material should be based on his judgment in the circumstances of a particular case. What is material in one set of circumstances may not be so in another. It is the auditor's judgment as to how material an item is that will determine the level of sampling risk which auditor can take.

3.3 Similarly, an auditor relies on a number of procedures for reaching a reasonable opinion regarding all transactions. The procedures on which auditor decides to rely more shall have a larger sample size as compared to the sample size for those procedures on which auditor relies less. The degree of reliance that an auditor may place on a certain set of internal control procedures would also depend upon the circumstances of the case and the auditor's assessment of the same.

3.4 Random sampling gives only the probability that items having representative characteristics will be included in the sample. It cannot replace the judgment of the auditor regarding the treatment of the sample result or the degree of materiality auditor attaches to particular transactions. It is however, a useful tool in the hands of the auditor since it provides a measure of risk.

Statistical sampling methods include:

a) Random sampling

b) Systematic random sampling

c) Stratified sampling

d) Value-weighted Selection

a) Simple random sampling

3.5 In a simple random sample ('SRS') of a given size, all such subsets of the frame are given an equal probability. Each element of the frame, thus, has an equal probability of selection. The frame is not subdivided or partitioned. Furthermore, any given *pair* of elements has the same chance of selection as any other such pair (and similarly for triples, and so on). This minimises bias and simplifies analysis of results. In particular, the variance between individual results within the sample is a good indicator of variance in the overall population, which makes it relatively easy to estimate the accuracy of results.

3.6 However, SRS can be vulnerable to sampling error because the randomness of the selection may result in a sample that doesn't reflect the makeup of the population. For instance, a simple random sample of ten people from a given country will *on average* produce five men and five women, but any given trial is likely to over represent one sex and under represent the other. Systematic and stratified techniques, discussed below, attempt to overcome this problem by using information about the population to choose a more representative sample.

3.7 SRS may also be cumbersome and tedious when sampling from an unusually large target population.

Example: Assume an office with 500 employees, divided equally into men and women, and 75 employees are to be selected for sampling. One could put all their names in a bucket and pull out 75 names. Not only does each person have an equal chance of being selected, one can also easily calculate the probability of a given person being chosen, since the sample size (n) and the population (N) is known and it becomes a simple matter of division:

n/N or 75/500 = 0.15 (15%)

This means that every employee in the office has a 15% or 1.5 in 10 chances of being selected using this method. Further, all combinations of 75 employees have the same probability of selection.

b) Systematic Random Sampling

3.8 One method of selection of random sample could be to select every *n*th item out of a series of entries using a random start. If auditors wish to select a random sample of 100 items out of a total population of 1200, he may, for example, select every 12^{th} item beginning from one or any other digit. Thus, if auditor begins from 3, he would select the 3^{rd}, 15^{th}, 27^{th}, 39^{th}, and 51^{st} items and so on. The method is known as systematic random sampling. Thus, where, for example, an auditor wishes to check 68 debtors out of 475 accounts auditor may just take up the 2^{nd}, 9^{th}, 16^{th}, 23^{rd}, 30^{th}, accounts and so on. In other words, the auditor may start from the digit 2 and selects every 7^{th} item therefrom. The selection of 2 as the starting item is just random and the auditor can as well select any other digit (from 1 to 7) as the starting point. To keep the sample free from bias one can decide about the starting point also by the following procedures.

3.9 Divide the total population by the sample size to reach the value of the *n*th item. Thus, if the total number of debtors, as in the given example, is 475 and the auditor wishes to have a sample size of 68, the value of the *n*th item would be 7. Seven slips, identical in size and bearing numbers from one to seven may be prepared and a slip picked up blindly. The number given on that slip may be used as the random start.

3.10 Sometimes bias may vitiate a sample chosen under this method. If the transactions are in a definite pattern, the sample would consist of only a particular type of account/population which appears after regular intervals. Thus, if in sampling payroll, every 7^{th} item is that of a supervisor, entries chosen under this method would certainly not represent the population as a whole. Systematic random sampling can be useful only where the transaction do not follow any regular pattern.

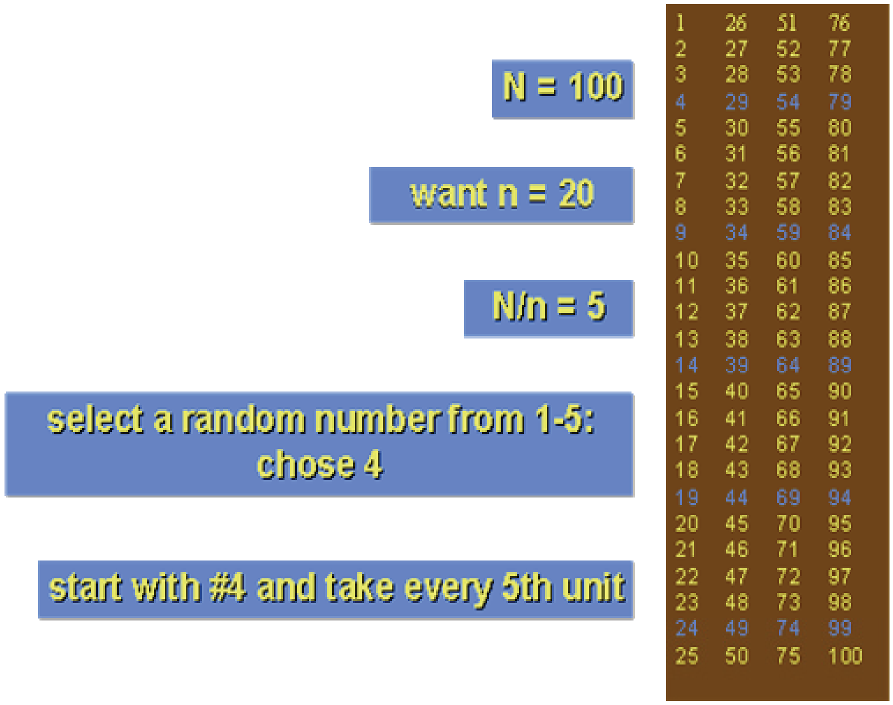
3.11 Today, the development of easy-to-use data analysis software tools such as Audit Command Language (ACL) allows auditors to incorporate audit sampling techniques into field work without use of cumbersome manual statistical tables and formulas. The challenge of audit sampling is to ensure the sample is selected properly to be representative of the population, especially if the objectives include development of meaningful conclusions about thousands of transactions (error rates, misstatements). Of course, data analysis tools may be configured to test 100% of the applicable data points, thereby assessing the entire population rather than a sample or a subset.

3.12 An understanding of audit sampling techniques can help an auditor properly select test sample sizes and develop conclusions for various audit tasks. This Guide describes basic sampling concepts, provides guidance on developing a sampling plan and reviews the common approaches to audit sampling. However, the auditors would need additional resources, training and tools for technical sampling to be incorporated into overall sampling initiatives in their audit(s). Computer Assisted Audit Tools (CAATs) make audit sampling a powerful integrated audit technique. Technical proficiency and adequate supervision, as always, are required.

3.13 Steps to be followed:-

- number the units in the population from 1 to N
- decide on the n (sample size) that you want or need
- k = N/n = the interval size
- randomly select an integer between 1 to k
- then take every kth unit

Example: Assume that auditor has a population that only has N=100 people in it and wants to take a sample of n=20. To use systematic sampling, the population must be listed in a random order. The sampling fraction would be f = 20/100 = 20%. In this case, the interval size, k, is equal to N/n = 100/20 = 5. Now, select a random integer from 1 to 5. In our example, suppose the auditor chooses integer 4. Now, to select the sample, start with the 4th unit in the list and take every k-th unit (every 5th, because k=5). The auditor would be sampling units 4, 9, 14, 19, and so on to 100 and would end up with 20 units in the sample.



c) Stratification

3.14 Stratification is the process of dividing a population into sub populations each of which is a group of sampling units having similar characteristics. Dictionary meaning of Stratification is as under:

- Process by which strata are formed;
- An arrangement is strata or layers;
- Any hierarchical division of society according to income culture or other characteristic stratify

For example, 20% of the items in a Population may make up 90% of the value of an account balance. One can decide to examine a sample of these items, and then evaluate the results of this sample and reach a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

3.15 Another common variation of variables sampling is stratified sampling. Like monetary unit, stratified sampling allows for a weighted selection on larger items with inherently more risk of material misstatement. Auditors can place more emphasis on larger items segregated into their own strata, dividing the population by type for more efficient testing (100% coverage in one group may be desired if problems are detected). Stratification is a common sampling technique and can be used in attribute testing as well. Also, where enough strata are created, usually two to five, the sampling risk is reduced while still applying random selection.

3.16 Other advantages of stratification include using smaller sample sizes. Each stratum's sample items are analyzed, and results are combined to understand the entire population. Strata can be created on any common characteristic, although large Rupee value items are often the criterion since they may be tested differently. For example, inventory items such as large finished goods versus parts and the corresponding accounts receivable would be natural stratum as many accounting populations will reflect. Stratification can also be used to test controls in attribute sampling, for example, by creating strata for different processing locations.

3.17 The basic steps in conducting a variables sampling procedure, although they are usually more complex for stratified sampling and better conducted utilising statistical software, include:

1. **Establish the Audit Objective** – there may be two sets of audit objectives including the overall audit to be completed by sampling combined with other tests, etc. and the sampling application objective.

2. **Develop a Sample** – (see above) the sample can be generated through use of tables with the confidence level and sampling error (derived from a random preliminary sample's average group ranges, divided by a statistical d_2 factor; it equals the estimated standard deviation used to divide the average sampling error to arrive at the stipulated

sampling error). The auditor, taking into consideration confidence intervals and sampling error, may reevaluate the appropriateness of the sample size.

3. **Examine the Sample** – evaluate the details and calculate revamped sampling error. Audit procedures are applied although they do not depend on the sampling approach. The results are usually summarized and may include a listing of error, their projection in the population and an inference statement.

4. **Extrapolate to Population and Evaluate Results** – the inference can be mathematical (based upon a point estimate) or non-mathematical (a judgment of overall reasonableness).

   Example: The additions to the Fixed Assets of the Company during the year is Rs. 10 Crores and the physical number of assets added is 250. Out of the 250 assets, 35 assets represent Rs. 9.7 crores out of the Rs. 10 crores. Therefore, these 35 assets may be used for audit sampling instead of the entire 250 and the remaining 215 can either be considered immaterial or further samples can be selected, depending upon the materiality, using other methods of sampling.

d) Value-Weighted Selection

3.18 When performing Tests of Details it may be efficient to identify the Sampling Unit as the individual monetary units that make up the population. For example, having selected specific monetary units from within the population of the accounts receivable balance; the auditor may then examine the particular items, such as individual balances, that contain those monetary units.

3.19 One benefit of this approach to defining the Sampling Unit is that the 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 (described in Appendix 4) and is most efficient when selecting items using random selection.

Example: The accounts receivable balance contains a balance of Rs. 100 Crores and the overall materiality of the audit is decided as Rs. 10 crores. Individual Accounts (debtors) having a balance of above Rs. 10 crores can be selected as samples. Let us assume that the company has total of 30 individual debtors out of which 6 accounts have an individual balance of above Rs. 10 crores totaling to Rs. 76 crores. These 6 accounts can be selected as samples and then further audit sampling can be done on the remaining 24 accounts depending upon the materiality using other methods of sampling.

3.20 Since the result of only representatives and unbiased sample can be statistically interpreted, an auditor should select his sample carefully. The selection procedures should ensure that each element in the population has an equal chance of being selected. In other words, the sample should be selected at random, i.e., in such a manner that each transaction has an equal chance of being included in the sample.

3.21 There are a number of methods by which random sample can be selected. The age old method of mixing various slips (containing numbers of different elements of population) in a bag and picking out a few may give us a random sample if adequate care is exercised.

3.22 A variety of sampling methods can be employed, individually or in combination. Factors commonly influencing the choice between these designs include:

- Nature and quality of the Population
- Availability of auxiliary information about units of the population
- Accuracy requirements, and the need to measure accuracy
- Whether detailed analysis of the sample is expected
- Cost/operational concerns

3.23 Specific sampling techniques are chosen based upon the type of sampling (attribute or variable) and the sample selection method (stratification, random number, interval or cluster). Both the type and sample selection **method would be driven by the overall audit objective and/or characteristics of the data examined**. For example, the inventory may be composed of small parts and of large unit finished goods. The audit team may decide to segregate these characteristics into groups prior to applying analysis. This sample is considered a stratified sample since different characteristics may generate various audit considerations. As stated above, one sample can be used for several sampling plans to support various conclusions.

3.24 The two common approaches to sampling presented below include attribute and variable (monetary unit and stratified applications) with guidance on usage, characteristics and application in the audit plan. An auditor should keep in mind that statistical analysis is a widely applied discipline with many types of uses including the few detailed here.

Attribute Sampling

3.25 This type of sampling assists auditors to **evaluate internal controls over many transaction items**. It can help to assess compliance with policy and procedures, standards or operational requirements. Attribute sampling usually will determine a range or percent of occurrence of either "yes" or "no" attribute. For example, does the purchase order have an approval signature: yes or no? This allows the auditor to make inferences about the status of the control condition and the extent to which the control is followed.

3.26 The basic steps for audit attribute sampling include the following:

1. Understand the items being sampled.
2. Establish parameters for the test.
3. Select the sample and perform procedures.
4. Evaluate the results and form conclusions.

3.27 First, develop an expected error rate or estimate how many errors will be tolerated recognizing that most operations contain errors regardless of controls and procedures. Although management may claim “zero errors,” error rates as a percent of transactions may be as minimal as 0.01% or as excessive as 10% or more. Developing an error rate estimate may be difficult if management has a “zero error rate” policy that precludes any management estimation. A good example is the control systems in diamond retail operations where inventory “shrinkage” is unacceptable. Their control procedures can include camera surveillance, double verification and checking employees. Still, a small amount of inventory is, normally, lost.

3.28 The sampling parameters will be established by carefully defining the types of tests planned along with acceptance or rejection rules. The attribute test, or estimation of expected error rate, infers an upper and lower limit to be determined within a particular confidence interval.

3.29 The basic sampling parameters include, as stated above, the maximum tolerable error (upper precision limit), confidence interval (recommended 95% or 98%) and estimate of overall population errors. These three parameters will determine the actual sample size that can be established through guidance from statistical tables. Statistical sample software will also provide correlated sample sizes. Then, by modifying the parameters, different sample sizes are generated that satisfy overall testing objectives such as management’s confidence in the testing results. A smaller estimated population error rate and/or lower confidence level will reduce the sample size. Further, a bigger gap between the estimated population error rate and the maximum tolerable error rate will naturally reduce the sample size. Population error rates are usually in the 1-2% range and should not exceed 5% since, depending upon subject matter; this would render controls inadequate beyond reasonable exception items. Understanding and working with these relationships is important to ensure quality results and valid conclusions.

Potential Characteristics of Audit Interest for Certain Classes of Transactions and Account Balances

3.30 The following is an illustrative list of potential characteristics of audit interest for certain classes of transactions and account balances.

Inventory

3.31 Examples of potential characteristics of audit interest for Inventory include:

- Inventory balances over Rs.[X]
- Inventory transactions over Rs.[X]
- Duplicate inventory items
- Inventory items listed with no count tags
- Duplicate inventory count tags
- Inventory items with negative quantities
- Inventory items with negative price
- Inventory items with negative cost
- Inventory items in which quantity is not zero and price is zero
- Inventory items in which cost is greater than retail price
- Inventory items with a profit margin below [X]
- Inventory items that have not moved in the last [X] days
- Inventory items which have a date last counted before [X]
- Inventory items with no recorded location
- Transactions before start of period
- Transactions after period end.

Accounts Receivable

3.32 Examples of potential characteristics of audit interest for Accounts receivable include:

- Accounts with credit balances
- Receivable balances over Rs.[X]
- Credit notes over Rs.[X]
- Invoices over Rs.[X]
- Accounts outstanding for greater than [X] days
- Accounts in excess of credit limit
- Total of items invoiced in last month of period
- Total of items invoiced in first month of next period
- Credit notes issued after period end
- Invoices in which the credit period taken exceeds [X] days
- Customers whose discount exceeds [X] percentage
- Gaps in sequence of orders
- Duplicates in sequence of orders
- Gaps in sequence of invoices and credit notes
- Duplicates in sequence of invoices and credit notes
- Gaps in sequence of delivery documents
- Duplicates in sequence of delivery documents
- Orders without invoices
- Invoices without orders
- Accounts that have had no activity since [date].

Fixed Assets

3.33 Examples of potential characteristics of audit interest for Fixed Assets include:

- Fixed Assets balances over Rs.[X]

- Fixed Assets transactions over Rs.[X]
- Fixed Assets items with negative net book values
- Fixed Assets items with nil net book values
- Transactions before start of period
- Transactions after period end
- Duplicate asset numbers
- Assets without a location

Accounts Payable

3.34 Examples of potential characteristics of audit interest for Accounts Payable include:

- Accounts payable balances over Rs.[X]
- Accounts payable transactions over Rs.[X]
- Accounts with debit balances
- Transactions before start of period
- Transactions after period end
- Payments over Rs.[X]
- Payments made before due date
- Payments made after due date
- Gaps in sequence of purchase orders
- Duplicates in sequence of purchase orders
- Gaps in sequence of receiving documents
- Duplicates in sequence of receiving documents
- Debts with a due date more than 12 months ahead
- Accounts that have had no activity since [date]
- Invoices without purchase order.

Salaries and Wages

3.35 Examples of potential characteristics of audit interest for Salaries and Wages include:

- Duplicate employees
- Transactions before start of period
- Transactions after period end
- Pay rates exceeding Rs.[X]
- Pay rates exceeding [X] percentage above the average pay rate
- Normal hours/days worked exceeding [X] hours/days
- Overtime hours/days worked exceeding [X] hours/days
- Total deductions are a "negative" amount.

Variable (Monetary and Stratified) Sampling

3.36 In general, variable sampling techniques are used to review an account balance to determine whether it is fairly stated. Variable sampling is focused on testing detailed items that support an account total and is divided into monetary and traditional stratified sampling. Both techniques give greater weight to items with larger values (monetary sampling also is known as a form of probability-proportional to size [PPS] selection). In fact, most types of sampling are defined by the characteristics of the population and development of a sample for testing. Monetary or PPS, random selection and systematic selection sampling are all considered random-based selection techniques that assure each sampling unit has an equal chance of being selected, which is important to prevent unintended bias.

3.37 Monetary Unit Sampling, also known as Rupee Unit Sampling, uses every Rupee or currency unit in the account under consideration as an individual sampling unit. In other words, the sample is selected based upon individual Rupees that, depending upon an established interval, will be part of various transaction balances that add up to the summary account balance under review.

3.38 Each Rupee has an equal chance of being selected throughout all the transactions in a group. Only transactions that include the Rupee units selected are examined for accuracy and ultimately make up the group of transactions in the "sample."

3.39 Monetary sampling, because of its selection nature, is limited to only determining when overall balances are overstated and will not catch zero balance transactions. Also, this type of sampling does not handle credit or negative balance amounts, and these should be removed from the overall population under examination. The selection interval is determined by dividing the total value of all transactions in the account under review by the number of transactions. Monetary unit sampling applications are especially valuable for auditors primarily interested in evaluating large Rupee items along with a mix of all amounts in the population.

3.40 However, the first step to performing a monetary sampling test, as listed below, is to determine the sample of "Rupees" (e.g. how many 760th Rupees in sample) for selection. Developing a sample size includes the following:

1) Determine the tolerable error or desired level of precision. In order to consider internal controls effective, a small percentage is often utilized such as 2-3%. (Same as attribute testing above.)

2) Establish the estimated confidence level 95- 98%. This will instill confidence in procedures rather than something lower that can be rejected by management.

3) Calculate the error rate for sampling – likelihood of incorrect acceptance/rejection.

4) Define population size or total value of the account under consideration.

3.41 Additional factors that may influence the sample size in variable sampling:

- High expected value or occurrence of misstatement will increase the sample.
- High overall risk assessment by the auditor will increase the sample.
- High standard deviation or variability of the population will decrease the sample.
- High level of tolerable misstatement will decrease the sample.

3.42 Based upon the unit sampling procedures above, an auditor may compare the balances tested to the balances recorded on the system of record. At this point, the auditor may consider developing an upper precision limit for each overstated account to establish an adjustment as required. However, this test would likely corroborate previous testing results.

3.43 Because monetary unit sampling ensures selection proportional to Rupee values there is a better chance of identifying material misstatements. All items larger than the calculated interval (e.g., 760) are selected. If the auditor establishes a very low tolerable error and no errors are found in the sample, then a small sample size is usually sufficient. As described above, the sample selection is comparatively easy and it is possible to rely on a simple calculator rather than using statistical software or employing specialized IT auditors. Conversely, monetary unit sampling does not detect zero balances, cannot utilize credit items, and is therefore precluded from extrapolating population understatements. Regardless of these limitations, internal auditors can use monetary unit sampling in attribute testing for picking samples where Rupee values are recorded.

Non Statistical Sampling

3.44 It is a sampling approach that does not have characteristics of:

a) Random selection of the sample items

b) Use of probability theory to evaluate sample results including measurement of sampling risk, is considered non-statistical sampling.

3.45 The problem arises when auditors reference samples, draw their conclusions and make recommendations with little or no statistical foundation to their tests. Such tests are considered a judgmental sample and any related reporting should be clear about the limitations of the conclusions. This does not mean that judgmental sampling cannot be a useful procedure. Non-statistical or judgmental sampling may serve the purpose of collaborating evidence with other tests in a secondary capacity. However, failure to explicitly describe sampling parameters such as confidence and precision intervals or sample and population sizes may mislead report readers. The mathematical foundation is the bridge between evidence and conclusion.

3.46 Non-statistical sampling is useful for many audit situations and can be an effective means of evaluating evidence. Again, any auditor should be careful not to overstate judgmental sampling results and to clearly explain the derivation of conclusions. Typically, management may not be interested in statistical support as long as it seems to represent the population under scrutiny.

3.47 In judgmental sampling, audit decisions to exclude remote locations for logistical or cost reasons are usually acceptable as long as the sample still represents the population and audit objectives. For example, if retail outlets are examined to determine whether inventory and daily cash count procedures are followed, then a close-to-random selection may suffice -- especially if it is representative of the outlet network (e.g., small/large locations; good geographical coverage). However, extrapolation across the entire population (e.g., of the percent of inventory shrinkage) would not be accurate unless statistical attributes are applied. The recommended management action to improve controls and performance across the retail network is the same. Judgmental sampling may lead to additional audit testing techniques or give reasonable confidence if it corroborates other positive testing results.

3.48 Generally, different auditors use standard judgmental sample sizes of 25, 50 or 100 to provide ample evidence to establish an adequate conclusion or understanding of existing conditions. If it appears based on the judgmental sample that significant weaknesses may exist, then the auditor should develop a formal statistical basis for an additional sample based on probability.

3.49 **Non-Statistical techniques include**

a) Haphazard sampling

b) Block selection

c) Judgment selection

a) Haphazard sampling

3.50 In haphazard sampling technique, the auditor selects the sample without following any structured methodology. Since no structured technique is used, the auditor should take steps to avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have an equal chance of selection. Haphazard selection is not appropriate when using statistical sampling.

Example: In a population of 100 items, where 9 samples are to be selected (which is determined through materiality), the auditor can randomly select the 2^{nd}, 11^{th}, 13^{th}, 25^{th}, 33^{rd}, 47^{th}, 65^{th}, 70^{th}, 80^{th} samples. There is no defined procedure for the selection of the number.

b) Block selection

3.51 Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example: In a population of 100, where 30 samples are to be selected (which is determined through materiality), blocks of say 6 samples can be selected after an interval of 4 samples. Thus leaving the first four samples the 5th, 6th, 7th, 8th, 9th, 10th sample is selected and then again after an interval of four samples the 15th, 16th, 17th, 18th, 19th, 20th sample is selected. Next the 25th, 26th, 27th, 28th, 29th, 30th sample is selected. This procedure is followed till 30 samples have been selected.

c) Judgment Sampling

3.52 This approach is used when a sample is taken based on certain judgements about the overall population. The underlying assumption is that the auditor will select units that are characteristic of the population. The critical issue here is objectivity, i.e., how much can judgment be relied upon to arrive at a typical sample. *Judgement sampling* is subject to the auditor's biases and is perhaps even more biased than haphazard sampling. Since any preconceptions the auditor may have are reflected in the sample, large biases can be introduced if these preconceptions are inaccurate. One advantage of judgement sampling, however, is the reduced cost and time involved in acquiring the sample.

Example: An auditor decides which population members to include in the sample for testing of receivables/payables based on his or her judgment. For example, if in the previous year, there has been a misstatement in the account balance of a certain debtor, the auditor may use his professional judgment in picking the same debtor for sampling in the current year even though the same has not been selected according to the statistical sampling methods adopted. The auditor may provide some alternative justification for the representativeness of the sample.

Chapter 4

Performing Audit Procedures and Evaluating Results of Audit Sampling

Performing Audit Procedures

4.1 The Revised SA 530 requires the auditor to perform audit procedures, appropriate to the purpose, on each item selected. If, however, the audit procedure is not applicable to the selected item, the auditor should perform the procedure on a replacement item.

4.2 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 cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

4.3 If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor should 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 (substantive procedures).

Nature and Cause of Deviations and Misstatements

4.4 The Revised SA 530 also requires the auditor to investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

4.5 Normally, sample results are considered in conjunction with all other tests and evidence prior to making final conclusions about account balances, transactions, etc. Sample results would be considered favorable if the total misstatements and known exceptions do not exceed the tolerable error or original expectations about the population. A mathematical inference may state "that balance is overstated by an estimated 14%" versus a non-mathematical inference such as "the results show the balance is not significantly overstated." Also, any likely errors or best estimates resulting from substantive tests including both listed exceptions (non-mathematical) and quantified misstatement amounts – even if not considered material – should be included.

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

4.7 For tests of details, the auditor should project misstatements found in the sample to the population. 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.

4.8 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.

4.9 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. SA 330, 'The Auditor's Responses to Assessed Risks' provides the following guidance when deviations from controls upon which the auditor intends to rely are detected:

"Para 17

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

(a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures.

Para A41

The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. 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. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor."

Tolerable Misstatement

4.10 It is 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

4.11 It is 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.

4.12 In mathematics and statistics, **Deviation** is a measure of difference for interval and ratio variables between the observed value and the mean. The sign of deviation (+/-), reports the direction of that difference (it is larger when the sign is positive, and smaller if it is negative). The magnitude of the value indicates the size of the difference.

4.13 Deviations are known as errors or residual - deviations from the population mean are error, while deviations from the sample mean are residuals. The sum of the deviations across the entire set of observations from the mean is always zero, and the average deviation is zero. Variation among the value of a data set when compared with a measure of central tendency such as the mean, median or mode.

Evaluating Results of Audit Sampling

4.14 Revised SA 530 requires the auditor to evaluate the results of the sample; and also whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. For the tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

4.15 In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor’s best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to the tolerable misstatement, the more likely it is the actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

4.16 If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments;

Or

- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Chapter 5
Computerised Audit Sampling

5.1 Exploratory Data Analysis(EDA) is a Computer Assisted Auditing Technique that allows the auditors to perform automated audit routines on information stored in computer files. The Exploratory Data Analysis software that is globally supported is Audit Command Language (ACL). Assistance from an Exploratory Data Analysis specialist ("EDA specialist") may be appropriate when using Exploratory Data Analysis software.

5.2 Exploratory Data Analysis can be used to analyze large volumes of data efficiently. Exploratory Data Analysis may be used to examine all records in a data file that meet the specified criteria, or reformat, aggregate, stratify, and report data in a variety of ways. This supports electronic preparation of the analyses required to perform planned audit procedures.

5.3 Exploratory Data Analysis encompass a number of generic types of processing that are used in a variety of ways and combinations to accomplish a wide range of audit objectives. In general terms, Exploratory Data Analysis can assist in performing the following audit tasks:

- Confirm the accuracy of calculations and make computations
- Identify gaps or duplicates in a sequence
- Search for unusual or exceptional items
- Compare data in separate files
- Perform statistical sampling
- Capture entity data.

5.4 The procedures performed by the entity's data processing systems can also be simulated using EDA, which allows the auditors to test the reasonableness of the entity's information.

5.5 Exploratory Data Analysis may provide more extensive audit evidence than manual audit procedures because of the following:

- Audit Tests can be performed on the entire population and not just on a sample. Certain audit procedures may be difficult to perform manually and might not be able to be readily performed on the whole population.
- Certain significant risks can be more effectively addressed by Exploratory Data Analysis as opposed to selection of an audit sample.
- Analyses of data that would not have been available using manual techniques can help the auditors identify significant risks.

5.6 Thus, Exploratory Data Analysis can significantly enhance audit efficiency as the time spent gathering and documenting information is reduced. Selection of a MUS sample can be performed in minutes instead of hours. For example, the speed, accuracy, and repetitive nature of the technique allow the auditors to test some populations in total in less time than it would take to manually select and test a sample.

5.7 Sampling methods used by the auditors have evolved over the years. A non-statistical approach to audit sampling though cheaper than statistical sampling is generally less capable of detecting material error than a statistical approach such as probability-proportional-to-size (PPS).

5.8 The use of qualitative analysis that documents the nature and cause of each misstatement found in a sample can mitigate some of the risk associated with sampling. The use of a statistical approach, such as PPS, can further reduce this risk, and, at the same time, permit the use of a smaller sample.

5.9 The downside of statistical sampling is its complexity when performed manually. However, the use of an Excel-based software programs such as, Audit Aid, enable an auditor to use PPS and thereby gain greater efficiency and reliability from sampling operations in financial statement audits.

Appendix 1
Stratification and Value-Weighted Selection

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

Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

3. 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. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a

further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

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

Value-Weighted Selection

5. 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 (described in Appendix 4 as reproduced in the subsequent paras here) and is most efficient when selecting items using random selection.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Developing a Sampling Approach or 'Application'

The sampling approach chosen will depend on the designated audit objectives, the characteristics of the elements tested (sometimes judgmental sampling is enough), and the agreed-upon approach or sampling type selected. More specifically, regarding development of a sample application (sampling program), there are three basic steps:

1. Determine what items to analyze and the **selection method** – derived from audit objectives.

2. Determine the **sample size** that will achieve the required degree of confidence and precision for the population that is judgmentally reasonable.

3. **Interpret results** – evaluate the sample for potential error rates and form conclusions, being careful to avoid misleading reporting beyond statistical support.

The auditor needs to determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Paragraphs A10 and A11 of Revised SA 530 state as follows:

"A10

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.

A11

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen."

Appendix 2
Examples of Factors Influencing Sample Size for Tests of Controls

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

FACTOR	**EFFECT ON SAMPLE SIZE**	
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase	The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of

		controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).
2. An increase in the tolerable rate of Deviation	Decrease	The lower the tolerable rate of deviation, the larger the sample needs to be
3. An increase in the expected rate of deviation of the population to be tested	Increase	The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
4. An increase in the	Increase	The greater the level of

auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population		assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
5. An increase in the number of sampling units in the population	Negligible effect	For 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.

Appendix 3
Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

FACTOR	**EFFECT ON SAMPLE SIZE**	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the Auditor does not perform tests of controls; the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low

		detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.

5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor's consideration of the expected misstatement amount include the extent, to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.
6. Stratification of the population when appropriate	Decrease	When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.
7. The number of	Negligible	For large populations, the

sampling units in the population	effect	actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).

The size of the sample should be determined carefully before one can generalize. It should not be so small that it is not representatives of the population as a whole. On the other hand, it must not be so large that it involves undue cost and time. An optimum sample size is therefore required to be worked out precisely and carefully.

The size of the sample is related directly to the sampling risk which an auditor is prepared to take. Whatever sampling technique an auditor chooses to employ, auditor has to make a judgment about the extent of sampling risk justified in the circumstances of the case.

Appendix 4
Sample Selection Methods

The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4 of Revised SA 530. This is reproduced below.

Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

(a) Random selection (applied through random number generators, for example, random number tables).

(b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

(c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(d) 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.

(e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

5
Implementation Guide on Reporting Standards (SA 700, SA 705 & SA 706)

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Foreword

Standards on Auditing are an important instrument in bridging the expectation gap. On the one hand they codify the best practices in the area of audit and thereby help the auditors enhance the value added by an independent audit. On the other hand, they are the performance benchmarks against which the performance of the auditors is measured by the stakeholders in the financial reporting process. It is therefore necessary that the auditors properly understand and implement these Standards in their audit engagements.

Implementation Guides to Standards are an important tool in the hands of the practitioners to appropriately understand the exacting requirements of these Standards and help them implement the Standards in an appropriate manner to meet the objectives which they are designed to achieve.

This Implementation Guide on Reporting Standards being brought out by the Auditing and Assurance Standards Board is, I feel, a benchmark publication. This Implementation Guide, written by a senior member of the profession, contains comprehensive guidance on the reporting Standards, *viz*., SA 700, SA 705 and SA 706. I am sure the Implementation Guide would be able to address the apprehensions, concerns and difficulties, if any, being faced by the practitioners in relation to these Standards and help them issue more meaningful and value add audit reports on the financial statements.

At this juncture, I may also mention that the mission of convergence with the International Standards on Auditing having been achieved early this year, our focus now is on taking these Standards to the common practitioners through various proactive awareness initiatives such as conferences/ seminars, training workshops, technical publications, etc for the benefit of the common practitioners.

I complement CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board who has been vigorously driving these awareness initiatives. I also keenly look forward to more such Implementation Guides and other technical publications from the Auditing and Assurance Standards Board.

November 16, 2010
New Delhi

CA. AMARJIT CHOPRA
President, ICAI

Preface

Importance of credible financial reporting to the economic activity of a nation cannot be exaggerated. It is the independent auditor's report that lends this credibility to the financial statements which are then relied upon by the various stakeholders in the financial reporting process, be it the creditors, the investors, the regulators or the government agencies and all others who have various interests in the state of affairs of the entity.

To enable the audit reports to serve a meaningful purpose to the users of the financial statements, it is essential that they convey the auditor's opinion on the financial statements in a clear and unambiguous manner. Uniformity and comparability in their format and contents are also elements essential to enhance the usability and value of the audit reports to the users.

In 2010, the Institute of Chartered Accountants of India, issued three separate Standards on Auditing (SA) to deal with the form and content of an independent auditor's report as also the various types of opinions and special other paragraphs that may be included in the auditors report. These Standards are, SA 700, *Forming an Opinion and Reporting on Financial Statements;* SA 705, *Modifications to the Opinion in the Independent Auditor's Report;* and SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report or "the Reporting Standards" as they are collectively called. All the three Standards are quite comprehensive and benchmarked with the corresponding International Standards on Auditing issued by the International Auditing and Assurance Standards Board and are a part of the 36 revised/ new Standards on Auditing issued by ICAI under the Clarity Project.

In line with the focus of the Auditing and Assurance Standards Board on creating awareness among the practitioners about the Standards on Auditing issued under the Clarity Project, the Board has brought out this implementation guide to help practitioners appropriately understand the requirements of these Reporting Standards and their implementation in various actual audit scenarios.

For ease of usage and understanding of the readers, the Implementation Guide is in a "Question – Answer". This also ensures quick referencing and avoidance of lengthy essay-type text. The Implementation Guide addresses all the major concerns of the auditor regarding reporting. The Implementation Guide consists of five chapters namely Scope of the Guide, Importance of Independent Auditor's Report, and the next three chapters cover the three important reporting standards namely SA 700, SA 705 and 706 dealing with how to form an audit opinion, reach audit conclusions and issue different types of auditor's reports.

The Appendix to the Guide also contains a number of useful illustrative scenarios wherein the auditor would be required to give different types of modified opinions, *viz.*, qualified/ adverse/ disclaimer of opinion.

At this juncture, I wish to express my deep gratitude to CA. Khurshed Pastakia, Mumbai who spared time out of his pressing professional and personal engagements to write this Implementation Guide in a demanding timeframe. I also wish to place on record my gratitude to CA. Amarjit Chopra, President, ICAI and CA. G Ramaswamy, Vice President, ICAI for their constant encouragement, guidance and support to the activities of the Board. I am also thankful to all my Council colleagues as well as the co-opted members and the special invitees on the Board for their valuable suggestions in making the Implementation Guide more useful.

I may, at this point, however, also caution the readers that an Implementation Guide is not a replacement of or a substitute for the original Standard(s) and must not therefore be read on a standalone basis. The Implementation Guide is meant to clarify and augment a practitioner's understanding of the Standards and provide guidance where appropriate.

I am sure that the members would find this Implementation useful in implementing the Reporting Standards and making their audit reports more meaningful to the readers. I shall also eagerly look forward to your feedback on this Implementation Guide.

November 15, 2010 **CA. ABHIJIT BANDYOPADHYAY**
Kolkata Chairman
Auditing and Assurance Standards Board

Contents

Foreword

Preface

Chapter 1: Introduction 538

Chapter 2: Importance of Independent Auditor's Report........ 540

Chapter 3: SA 700 - Forming an Opinion and Reporting on Financial Statements (FAQs).......... 542

Chapter 4: SA 705 – Modifications to the Opinion in the Independent Auditor's Report (FAQs) 563

Chapter 5: SA 706 – Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report (FAQs) 578

Appendices:

Appendix I: Illustrative Formats of Auditor's Reports on Financial Statements 585

Appendix II: Illustrative Formats of Auditor's Reports with Modifications to the Opinion 594

Appendix III: Illustrative Formats of an Auditor's Report that includes an Emphasis of Matter Paragraph/ Other Matter Paragraph....................................... 613

Appendix IV: Illustrative Qualified Opinion Paragraphs, Emphasis of Matter Paragraphs, Disclaimer of Opinion Paragraphs........................ 621

Chapter 1
Introduction

1.1 The *Standards on Auditing and Quality Control* are divided into two groups: Standards on Quality Control (which apply to quality control at the firm level) and the Standards on Audit (SAs) which apply to audits of historical financial information. The latter are further categorised into: Standards dealing with *(a)* general principles and responsibilities (200-series), *(b)* risk assessment and response to assessed risks (300 and 400-series), *(c)* audit evidence (500- series), *(d)* using the work of others (600-series), *(e)* audit conclusions and reporting (700-series); and *(f)* specialised areas (800-series).

Scope of the Implementation Guide

1.2 The scope of this Implementation Guide is limited to the SA 700, "Forming and Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraph and Other Matter Paragraph in the Independent Auditor's Report" that deal with how to form an audit opinion, reach audit conclusions and issue different types of auditor's reports.

1.3 These Standards are arguably the most important ones because they deal with processes that culminate into the end product of an auditor's work. They are crucial from an auditor's risk perspective because they lay down the principles and procedures on how an auditor forms his opinion and the manner in which he communicates the opinion, which determines how the society in general or specific stakeholders will make important economic decisions. In other words, the opinions and conclusions stated in an auditor's report and how those were reached will be what regulators and investigative agencies challenge in the event that something goes wrong subsequently. It is therefore of great professional concern that the practitioners appropriately understand and carefully implement the Standards relating to these areas that are broadly referred to in this Implementation Guide as "*the Reporting Standards*".

1.4 Before the Clarity Project of the International Auditing and Assurance Standards Board (IAASB) that was completed in March 2009 and that of the Auditing and Assurance Standards Board of the ICAI that got completed in January 2010, the Reporting Standards were organised differently and there were far fewer of them. Presently, there are as many as 10 Standards that involve different types of reporting. It was for this reason that the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India considered it appropriate to issue this Implementation Guide that puts guidance on these diverse reporting requirements comprehensively into a single book.

1.5 It should, however, be noted that this Implementation Guide is not a replacement of or a substitute for the original Standard(s) and must not therefore be read on a stand-alone basis. It is meant to clarify and augment a practitioner's understanding of the Standards and provide guidance where appropriate. Practitioners are therefore urged to first read the relevant Standard(s) and refer to them as they use this Implementation Guide. For ease of usage, the issues have been dealt with in an easy-to-follow "Question – Answer" format.

Chapter 2

Importance of Independent Auditor's Report

2.1 Dependable financial information is essential to the very existence of our society. The underlying objective of an independent audit is to add credibility to the financial statements prepared by management.. Access to capital markets, mergers, acquisitions, and investments in an entity depend not only on the information that management provides in financial statements, but also on the assurance that such financial statements are free of material misstatements. This assurance is provided, to a considerable extent, by an independent audit. While an audit does not by itself guarantee accuracy of the financial statements, it provides users with a reasonable assurance that an entity's financial statements give a true and fair view in conformity with accounting pronouncements within the applicable financial reporting framework.

2.2 Whether it is a business granting trade credit, an investor buying or selling securities, a banker sanctioning a loan, or a government collecting taxes, stakeholders depend on financial information provided by the very people whose interests often run directly counter to their own. The help of an independent auditor, reputed for upright reporting, is what such stakeholders therefore seek.

2.3 The contribution of the independent auditor is therefore to give credibility to the financial statements. Credibility means that the financial statements can be believed; that is, they can be relied upon by stakeholders such as creditors, bankers, stockholders, government and other interested third parties as being true and fair.

2.4 Audited financial statements are now the accepted means by which business corporations report their operating results and financial position. The word "audit", when applied to financial statements, means that the balance sheet, statements of profit and loss and cash flows, and the related accounting policies and notes which are covered by an auditor's report given by an independent auditor, expressing his professional opinion as to the fairness or otherwise of the entity's financial statements and the fact that in his view, the said financial statements are or are not (a) free from material misstatement due to fraud or error and (b) that they are fairly presented.

2.5 The goal is to determine whether these statements have been prepared in conformity with the generally accepted accounting principles (GAAPs). While financial statement audits in India are performed by chartered accountants, the key users of auditors' reports include trade creditors, management, investors, bankers, financial analysts and government agencies.

2.6 The public perception of an auditor's responsibility is often at variance with the auditor's actual responsibility. This creates an "expectation gap" that clearly needs to be closed. To begin with, in public mind there is little distinction between a chartered accountant and an auditor. Many people believe that an auditor *prepares* the financial statements as well as handles all income tax matters from preparing and filing tax returns to managing assessment proceedings. Even the knowledgeable among users often do not know the distinction and the different degrees of assurance provided by an auditor's report, an auditor's certificate, a review report, a compilation report and an agreed-upon procedures report. What most people expect is that if a chartered accountant has put his signature and seal on a document, irrespective of whatever his report may say, that document must be completely free of fraud or error. If it is not, then they tend to hold the auditor responsible for the fraud or error.

2.7 Auditors, in the end, are providers of service to society. This "expectation gap" between them and the society that uses their services creates extremely onerous circumstances for auditors. Auditors therefore need to exercise every available opportunity to educate the users of their reports on the responsibilities of the management for preparing the financial statements versus their responsibilities, as auditors, to opine on those financial statements, based on the work they have done. They also need to amply stress that they are "independent" of the management.

Chapter 3

SA 700 Forming an Opinion and Reporting on Financial Statements

Introduction to the Standard

3.1 The title of this Standard on Auditing (SA) gives no indication that, apart from this, there are a number of other SAs that one needs to look to for different types of reports. This SA deals with (a) how to form an opinion, and (b) how to give a '*clean'* opinion in the auditor's report on *the financial statements* of an entity that prepares *general purpose* financial statements.

3.2 There are other SAs to be followed if the opinion is modified (ie – qualified, disclaimer or adverse), or contains an emphasis of matter and/or other matters paragraph, or if the report is on special purpose financial statements or on a single financial statement (eg – audit of income statement alone) or of a specific element, account or item of a financial statement (eg – audit of receivables).

3.3 Nevertheless, one could say that SA 700 is like a parent of all reporting standards because it lays down the fundamental principles of reporting. The other reporting standards draw their structure from those principles. Given below are the key issues brought out in this Standard in a question – answer format.

Question 1: For which audits does the auditor need to follow this SA?

Response 1: The SA 700 is applicable for audits for financial statement for period begining on or after 1st April, 2011.

Question 2: The SA applies to audits of general purpose financial statements. What does that mean?

Response 2: To begin with, the SA applies to 'audits' and therefore not to engagements where a practitioner performs, for example, 'reviews' or 'compilations' or 'agreed-upon procedures'.

Secondly, the SA applies to audits of 'financial statements'. This includes the set of general purpose financial statements generally comprising of a balance sheet, statement of profit and loss (or income statement), cash flow statement, significant accounting policies and notes, and where applicable, statement of changes in equity. So, this SA does not apply to audits of a single financial statement or of a specific element, account or item of a financial statement.

Thirdly, 'general purpose' financial statements are those that are prepared in accordance with a 'general purpose financial reporting framework', which is a framework designed to meet the needs of a wide range of users as distinguished from a 'special purpose financial reporting framework' that caters to the needs of a specific set of users. Reports on special purpose financial statements are discussed in SA 800.

Question 3: A 'general purpose framework' includes two sub-groups – a 'fair presentation framework' and a 'compliance framework'. What are these?

Response 3: A fair presentation framework is where the auditor gives a "true and fair" report, whereas a compliance framework is one where the auditor reports on whether the financial statements comply with the requirements of the applicable laws, or rules and regulations, or a set of contractual terms and conditions. There can even be a mixture of the two such as when the auditor reports on the financial statements of a bank or a non-banking financial company (NBFC) that is regulated by the Reserve Bank of India (RBI), where part of the auditor's report is on compliance with RBI rules, and other part of the auditor's report is on the true and fair portrayal of the entity's financial position, performance and cash flows.

Technically, for a framework to be a fair presentation framework, it should meet the requirements of the framework and, to achieve this, the management has the freedom to (a) provide disclosures beyond those that are mandated by the framework or, (b) in rare cases, to even depart from the requirements of the framework in order to achieve a true and fair presentation. A compliance framework, on the other hand, requires meeting the requirements of the framework but does not give management such freedom.

Question 4: In an auditor's report there is an 'opinion paragraph' where he expresses his opinion on the financial statements (which could be a fair presentation opinion or a compliance opinion or a combination of both). How does an auditor decide whether he should give a 'clean' or 'unmodified' opinion?

Response 4: When he gives a clean opinion, the auditor says that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Note (a) that he is forming his opinion on the whole set of financial statements taken together, and not on a component or element of those financial statements, and (b) his opinion is formed in the context of the overall 'materiality' of those financial statements.

In order to assert that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, the auditor reaches a conclusion that those financial statements as a whole are free from material misstatement whether due to fraud or error.

To reach this conclusion, he has to determine whether:

(a) Sufficient appropriate audit evidence has been obtained in accordance with SA 330[1];

(b) Uncorrected misstatements are, individually or in the aggregate, material in accordance with SA 450[2];

(c) Requirements of the reporting framework (eg., the Accounting Standards) have been materially complied with;

(d) Management's judgements in preparing the financial statements are free from 'bias' (refer SA 260[3] and SA 540[4]);

(e) The financial statements adequately disclose the accounting policies selected and applied;

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[1] SA 330, The Auditor's Responses to Assessed Risks.
[2] SA 450, Evaluation of Misstatements Identified During the Audit.
[3] SA 260, Communication with Those Charged with Governance.
[4] SA 540, Auditing Accounting Estimates, including Fair Value Accounting Estimates and Related Disclosures.

(f) Those accounting policies are (a) appropriate, and (b) consistent with the financial reporting framework;

(g) The accounting estimates made by management are reasonable;

(h) The information presented in the financial statements is relevant, reliable, comparable and understandable;

(i) There are adequate disclosures for users to understand the effect of material transactions and events on the information conveyed in the financial statements;

(j) The terminology used in the financial statements is appropriate, and the financial reporting framework is adequately referred to or described;

(k) In reporting under a fair presentation framework, the financial statements indeed achieve a true and fair presentation after considering –

- The overall structure and content of the financial statements, and that
- The financial statements, including notes, represent the underlying transactions in a manner that is true and fair.

If one considers the relevant body of GAAP (generally accepted accounting principles – which includes accounting standards and other pronouncements as well as the relevant law) that comprises the financial reporting framework with which the financial statements must be in accord[5], as well as the auditor's responsibilities under the auditing standards and other pronouncements, reaching an audit opinion on a set of financial statements involves doing a *considerable* amount of diligent work, and documenting the work done, in order to be able to "prove" that he reached an informed opinion before signing a clean audit opinion. Issuing a clean opinion is, therefore, an outcome based on meticulous collection of evidence, detailed documentation of work performed, and analyzing it all with professional skill, competence and reasoned judgements.

[5] See item (c) above.

Question 5: When should an auditor refuse to give a clean (unmodified) opinion?

Response 5: There can be two situations: (a) when the auditor has obtained sufficient appropriate audit evidence, and (b) when he was unable to obtain sufficient appropriate audit evidence.

In the first situation, he cannot give an unmodified opinion if he reaches a conclusion that the financial statements taken as a whole are not free from material misstatement(s). In the second situation, due to non-availability of sufficient appropriate evidence, he does not have the ability to reach a definite conclusion that the financial statements taken as a whole are free from material misstatement(s). In either situation, he must give a modified opinion under SA 705[6].

When reporting under a fair presentation framework, if the audtior concludes that fair presentation is not achieved, he should discuss the matter with management to resolve the issue (by giving additional disclosures or, in rare cases, departing from the framework) and, based on the outcome, decide whether he should give a modified opinion.

From this point on, please refer to the Appendix to the SA that gives Illustrative Formats of Auditor's Reports.

Question 6: Is it necessary that an auditor's report should follow a particular form and style?

Response 6: Yes. Consistency in auditors' reports (as required under this SA) promotes credibility in the global marketplace. It helps to promote the users' understanding, and to identify unusual circumstances when they occur.

Question 7: What are the headings of the various paragraphs needed in an auditor's report?

Response 7: An auditor's report has the following paragraphs in the given order:

(a) Title
(b) Addressee

[6] SA 705, Modifications to the Opinion in the Independent Auditor's Report.

(c) Introductory paragraph
(d) Management's responsibility paragraph
(e) Auditor's responsibility paragraph
(f) Auditor's opinion paragraph
(g) Other responsibilities paragraph
(h) Signature
(i) Date of the auditor's report
(j) Place of signature

Question 8: What has changed in the *Title* of an auditor's report?

Response 8: The title of an auditor's report is now: *"Independent Auditor's Report"* as versus titles used earlier such as "*Auditor's Report*" or "*Audit Report*". The use of the word "Independent" is important in the context of the promulgation of SQC 1[7] (applicable to all engagements relating to accounting periods beginning on or after 1st April 2009). SQC 1 deals with quality control standards including those relating to auditor's responsibilities with regard to independence. Use of the word "Independent" affirms to a user that the auditor providing the report has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Question 9: Who should the report be addressed to?

Response 9: As earlier, the auditor's report is usually addressed to those for whom it is prepared. For example, a report on year-end financial statements under the Companies Act, 1956 is addressed to the members of the company. Similarly, report on the financial statements of a partnership firm may be addressed to the partners, and a report on the financial statements of a government undertaking may be addressed to the President of India.

[7] SQC 1 Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements

Question 10: What does the *Introductory paragraph* contain and what is the change *vis a vis* the erstwhile AAS 28*?

Response 10: Under the requirements of AAS 28, the management's responsibility and the auditor's responsibility were mentioned in a very summary/ concise form at the end of the Introductory paragraph. In the auditor's report under this SA, there are two separate paragraphs, each covering the responsibility of the management and the responsibility of the auditor.

Secondly, it was not the general practice to separately mention "summary of significant accounting policies and other explanatory information" along with the identification of the various financial statements on which an auditor reports. This SA specifically requires such a reference.

Apart from this, the Introductory paragraph identifies the entity whose financial statements the report is being issued, states that the financial statements have been audited, identifies each statement that comprises the financial statements and specifies the date or period covered by each of the statements. In this there is a slight variance from the language used in AAS 28, for example the term "financial statements" was not being mentioned earlier, and the auditors used the term "*attached*" (w.r.t. balance sheet) as against the term "*accompanying*" (financial statements) used in this SA.

Note also that under the existing Indian GAAPs, the term "Profit and Loss Account" is redundant and incorrect. The correct term is "Statement of Profit and Loss". The auditors should request the clients to change the nomenclature of this statement so as to match it with that used in the accounting and auditing standards. Under other GAAPs, terms such as "Income Statement" or "Statement of Comprehensive Income" may be used, as appropriate.

Likewise, "*Notes to Accounts*" is also a redundant and incorrect term. The correct term is "*Notes to the Financial Statements*". However, in this SA, the term used is "*Summary of Significant Accounting Policies and Other Explanatory Information*", and that term should now be used. The auditors should request the clients

* Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements".

to also change this nomenclature so as to match it with that used in the auditing standards.

In other GAAPs, there may also be additional statements such as the "*Statement of Changes in Equity*" that form part of the financial statements.

Question 11: What is *Management's Responsibility paragraph*?

Response 11: It is important for the users of the financial statements to explicitly know that the independent auditors do not share the responsibility for the preparation of the financial statements on which they report. This is therefore an important paragraph that clarifies the limit of the auditor's responsibility.

The word 'management' is illustrative. It may be substituted by the designation of whoever in the entity is actually responsible for the preparation of financial statements. For example, in case of a partnership firm , it would be the partners.

Note that it is inappropriate for an auditor to describe management's responsibility in his report unless the management and he have clearly agreed on it. It is therefore very important for the auditor to include the exact language that he intends to insert in his auditor's report on management's responsibility in the engagement letter that is signed by both parties at the start of the audit.

The illustrative language of a management's responsibility paragraph (in a fair presentation framework scenario) is as under:

<< Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with accounting principles generally accepted in India; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. >>

In circumstances where the nature of the entity or its jurisdiction casts additional responsibilities on the management in respect of the financial statements, the auditor may deem it appropriate to suitably add those in this paragraph as well as in the engagement letter.

A question that arises is that if the auditor finds that the internal controls are not up to expectation, should he '*qualify'* the management's responsibility paragraph? The answer is clearly "no".

A responsibility paragraph cannot be qualified. This paragraph's limited purpose is to recite the fact that management is responsible for the design, implementation and maintenance of internal controls. If the auditor subsequently finds that their design, implementation or maintenance is so poor that it requires qualification, the place to make that qualification would be in the auditor's opinion paragraph (and the report under the Companies (Auditor's Report) Order, 2003, where applicable.)

Question 12: What is the *Auditor's Responsibility paragraph*?

Response 12: Like the management's responsibility paragraph, the auditor's responsibility paragraph is also an important paragraph since the auditor makes certain very important assertions in this paragraph about the work that he has done.

The illustrative language of an auditor's responsibility paragraph (in a fair presentation framework scenario) is as under:

<< Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing of the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

<< *An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation of financial statements that give a true and fair view 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 the Company's internal control[8]*. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.*

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. **>>**

A key assertion that is made in this paragraph is that the audit was conducted in accordance with the SAs. SA 200[9], which in a way is the "parent standard" on auditing, prohibits the auditor from representing compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

This is a very broad and onerous assertion for an auditor to make. If during a subsequent review of the audit process, it is found that some of the audit procedures detailed in the SAs were not in fact complied with, it may tantamount to the auditor making a deliberately false declaration in his report and the consequences for the auditor could be very serious indeed.

It would therefore be advisable for the practitioner signing the audit report to ensure that the audit team plans and performs audits in a way that covers all the relevant SAs. Subsequently, when reviewing the audit file, he should ensure that the auditing standards compliance checklist (including compliance with SQC 1[10]) has been thoroughly looked into. If, in certain circumstances, a departure has been made from compliance with SAs, a detailed memorandum explaining the reasons for such departure and the

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[8] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

[9] SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing.

[10] SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

alternate procedures performed to overcome such non-compliance should be kept in the audit working papers file.

It is one thing to have done the work and another to be able to prove that such work was indeed done. Notwithstanding the Standard dealing with Documentation, SA 230[11], and other specific references to documentation in other SAs, looking to the generality of the assertion being made, an auditor would be well advised to adequately document the work performed and conclusions arrived at. This is especially critical in instances where the auditor has applied his professional judgment in a situation where more than one view might have been possible.

Question 13: Where does Section 227(3) and 227(4A) of Company Act, 1956 reporting go if Auditor's Opinion paragraph immediately follows the responsibility paragraphs?

Response 13: This is one major departure from the form of auditor's report that was earlier used in terms of the requirements of AAS 28. Earlier, in case of audit report of a company, the auditor's opinion/ findings in respect of a number of assertions such as in respect of CARO, about obtaining all the information and explanations, books of account, agreement of financial statements with books of account, compliance with accounting standards, directors' disqualification under section 274(1)(g), etc, were given in the auditor's report *before* giving his audit opinion on the financial statements.

In fact, these are the assertions that are required to be made by the auditor not in order to give an opinion on the true and fair financial position, performance or cash flows, but to comply with the specific requirements of section 227(3) or (4A) of the Companies Act, 1956. By reporting on these assertions and, simultaneously, giving below them an audit opinion on the true and fair financial position, performance or cash flows, made it appear to the user that these assertions were also essential for an auditor in forming his true and fair opinion on the financial statements. This is not correct. Even if the finding/ opinion of the auditor in respect of one or more of these assertions is negative, it does not by itself preempt

[11] SA 230, Audit Documentation.

the auditor from issuing a clean opinion under this SA provided, as a result of his audit performed in accordance with the SAs, he is satisfied that the financial statements have been prepared in accordance with the financial reporting framework and, taken as a whole, are free from material misstatement(s).

This SA therefore divides the auditor's report into three sections:

(a) the general section prior to the responsibility paragraphs, (b) the responsibility paragraphs and the auditor's opinion paragraph, and (c) report on other legal and regulatory requirements. This means that the fair presentation opinion on the financial statements is clearly separated from the opinion on compliance matters. This reflects the situation correctly, while also meeting the requirements of law.

Question 14: What happens if wording of Auditor's Opinion is prescribed by law or regulation?

Response 14: The wording of an auditor's report (including the auditor's opinion) may sometimes be prescribed by the law or regulation applicable to the client. While mostly that is not the case, it is possible that the prescribed terms may be significantly different from the requirements of SAs.

When this is so, SA 210[12] requires an auditor to evaluate:

- Whether users might misunderstand the assurance obtained from the audit, and if so
- Whether providing additional explanation in the auditor's report can mitigate such misunderstanding.

Where he concludes that even additional explanation in the auditor's report cannot mitigate possible misunderstanding, SA 210 requires the auditor not to accept the audit engagement.

If the applicable law or regulation compels an auditor to accept such an engagement, then as per SA 210 such an audit does not comply with the SAs. The auditor when reporting on such audit therefore does not include any reference to the audit having been conducted in accordance with the SAs in his auditor's report.

[12] SA 210, Agreeing the Terms of Audit Engagements.

Question 15: How is an unmodified opinion worded generally in case of a fair presentation framework and in case of a compliance framework?

Response 15: The opinion paragraphs given in the illustrative reports given at the end of this SA are reproduced below.

Under a fair presentation framework:

For non-company entities –

<< In our opinion, the financial statements give a true and fair view of the financial position of ABC Company as at December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with accounting principles generally accepted in India. **>>**

Under a compliance framework:

<< In our opinion, the financial statements of ABC Company for the year ended December 31, 20X1 are prepared, in all material respects, in accordance with XYZ Law of Jurisdiction X. **>>**

Question 16: How should an unmodified opinion be worded in case of a fair presentation framework under the Companies Act?

Response 16: Considering the fact that Schedule VI of the Companies Act, 1956 prescribes the form and contents of the financial statements of companies in India, it is appropriate for the auditor to word the opinion paragraph in conformity with Section 227(2) of the Act to the extent that it meets the spirit (rather than the letter) of the law as well as meets the needs of this SA.

The following wording should be used:

<< In our opinion and to the best of our information and according to the explanations given to us, the financial statements give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view of the financial position of ABC Company Limited as at March 31, 20X1, and of its financial performance and its cash flows for the year then ended, in accordance with accounting standards referred to in sub-section (3C) of section 211 of the said Act. **>>**

Note that presently the financial reporting framework that we call "accounting principles generally accepted in India" comprises of the Accounting Standards issued by the Institute of Chartered Accountants of India that are applicable to non-company entities. For companies, the financial reporting framework comprises of and should be described as the "*Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956".*

Question 17: Is it possible for the financial statements to be prepared in accordance with two financial reporting frameworks and if so, how is auditor's opinion expressed?

Response 17: If, for instance, the local country GAAP of a jurisdiction is only very slightly different from the IFRSs, the management may prepare a single set of financial statements that are simultaneously in accordance with both the financial reporting frameworks.

Each framework is considered separately in forming an auditor's opinion. If the financial statements are found to be in compliance with each of the frameworks, the auditor may issue two separate opinions, one for compliance with each framework, in either two different sentences or in a single sentence, eg, "*the financial statements give a true and fair view in accordance with the accounting principles generally accepted in India and with International Financial Reporting Standards*".

If they are in compliance with one framework but not the other, an unmodified opinion may be given on the former under this SA and a modified opinion on the latter under SA 705.

Question 18: If the financial statements are prepared as per one framework but contain information on the extent of compliance with another framework, what is the auditor's responsibility in such a situation?

Response 18: Such a case could be for example where the Notes to the Financial Statements include a Note giving reconciliation of Indian GAAPs profit with, say, US GAAPs. As this information forms part of the financial statements it gets covered by the auditor's opinion.

What this means is that the financial statements as covered by the auditor's report in effect assert that the said reconciliation to US GAAP is free of material misstatement due to fraud or error. In order to be able to make such an assertion the auditor would obviously have to audit this financial information (ie, the reconciliation) and obtain his audit assurance that the numbers in the reconciliation are arrived at after considering all the applicable provisions of US GAAPs and are in compliance with at least the recognition and measurement principles of US GAAPs.

Question 19: How should an auditor frame his opinion where a statute or court order or government directive/ permission allows an entity to prepare financial statements without meeting a GAAP requirement?

Response 19: Sometimes the Central Government or a court of law, say, at the request of the entity, permits it to follow a specific accounting treatment in respect of a particular transaction. For example, an entity may be permitted to account for a certain type of income or expenditure on cash basis or on a deferral basis that may not be permitted by the Accounting Standards. The question is whether a departure from the framework under such circumstances requires an auditor to qualify his report?

The answer is "*no*". In such a situation, the departure is not a non- compliance with the framework but compliance with a modified framework. If the effect of doing this is material, the auditor should describe the resultant deviation from the framework in sufficient detail in an emphasis of matter paragraph.

Question 20: In reply to Question 13 it was mentioned that the report on other legal or regulatory requirements is separated from the opinion paragraph. How is that done?

Response 20: For example, under the Companies Act, 1956, the auditors are required to answer a set of questions pertaining to the entity under the Companies (Auditor's Report) Order, 2003 (CARO). The answers are normally given in an Annexure that is referred to in the auditor's report. Under this SA, the same situation continues but the reference paragraph in the auditor's report comes in a separate section of the report following the opinion paragraph. This section may be titled "*Report on Other Legal and Regulatory Requirements*".

Another example is of the assertions required to be made under section 227(3) of the Companies Act, 1956 on obtaining all the information and explanations necessary for audit, keeping of proper books of account, agreement of balance sheet and statement of profit and loss with the books, compliance with accounting standards prescribed under section 211(3C), disqualification of directors, and cess leviable under section 441A. All these assertions are made *after* the opinion paragraph in the "*Report on Other Legal and Regulatory Requirements*" section. If any of these assertions is negative or partial, that fact needs to be brought out while reporting on that assertion.

The question one may ask is whether the audit opinion will be qualified if one or more of the legally required assertions above is negative. The answer will depend on the merits of each case. For example, if there has been a material departure from Standards prescribed under section 211(3C) as reported in the "*Report on Other Legal and Regulatory Requirements*" section of the report, the opinion will also obviously need to be qualified or adverse. If all the information and explanations have not been provided, it is likely that there may have been a scope restriction on the audit which, if material, would require a disclaimer of opinion. But if a director is disqualified from being a director, that would have no bearing on the true and fair view of the financial statements, and a clean opinion may be given.

Question 21: How does an auditor sign an auditor's report?

Response 21: The SA mentions that "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 intention of the SA here is not to have two separate signatures, one in personal name and one in the firm name, but that the partner signing should sign in his personal name *for and on behalf of the firm* which has been appointed as the auditor with the name and registration number of the firm also mentioned as signatory.

Where a firm is appointed as auditor, the suggested manner to sign would be:

For XYZ and Co Chartered Accountants Firm's registration number   Signature Name of the signing member Designation (partner/ proprietor) Membership number   Place of signature Date:

Question 22: What is the significance of the date of the auditor's report?

Response 22: Date of the auditor's report informs the user that the auditor has considered subsequent events up to that date in making his report[13] and makes the auditor responsible for events and transactions up to that date.

Secondly, since the financial statements are the responsibility of management, the auditor's report should not be signed before the date of approval of the financial statements by the board of directors or equivalent governing body. It may, however, be dated after the date of the board meeting in which the financial statements are approved.

Question 23: Can an auditor sign the auditor's report at a place other than the city where the registered office of the entity is situated? Do the directors and auditor need to sign the financial statements at the same location?

[13] It is therefore important to ensure that the working paper on subsequent events is dated the same as the date of the auditor's report and has been reviewed as at that date by the signing partner.

Response 23: The SA 700 does not contain any such requirement or mandate. An auditor should mention the name of the place where he signs the report. For example, if the auditor signs the report when he is in Hyderabad, he should mention the place of signature as Hyderabad, irrespective of the fact that the registered office of the entity is in New Delhi or that directors may have signed the financial statements in Mumbai.

Question 24: How does the auditor comply with this SA if the law or regulation prescribes a format of auditor's report that is different from the format required under this SA?

Response 24: This situation frequently confronts an auditor in India. Various laws and regulatory agencies prescribe the form in which they expect the auditor's report to be given. This often creates a hard situation for an auditor as he finds that he has performed audits as per the SAs but the form in which he is required to report puts a greater burden on him. For example, there are situations when the auditor is expected to "certify" the financial statements or to attest them as being "true and correct" rather than "true and fair". Also, in most cases the form does not have the management's and auditor's responsibility paragraphs.

The advice to auditors is that wherever they have the liberty to modify the prescribed format to broadly bring it in line with the requirements of this SA, they should do so to the extent possible. This is important from the viewpoint of achieving the fundamental objective of this SA, namely, to achieve consistency in reporting that promotes credibility for an auditor's report in the marketplace. So, for example, if the prescribed report does not have the responsibility paragraphs, he may insert them without disturbing the other layout of the prescribed report.

This SA requires that if the difference between the prescribed format and this SA are only in layout and some wording, the auditor needs to assess if, at a minimum, the various elements required under paragraph 43 of this SA form a part of the prescribed format. If they are all there but in a different layout, he may give his report in the prescribed form so long as the basic principles of the SA are met.

Paragraph 43 mentioned above requires an auditor's report to contain, at a minimum, the following elements: (a) title, (b) addressee, (c) introductory paragraph to identify the financial statements audited, (d) management's responsibility, (e) auditor's responsibility for the audit wrt SAs/ laws/ regulations, (f) opinion wrt the applicable financial reporting framework, (g) signature, (h) date, and (i) place of signature.

However, if the prescribed form of the report does not include the minimum elements required under paragraph 43 of this SA and if the auditor does not have the liberty to change the format to include the missing elements, then he ***cannot*** include a statement in the auditor's responsibility paragraph of the report that "*We conducted the audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India.*" As regards the other assertions that are made in the auditor's responsibility paragraph or elsewhere in the report, the auditor will have to determine if it is appropriate in the circumstances for him to make those assertions or if he should modify them to suit the exact circumstances.

It goes without saying that in no event should an auditor accede to making an assertion for which he has not been able to perform adequate procedures or for which there was a scope limitation or inadequate evidence. Under such circumstances, the auditor is well advised to give a modified report under SA 705 or an emphasis of matter paragraph under SA 706, as may be appropriate.

Question 25: Can an audit be done under two different sets of auditing standards: such as the SAs and International Standards on Auditing (ISAs)? How will reporting be done in such a situation?

Response 25: This situation often arises when Indian GAAP financial statements of a subsidiary or branch of a foreign company are statutorily audited for local filing under SAs; and for parent reporting where audit under ISAs is required, assuming that the year-ends are the same for both the reports. In such a situation, an auditor performs audit procedures that simultaneously meet the requirements of both sets of Standards, in order that he does not have to do two audits.

If the two sets of Standards do not have any conflict that would require the auditor to form a different opinion under each of them, his report may refer to compliance with *both* Standards by specifically naming them in his report. eg "*We conducted the audit in* *accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India and the International Standards on Auditing*".

If a conflict exists, the auditor needs to give two separate auditor's reports where, for example, one could include a clean opinion and the other may include an emphasis of matter paragraph or modified opinion as may be necessary.

Question 26: How does an auditor deal with a situation where the audited entity voluntarily provides supplementary information or where a law or regulation requires additional information that is outside the scope of the applicable financial reporting framework?

Response 26: Supplementary information, in this context, should not be confused with "*Other Legal Or Regulatory Requirements*" mentioned in Questions 13 and 20 above.

Where there is such information embedded in the financial statements, the auditor discusses with the client if such information could be displayed separately outside the financial statements. If that is possible, there is no further issue.

Where such supplementary information (eg., a GAAP reconciliation between Indian GAAP and IFRSs included in the Notes to the Financial Statements) cannot be clearly differentiated from the rest of the financial statements, the auditor's opinion shall have to cover that too. This means that the auditor would need to audit this information and report on it in the ordinary course.

If the management (or law/ regulation) requires such information not to be subjected to audit, the auditor must ensure that such information is presented in a way that clearly shows that it is "unaudited". For example, if prior period numbers that were not audited are presented as comparative information, the columns giving such information could be clearly labeled as "*Unaudited*" and an explanatory note may be given to explain why such unaudited information is presented. Alternatively, the Notes to the Financial Statements that include such information could be put in a separate section of the Notes that is clearly labeled as "*Unaudited*".

A question arises as to whether the auditor will have any responsibility for the supplementary information included in the financial statements if it is labeled as "Unaudited"? The answer is "*yes*". Under SA 720[14] the auditor still has the responsibility to read that information to identify if it contains any material inconsistency with the audited financial statements. If so, he will have to deal with it as per SA 720.]

[14] SA 720 The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

Chapter 4

SA 705 Modifications to the Opinion in the Independent Auditor's Report

Question 27: What is the difference between a "qualified" auditor's report and a "modified" auditor's report?

Response 27: In fact, it is not the auditor's report which is "qualified" or "modified", it is the audit opinion within the auditor's report which can be a "qualified opinion" or a "modified opinion".

When the auditor has no reservation on the financial statements (beyond the tolerance limits of materiality), he gives what is generally called a "*clean*" opinion. This is an auditor's report containing an "unmodified opinion" governed by SA 700 that has been discussed in Chapter 3.

Then there are auditor's reports containing "modified opinions". These are issued where the auditor has some reservation about the financial statements. Under SA 705[15] there can be three types of "modifications" to an auditor's opinion: (a) a "qualified opinion", (b) a "disclaimer of opinion", or (c) an "adverse opinion".

So, a qualified opinion is one kind of a modified opinion, the other two being either a disclaimer or an adverse opinion. When an audit opinion is other than "clean", the standard language of the opinion in SA 700 is *modified* to express the auditor's reservation about the financial statements.

Question 28: How does one decide the nature of modification that should be made?

Response 28: An auditor has to evaluate the situation carefully before making his judgment as to the nature of modification. It is very important that he, in terms of the principles laid down in SA 230, *Audit Documentation,* also documents in his work papers how and why he reached this professional judgment.

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[15] Under the erstwhile AAS 28, inclusion of an emphasis of matter paragraph was also considered as a "modified" opinion. SA 705 no longer considers it as such.

There can be two situations:

(a) There is a matter for which the auditor *has* sufficient appropriate audit evidence to determine that due to such matter the financial statements *are* materially misstated, and

(b) There is a matter for which the auditor *is unable to obtain* sufficient appropriate audit evidence to determine whether due to it the financial statements *may be* materially misstated.

In either case the report will be modified, but the nature of modification can be different.

After this, the auditor uses his professional judgment to determine if the *effects* or *possible effects* of the matter on the financial statements is/ are *pervasive* or *not pervasive.* Again, depending on the extent of pervasiveness, the nature of modification can be different.

The following table summarises the criteria and the nature of modification:

Nature of matter giving rise to modification	***Auditor's judgment about the Materiality and Pervasiveness of the Effects or Possible Effects on the financial statements***	
	Material but Not Pervasive	**Material and Pervasive**
FS are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Question 29: What is a 'material misstatement'?

Response 29: For financial statements to comply with an applicable financial reporting framework, the transactions and events as reflected therein need to comply with four aspects. These are:

(a) Recognition

(b) Measurement

(c) Classification and presentation, and

(d) Disclosure

A "*misstatement*" of the financial statements occurs when there is a difference between how each of these aspects is reported by the management in the financial statements and how it should be as per the applicable financial reporting framework.

As per SA 450, *Evaluation of Misstatements Identified during the Audit*, material misstatement of the financial statements may arise in relation to:

(a) The appropriateness of the selected accounting policies;

(b) The application of the selected accounting policies, or

(c) The appropriateness or adequacy of disclosures in the financial statements.

The selected accounting policies may not be consistent with the applicable financial reporting framework, or the financial statements (including the Notes) do not reflect the events and transactions in a manner that achieves fair presentation, for example, where a change in policy from prior period is not adequately reported. There might also be inconsistency in application of policies between periods or transactions and events of a similar nature or the method of application of the policy is erroneous. As regards disclosures, all of the required disclosures may not be given or, if given, may not be presented as they should be, or the financial statements may not give disclosures that ensure a fair presentation (that is, they do not contain disclosures of events or transactions that are needed to properly reflect a true and fair view).

It is often wrongly believed that a "*material misstatement*" is only a recognition and measurement issue alone. In other words, there is a perception that one does not need to modify an opinion unless the rupee amounts are misstated. Due to this perception, auditors may fail to modify their opinion in respect of material misstatement of the financial statements caused by inappropriate classification or presentation, or inadequate disclosure.

Modifying an audit opinion where such modification is warranted is a very important decision that an auditor has to make. It is a decision that may subsequently be challenged by the client, or called into question by a regulator, or by investigating agencies and courts of law in the course of a fraud investigation. Therefore, in reaching his decision on modifying or not modifying an auditor's report, the auditor should ensure that the decision is not only in accordance with the related accounting and auditing pronouncements but one that will stand up to scrutiny.

It is therefore crucial for an auditor, when making an evaluation for purposes of modifying or not modifying an audit opinion to properly understand the meaning, context and importance of these three key concepts: "*evidence*", "*materiality*" and "*misstatement*". Each of these topics have been dealt with in separate Standards on Auditing. For example:

- SA 320, *Materiality in Planning and Performing an Audit*
- SA 450, *Evaluation of Misstatements Identified during the Audit*
- SA 500, *Audit Evidence*
- SA 501, *Audit Evidence – Specific Considerations for Selected Items*
- SA 505, *External Confirmations*
- SA 570, *Going Concern*

Since the entire suite of SAs has undergone substantive revision under the Clarity Project, auditors are well advised to study these concepts afresh.

Question 30: What is inability of an auditor to obtain sufficient appropriate audit evidence?

Response 30: Ordinarily, an auditor would be unable to obtain sufficient appropriate audit evidence in the following situations:

(a) *Circumstances beyond the control of an entity* – For example, the entity's accounting records are destroyed by fire or are seized by an investigating agency;

(b) *Circumstances related to the nature and timing of the auditor's work* – Examples: (a) for equity accounting of an associate, adequate financial information of the associate is not available; (b) the auditor is appointed after year-end and is therefore unable to observe physical verification of inventory; or (c) where the controls of the entity are not effective and the auditor concludes that performing substantive procedures alone is not sufficient;

(c) *Limitation imposed by management* – For example, management prevents the auditor from observing inventory count or from requesting external confirmation of specific account balances, or imposes unrealistic time deadlines within which to issue an auditor's report.

Question 31: If the management imposes a scope limitation after the auditor has accepted the engagement, what should he do?

Response 31: As a first step, the auditor should request the management to remove the scope restriction. If the management refuses, he should communicate with those charged with governance and simultaneously explore ways to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor concludes that he is still unable to get sufficient appropriate audit evidence, he should determine if the possible effect of undetected misstatements is likely to be material but not pervasive. If so, he should qualify his opinion.

If he concludes that the possible effect of undetected misstatements is likely to be both material and pervasive and qualification alone would not suffice, he should resign from the audit if permitted to do so by the applicable law or regulation. But where the law or regulation does not permit resignation of the auditor for such reason after accepting an audit, he should give a disclaimer of opinion.

Question 32: When is the effect of a misstatement or a possible misstatement considered to be "*pervasive*"?

Response 32: As can be seen from the question itself, both a material misstatement (where evidence is available) and a possible misstatement (where evidence is not available) are to be evaluated for being pervasive or otherwise. (Refer the table in response to Question 27.)

The effect of a material misstatement/ possible misstatement is *pervasive*, when:

(a) Where it pertains to an amount(s) in the financial statements, it is not confined to specific components, accounts or items of the financial statements. If it is so confined, it represents or could represent *a substantial portion* of the financial statements; or

(b) Where it pertains to disclosures, such disclosures or the matter(s) therein are/ could be *fundamental* to the user's understanding of the financial statements.

For example, where an auditor detects a bias in the valuation of estimates on the assets side of a balance sheet (such as increasing the useful lives of fixed assets without justification, not treating impairment in investments as other than temporary, treating doubtful receivables as good, not providing adequately for inventory obsolescence, etc.) all building up to an overstatement of earnings, the aggregate effect of which may be material to the financial statements taken as a whole, the possible misstatement is said to be pervasive.

In another example, when the misstatement is only in valuing inventory of a major raw material at cost in stead of at net realisable value when clear evidence is available that the fair value of the material was substantially lower than cost and the selling price of the finished product is pegged to current raw material prices, and the difference in valuation, if booked, could wipe out a substantial portion of the profit before tax of the entity, the misstatement is said to be pervasive.

In yet another example, the entity is unable to resolve to the satisfaction of the auditor a going concern issue in relation to one of its major subsidiaries in which the entity has substantial exposure in terms of equity, debt and guarantee commitments and it refuses to either make a provision or a satisfactory disclosure of the matter, the misstatement is said to be pervasive.

Question 33: There is a misstatement or a series of misstatements in the financial statements that the auditor evaluates as material and pervasive to the financial

statements, singly or in the aggregate. The auditor explains each such misstatement by giving separate paragraphs in his report and then states in his opinion that '*subject to the matters stated in the said paragraphs, the financial statements give a true and fair view*'… Is this permissible?

Response 33: No. The auditor's duty is to evaluate if the effect of all the misstatements and possible misstatements in the aggregate is material and pervasive to the financial statements taken as a whole. If that is true, he cannot give an overall qualified opinion. He has to give an adverse opinion. This means he has to state in the audit opinion that the financial statements *do not give* a true and fair view. This is a very important and significant matter where professional judgement needs to be well-founded.

Question 34: There is a possible misstatement or a series of possible misstatements in the financial statements or a mix of misstatements and possible misstatements that the auditor evaluates as material and pervasive to the financial statements, singly or in the aggregate. The auditor explains each such misstatement by giving separate paragraphs in his report. In case of misstatements he quantifies the impact thereof. In case of possible misstatements he states the matter and expresses his inability to quantify the impact thereof in the absence of availability of evidence. He then states in his opinion that subject to the matters stated in the said paragraphs, the financial statements give a true and fair view …Is this permissible?

Response 34: No. The auditor's duty is to evaluate if the possible effect of a single possible misstatement or a number of possible misstatements taken together is likely to be material and pervasive to the financial statements taken as a whole. If that is true, he cannot give an overall qualified opinion. He has to give a disclaimer of opinion. This means he has to state in his audit opinion that due to the significance of the matters described, he has been unable to obtain sufficient appropriate audit evidence, and accordingly he *is unable to express an opinion* on the financial statements.

In case of a mix of misstatements and possible misstatements that are singly and/or collectively evaluated as being material and pervasive, the auditor would have to decide if his opinion should be adverse or a disclaimer. It cannot be both, a disclaimer for some matters and adverse in respect of others as such reporting would confuse the users. In such cases, the auditor should give an adverse opinion. This means he has to state that the financial statements *do not give* a true and fair view.

Question 35: In the situations described in Questions 32 and 33, if the misstatements or possible misstatements or a mix of the two are evaluated by the auditor as being material but not pervasive to the financial statements, can he give a narration of the material misstatements, possible misstatements or a mix of the two in separate paragraphs of his report and then, giving reference to those paragraphs, state that '*subject thereto the financial statements give a true and fair view*'…?

Response 35: Yes. Where the aggregate effect of misstatements or possible misstatements is material but not pervasive, the auditor can express a qualified opinion.

Question 36: What does this bring out in terms of an auditor's responsibility for correct reporting?

Response 36: The auditor's opinion on a set of financial statements is read very keenly by a variety of users who make important economic decisions based on it. The distinction between a clean opinion, a qualified opinion, a disclaimer of opinion and an adverse opinion is therefore critical for such users. An opinion that is inappropriately worded could result in a user making a wrong economic decision that could have significant financial implication and for which he could hold the auditor to be accountable.

Using professional judgement in making his decision for modifying or not modifying his opinion is of course the privilege of an independent auditor. But such professional judgement has to be made within the framework of the accounting and auditing standards, in keeping with the competencies expected from the training, knowledge and experience of the auditor, as well as due processes of internal/ external consultation and documentation. It is important therefore to understand what using "professional judgement" entails.

SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing*, deals with the subject of professional judgement as well as with other fundamental matters of great importance to auditors. Extracts from that SA are given below for ready reference:

"Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23- A27)

Professional Judgment *(Ref: Para. 16)*

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

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

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the *course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by SA 220 assist the auditor in making informed and reasonable judgments.*

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence."

It should also be noted that when an auditor expects to give a modified opinion, he has a duty to first discuss the matter giving rise to the expected modification with those charged with governance which generally means with the audit committee, board of directors, or equivalent governing body, and not just with the management or the Chief Financial Officer.

Question 37: If there are multiple uncertainties, but for each of those uncertainties the auditor has been able to obtain sufficient appropriate audit evidence, can he still give a disclaimer of opinion on the financial statements?

Response 37: Such a situation is rare but possible. If the auditor concludes that notwithstanding his having obtained sufficient appropriate audit evidence regarding individual uncertainties, it is not possible for him to form an overall opinion on the financial statements due to the possible interaction of the uncertainties and their possible cumulative effect on the financial statements, he would need to give a disclaimer of opinion.

Question 38: Can an auditor give an unmodified opinion in respect of one (or more) financial statements or account or element or item of a financial statements while giving an adverse or disclaimer of opinion on the financial statements as a whole?

Response 38: No. If an auditor is engaged to audit and report on the financial statements of an entity and he concludes that his overall opinion on those financial statements is either disclaimer or adverse, he cannot give in the same report an unmodified opinion in respect of a single financial statement or an account or element or item of a financial statement.

However, if he is engaged to audit and report under SA 805, *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, where his engagement is to audit and report on a single financial statement or a specific account or element or item of a financial statement, he may give a separate unmodified report under that SA. The two reports, one under SA 805 and the other on the audit of financial statements as a whole must be separate with separate terms of engagement.

In another situation where an auditor is engaged to report on a set of financial statements under two different financial reporting frameworks – say Indian GAAP and IFRSs, and in stead of giving separate reports under each GAAP, he chooses to issue a combined report, he may give an unmodified opinion on the financial statements under one framework but an adverse opinion or disclaimer of opinion under the other framework. In such circumstances, he would have to word the report carefully in order to prevent any misinterpretation of his intent by the users.

Thirdly, even where he is appointed to audit and report on the financial statements as a whole, it would be possible for an auditor to give, for example, a disclaimer of opinion on the results of operations and cash flows but an unmodified opinion on the financial position of the entity in a situation envisaged under *SA 510, Initial Audit Engagements – Opening Balances*, paragraphs 10 and A5. In this situation, he does not express any overall audit opinion on the financial statements as a whole.

Question 39: Is there a difference in the way an audit opinion is modified now?

Response 39: Yes. First, it may be reiterated that inserting an Emphasis of Matter paragraph or an Other Matters paragraph (new concept) in the auditor's report is no longer considered to be a "modification" of the audit opinion. A separate Standard *viz*., SA *706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* now deals with these.

Secondly, the matter giving rise to modification is now to be described in a separate Basis for Modified Opinion paragraph that may be titled as "*Basis for Qualified Opinion*" or "*Basis for Adverse Opinion*" or "*Basis for Disclaimer of Opinion*", as may be appropriate. Accordingly, the opinion paragraph that follows is also clearly titled as "*Qualified Opinion*" or "*Adverse Opinion*" or "*Disclaimer of Opinion*", respectively and refers to the matter given in the Basis for Modified Opinion paragraph.

Earlier, under the AAS 28, there was no requirement to give a title to the basis for modified opinion paragraph or to the opinion paragraph. As can be seen, the objective of this change is to help the user clearly understand which part of an auditor's report is actually the audit opinion and what exactly is the modificatory matter.

Question 40: What does the Basis for Modified Opinion paragraph contain?

Response 40: If there is a material misstatement in the financial statements that relates to specific amounts, including amounts given in the Notes, the auditor gives a description and a quantification of the misstatement. Where an accurate quantification is not possible but a management estimate is available, the auditor performs such audit tests on those management estimate as are possible, and clearly indicates that the amount quantified is based on management's estimate. (This could be put in a Note with the auditor drawing reference to the Note in his report.) If it is impracticable for him to quantify or estimate the effect of the misstatement, he states so in the Basis for Modified Opinion paragraph.

If there is a material misstatement in the financial statements that relates to narrative disclosures, the auditor gives an explanation of how the disclosures are misstated.

If required disclosures are not made in the financial statements, the auditor is required to follow the following process:

(a) He discusses the non-disclosure with those charged with governance[16].

This could present a practical difficulty if the auditor's report is to be issued on the date of the audit committee meeting itself. The auditor may overcome this by seeking an audio/ video conference call with the audit committee or a one-on-one meeting with its chairperson and discuss the matter well in advance of the scheduled audit committee meeting.

(b) He describes the nature of the omitted information in the Basis for Modified Opinion paragraph, and

(c) Unless prohibited by law/ regulation, he includes the omitted disclosures in his report, provided it is practicable to do so (eg, it may not be practicable if the disclosures are not prepared by the management, or are not otherwise readily available to the auditor, or are far too voluminous to be included in an auditor's report) and he has obtained sufficient appropriate audit evidence about the omitted information.

If the modification is because of his inability to obtain sufficient appropriate audit evidence, the auditor provides the reasons for that inability. In such cases, the auditor should be careful that his explanations in the report about the said inability are his own assertions and not inadvertently an advocacy of the management's representations.

Where an auditor gives a disclaimer or an adverse opinion for a given reason that he explains in the *Basis for Disclaimer of Opinion* or *Basis for Adverse Opinion* paragraph but there are also other matters that would have independently merited a

[16] Wherever possible, communication with Those Charged with Governance should be in writing. Where such communication is done orally, it is advisable for the auditor to document the minutes of the conversation and, unless impracticable, send the minutes to the other party stating that he would presume confirmation unless objection is received. This creates evidence that he fulfilled his duty of communicating with Those Charged with Governance.

modification, he describes and gives the reasons and effects of those matters as well in the same paragraph.

Question 41: How is the Modified Opinion paragraph to be given?

Response 41: Where opinion is modified, the paragraph is titled as "*Qualified Opinion*" or "*Adverse Opinion*" or "*Disclaimer of Opinion*" as may be appropriate.

Where the opinion is qualified due to material misstatement in the financial statements, the auditor uses the words: "Except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph", the financial statements give a true and fair view, etc.

Where the qualification is because of inability to obtain sufficient appropriate audit evidence, the phrase to be used is "Except for the possible effect(s) of matters described in the Basis for Qualified Opinion paragraph", the financial statements give a true and fair view, etc.

Note that use of the words "*Subject to*" that were hitherto being used for qualified opinions so far is discouraged under SA 705 as these words are considered to be not sufficiently clear or forceful.

Where the opinion is a disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence, the auditor states that "*because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph*", he has "*not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly*", he does "*not express an opinion on the financial statements*."

Where the auditor expresses an adverse opinion under a fair presentation framework he states that "*in his opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view in accordance with the applicable financial reporting framework*…."

Where the auditor expresses an adverse opinion under a compliance framework he states that "*in his opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph, the financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework*…"

Question 42: When a modified opinion is given, does the Auditor's Responsibility paragraph also correspondingly change?

Response 42: Yes. When the auditor gives a qualified opinion, in the last sentence of the Auditor's Responsibility paragraph would state, "*We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion*."

When the auditor gives an adverse opinion, the aforementioned last sentence of the Auditor's Responsibility paragraph would stand modified as follows, '*We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.*"

When the auditor gives a disclaimer of opinion, he states in the Auditor's Responsibility paragraph as follows, "*Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion*".

Question 43: What is an auditor obligated to do if he expects to modify his report?

Response 43: If the auditor expects to issue anything other than a clean opinion, he has an obligation to communicate this to those charged with governance (eg, an audit committee or board of directors or partners/ trustees in case of a firm/ trust) that he intends to do so, as well as provide them the proposed wording.

An issue that results in a modification to the audit opinion or which involves including an emphasis or other matter paragraph in the auditor's report is obviously important enough to require such communication before report issuance. Likewise, those charged with governance too get the opportunity to provide further information and explanations, that hitherto might not have been provided to the auditor by the management, which might lead the auditor to reconsider his earlier decision.

Chapter 5

SA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Question 44: Does insertion of an emphasis of matter paragraph in the auditor's report make the opinion "modified"?

Response 44: No. In the erstwhile Standard (ie AAS 28), an emphasis of matter paragraph was included under "modified opinion", but SA 705 excludes emphasis of matter paragraphs and other matter paragraphs from being termed as "modifications to the audit opinion". These now form the subject-matter of a new standard, *viz.,* SA 706.

The point to note is that an emphasis of matter is not a part of the audit opinion at all. It is a separate, independent paragraph designed to provide "additional communication" to the users.

Question 45: Why is an "emphasis of matter" paragraph given by an auditor?

Response 45: An extremely important point to note is that an emphasis of matter paragraph deals with matters that are already *appropriately presented or disclosed* in the financial statements. This means that the auditor does not have any reservations about such matters.

It is seen that sometimes auditor's reports contain paragraphs that begin with the words "*Without qualifying our opinion* ….", but the issue then described is one where the auditor has a clear reservation. At times even the words "*without qualifying our opinion*" are not used for a matter that is actually qualificatory in nature but the opinion is not made "*subject to*" that matter, so that it appears as if it is not a qualification. In such cases, where the impact is either material or pervasive, the auditor needs to suitably modify his opinion.

Using an emphasis of matter paragraph where a qualification should be given is clearly a non-compliance with the Standards. Standard on Auditing (SA) 706 specifically states that "*An Emphasis of Matter paragraph is not a substitute for either the auditor expressing a qualified opinion or an adverse opinion, or disclaiming an opinion, when required by the circumstances of a specific audit engagement*."

The question then is, if the matter is already appropriately presented or disclosed, why is it necessary for an auditor to emphasize it in his report?

An emphasis of matter paragraph is defined as "*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 judgment, is of such importance that it is fundamental to users' understanding of the financial statements*."

Question 46: What kind of circumstances may require issuing an emphasis of matter paragraph?

Response 46: Examples given in the Standard itself are:

- An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- Early application (where permitted) of a new Accounting Standard that has a pervasive effect on the financial statements in advance of its effective date.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

A current topical example could be the likely impact that migration from the existing Indian Accounting Standards to the converged Accounting Standards will have on the financial position and performance of an entity in the coming accounting period where such migration has been notified by law or regulation.

Another example could be the impact, if significant, of an unconventional interpretation of an Accounting Standard that an entity may have taken, even though the auditor is fully in agreement with it.

Question 47: Is it advisable for an auditor to give emphasis of matter paragraphs to highlight all significant matters and transactions that affect the financial statements?

Response 47: No. The SA 706 clearly states that "widespread use of emphasis of matter paragraphs diminishes the importance of the auditor's communication of such matters". An auditor's report is a carefully worded document that should contain only as much information as is required.

When giving an emphasis of matter, care should also be taken to ensure that the auditor does not introduce new fact or information that is not already presented or disclosed in the financial statements. It is because the Standard is clear that "An Emphasis of Matter paragraph is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make."

Question 48: What is an "Other Matter" paragraph, and how is it different from an Emphasis of Matter paragraph?

Response 48: In the erstwhile Standard (i.e., AAS 28) there was no concept of an Other Matter Paragraph and thus, no distinction between the Emphasis of Matter Paragraph *vis a vis* Other Matters Paragraph. SA 706 draws a distinction between the two.

An Other Matter Paragraph is defined as "A paragraph included in the auditor's report that refers to matters *other than those presented or disclosed in the financial statements* that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report."

In other words, the distinction is that while an Emphasis of Matter Paragraph refers to matters that **are** appropriately presented or disclosed in the financial statements, an Other Matter paragraph refers to matters that are **not** presented or disclosed in the financial statements but the auditor feels the need to bring them to the users' attention.

The other point of difference to note are that while the definition of emphasis of matter paragraph uses the word "*fundamental*" with reference to understanding of the financial statements, the definition of other matter paragraph uses the word "*relevant*". The reason is that *matters of emphasis* are mentioned in the financial statements and are therefore already available to the users. By highlighting them in his report, the auditor specifically points the readers' attention to these matters. It is only the most "fundamentally important" matters that are therefore included in emphasis of matter.

On the other hand, *other matters* are those related to the users' understanding of the audit, the auditor's responsibility or the auditor's report that are not mentioned at all in the financial statements and therefore the users are likely to be unaware of them. So, if the auditor believes that such information is "relevant", he informs the users through his report.

A key point to note is that an Other Matter paragraph is limited to information about the audit, the auditor's responsibility or the auditor's report, and does not include matters related to the financial statements as is the case with the Emphasis of Matter paragraph.

Question 49: If an auditor disagrees with or is uncomfortable about the recognition, measurement, disclosure or presentation of a transaction or event reflected in the financial statements, can he highlight it in an emphasis of matter paragraph?

Response 49: No. It is important to note that Emphasis of Matter is given only in respect of matters that are "appropriately presented or disclosed" in the financial statements. This means that the auditor should and is deemed to agree entirely with the treatment of that matter in the financial statements.

In case he has a reservation, he refers to SA 705 and considers if his reservation merits a modification to the auditor's opinion. If, in terms of the guidance given in SA 705, he concludes that the matter is not worthy of a modification to his opinion, he cannot then use an Emphasis of Matter paragraph to highlight that matter merely because he cannot qualify his opinion.

Question 50: What are the requirements for including an Emphasis of Matter paragraph in the auditor's report?

Response 50: There are four requirements: (a) Emphasis of matter paragraph is given immediately after the opinion paragraph; (b) It has a heading "Emphasis of Matter" (to make its nature very clear to the users); (c) The paragraph must provide a reference to the matter being emphasized and where, in the financial statements, that matter in its elaborated form is to be found; and (d) the paragraph contains a declaration that the auditor's opinion is not modified in respect of the matter emphasized.

Question 51: Is it appropriate to insert an emphasis of matter paragraph also in the section of the auditor's report titled "*Report on Other Legal and Regulatory Requirements*"?

Response 51: An emphasis of matter paragraph is given to draw the uses' attention to a fundamentally important matter that is already appropriately presented or disclosed in the financial statements.

Where the auditor also has reporting obligations under a law or regulation in addition to providing an audit opinion, these obligations would be more or less in the nature of compliance reporting ie where the auditor makes assertions about whether something exists or does not exist or whether something has been done or not. Such reporting would, by and large, be on factual matters, even if it requires exercising the auditor's professional judgement.

In the light of this, it is difficult to visualize a situation where it may be appropriate to give an emphasis of matter paragraph also in the section of the auditor's report titled "Report on Other Legal and Regulatory Requirements".

Question 52: Where is an Other Matter paragraph given in the auditor's report?

Response 52: If the other matter pertains to the audit, the auditor's responsibility or the auditor's report insofar as expressing an opinion on the financial statements is concerned, the other matter paragraph is placed immediately below the opinion paragraph. If there is also an Emphasis of Matter paragraph following the opinion paragraph, then the Other Matter paragraph is placed immediately below the Emphasis of Matter paragraph.

If the Other Matter pertains to audit, the auditor's responsibility or the auditor's report insofar as other reporting responsibilities of the auditor are concerned (eg., reporting responsibilities under CARO, 2003), an other matter paragraph is included in the section of the auditor's report titled: "Report on Other Legal and Regulatory Requirements".

Question 53: What kind of circumstances may require issuing an Other Matter paragraph?

Response 53: An Other Matter paragraph may be required to enhance users' understanding of an audit. For example, assume that a client imposes a major scope limitation after the auditor has, in good faith, accepted the engagement and performed a substantial part of the audit. Paragraphs 11 to 14 of SA 705 deal with this situation and say that in case the possible effects on the financial statements of resulting undetected misstatements is both material and pervasive such that giving a qualified opinion would not be adequate, the auditor should resign from the engagement. Further, assume that the appointment of the auditor is under a law and that law does not permit the auditor once appointed to simply resign. Under these circumstances, the auditor should explain the scope limitation and his inability to resign in an Other Matter paragraph.

An Other Matter paragraph could also be required if it is relevant to users' understanding of the auditor's responsibilities or the auditor's report. For example, the same auditor is engaged to audit financial statements of an entity both under Indian GAAPs and under IFRSs. He issues two separate auditor's reports on the two sets of financial statements, both under the general purpose framework for the same accounting period. In such case, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

In another instance, if the financial statements are special purpose financial statements but prepared as per a general purpose framework, an other matter paragraph is the place where the auditor would state that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

Question 54: What does an Other Matter paragraph not include?

Response 54: An Other Matter Paragraph does not include:

- Any matter that is required to be presented or disclosed in the financial statements – this is because anything to do with such matters falls within the purview of an emphasis of matter paragraph;
- Any information that the auditor is prohibited from providing by law, regulation or other Standards, for example, ethical requirements relating to confidentiality of client information;
- Information that is required to be provided by management – this is because auditors should keep away from trespassing into management's territory in order to retain their independence. The management's and auditor's responsibility paragraphs clearly demarcate what each is responsible for.

Question 55: What is an auditor obligated to do if he expects to include either an Emphasis of Matter Paragraph or an Other Matter Paragraph in his report? (See Question 43 above)

Response 55: If the auditor expects to issue anything other than a clean opinion, he has an obligation to communicate this to those charged with governance (eg, an audit committee or board of directors or partners/ trustees in case of a firm/ trust) that he intends to do so as well as to provide them the proposed wording.

An issue that involves including an emphasis or other matter paragraph in the auditor's report is obviously important enough to require such communication before report issuance. Likewise, those charged with governance too get the opportunity to provide further information and explanations, hitherto not provided to the auditor by the management, which might lead the auditor to reconsider his earlier decision.

Appendix I

Illustrative Formats of Auditors' Reports on Financial Statements*

Illustration 1:

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework, which is a fair presentation framework.
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial

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* Reproduced from Appendix to SA 700, "Forming an Opinion and Reporting on Financial Statements".

statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Statement of Profit and Loss, of the profit/loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Act, we report that:

    (a) We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

    (b) In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][17];

    (c) The Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][18];

    (d) In our opinion, the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement comply with the Accounting Standards referred to in subsection (3C) of section 211 of the Companies Act, 1956;

    (e) On the basis of written representations received from the directors as on March 31, 20XX, and taken

[17] To be included if relevant.

[18] To be included if relevant.

on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.

(f) Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[19])
Membership Number

Place of Signature
Date

[19] Partner or Proprietor, as the case may be.

Illustration 2:

Circumstances include the following:

- Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India, as required for compliance with SEBI's regulatory requirement, which is a fair presentation framework.
- The terms of the group audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of ABC Company Limited

We[20] have audited the accompanying consolidated financial statements of ABC Company Limited ("the Company") and its subsidiaries, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss and the consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Company in accordance with accounting principles generally accepted in India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and

[20] As there is no reporting on 'Other Legal and Regulatory Requirements', there is no necessity of including the heading 'Report on the Financial Statements' above the introductory paragraph.

presentation of the consolidated financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and presentation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the consolidated Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and

(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[21])
Membership Number

Place of Signature
Date

[21] Partner or Proprietor, as the case may be.

Illustration 3:

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of an entity prepared in accordance with the requirements of XYZ Law of India under a compliance framework.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210 (Revised).
- The report is unmodified and does not include either an Emphasis of Matter paragraph or an Other Matter(s) paragraph.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We[22] have audited the accompanying financial statements of ABC and Associates, which comprise the Balance Sheet as at March 31, 20XX, and the Profit and Loss Account[23]for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with XYZ Law of India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that

[22] As there is no reporting on 'Other Legal and Regulatory Requirements', there is no necessity of including the heading 'Report on the Financial Statements' above the introductory paragraph.

[23] Provide titles of all financial statements that comprise a full set of financial statements required by XYZ Law of India.

we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion[24]

In our opinion and to the best of our information and according to the explanations given to us, the financial statements of ABC and Associates for the year ended March 31, 20XX are prepared, in all material respects, in accordance with XYZ Law of India.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[25])
Membership Number

Place of Signature
Date

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[24] Note that the opinion excludes the words 'true and fair' as this report is not under a fair presentation framework.
[25] Partner or Proprietor, as the case may be.

Appendix II

Illustrative Formats of Auditors' Reports with Modifications to the Opinion*

Illustration 4

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements. The audit opinion is qualified for the misstatement.
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the Accounting Standards referred to in sub-section (3C) of

* Reproduced from the Appendix to SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standards referred to in sub-section (3C) of section 211 of the Act. The Company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX, respectively.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Statement of Profit and Loss, of the profit/loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.
2. As required by section 227(3) of the Act, we report that:
   a. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;
   b. In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][26];
   c. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited

[26] To be included if relevant.

by us][27];

d. Except for the effects of the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

e. On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

f. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[28])
Membership Number
Place of Signature
Date

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[27] To be included if relevant.
[28] Partner or Proprietor, as the case may be.

Illustration 5:

Circumstances include the following:

- Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India (as required for compliance with SEBI's regulatory requirement).
- The terms of the group audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the financial statements. The effects of the misstatement on the financial statements have not been determined because it was not practicable to do so. An adverse audit opinion is given under the circumstances.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of ABC Company Limited

We[29] have audited the accompanying consolidated financial statements of ABC Company Limited ("the Company") and its subsidiaries, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss and consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Company in

[29] As there is no reporting on "Other Legal Requirements", there is no necessity of including the heading "Report on the Financial Statements" above the introductory paragraph.

accordance with accounting principles generally accepted in India. This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the consolidated financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and presentation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion

As explained in Note X, the Company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20XX because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This acquisition is therefore accounted for as an investment.

Under the accounting principles generally accepted in India, the subsidiary should have been consolidated because it is controlled by the Company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the consolidated Statement Profit and Loss, of the profit/ loss for the year ended on that date; and

(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[30])
Membership Number
Place of Signature
Date

[30] Partner or Proprietor, as the case may be.

Illustration 6:

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statement. The audit opinion is qualified for the misstatement.
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

ABC Company Limited's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. XXX in the Balance Sheet as at March 31, 20XX, and ABC's share of XYZ Company's net income of Rs. XXX is included in ABC Company Limited's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX and ABC Company Limited's share of XYZ Company's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects[31] of the matter described in the Basis for Qualified Opinion paragraph, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.
2. As required by section 227(3) of the Companies Act, 1956, we report that:

a. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit except for the matter described in the Basis for Qualified Opinion paragraph;
b. In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][32];
c. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns

[31] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.
[32] To be included if relevant.

received from branches not visited by us][33];

d. Except for the possible effects[34] of the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

e. On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

f. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[35])
Membership Number
Place of Signature
Date

[33] To be included if relevant.
[34] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.
[35] Partner or Proprietor, as the case may be.

Illustration 7:

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the financial statements. That is, the auditor was unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the Company's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements. A disclaimer of audit opinion is given in the circumstances.
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We were engaged to audit the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and the Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

The Company's investment in its joint venture XYZ Company is carried at Rs. XXX in the Company's Balance Sheet, which represents over 90% of the Company's net assets as at March 31, 20XX. We were not allowed access to the management and the auditors of XYZ Company. As a result, we were unable to determine whether any adjustments were necessary in respect of the Company's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ Company's income and expenses for the year, and the elements making up the Cash Flow Statement.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters

specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Companies Act, 1956, we report that:

   a. As described in the Basis for Disclaimer of Opinion paragraph, we were unable to obtain all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

   b. Due to the possible effects[36] of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][37];

   c. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][38];

   d. Due to the possible effects of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

   e. On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause

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[36] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.
[37] To be included if relevant.
[38] To be included if relevant.

(g) of sub-section (1) of section 274 of the Act.

f. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[39])
Membership Number
Place of Signature
Date

[39] Partner or Proprietor, as the case may be.

Illustration 8:

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. That is, the auditor was unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements. A disclaimer of audit opinion is given in the circumstances.
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 (“the Act”). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were appointed as auditors of the Company after March 31, 20XX and thus could not observe the counting of physical inventories at the beginning and end of the year. Accordingly, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and March 31, 20X1 which are stated in the Balance Sheet at Rs. XXX and Rs. XXX, respectively.

In addition, the introduction of a new computerised accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of Rs. XXX as at March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the Statement of Profit and Loss and Cash Flow Statement.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

2. As required by section 227(3) of the Companies Act, 1956, we report that:

   a. As described in the Basis for Disclaimer of Opinion paragraph, we were unable to obtain all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

   b. Due to the possible effects[40] of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][41];

   c. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][42];

   d. Due to the possible effects of the matter described in the Basis for Disclaimer of Opinion paragraph, we are unable to state whether the Balance

[40] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.
[41] To be included if relevant.
[42] To be included if relevant.

Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

e. On the basis of written representations received from the directors as on March 31, 20X1, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20X1, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

f. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[43])
Membership Number
Place of Signature
Date

[43] Partner or Proprietor, as the case may be.

Appendix III

Illustrative Formats of an Auditor's Report that Includes an Emphasis of Matter Paragraph/Other Matter Paragraph*

Illustration 9:

Circumstances include the following:

- Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework.
- The terms of the audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements. The audit opinion is qualified for the misstatement.
- There is uncertainty relating to a pending exceptional litigation matter. This is highlighted in the auditor's report by an Emphasis of Matter paragraph.
- In addition to the audit of financial statements, the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

* Reproduced from the Appendix to SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

The Company's inventories are carried in the Balance Sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the accounting standards referred to in sub-section (3C) of section 211 of the Act. The Company's records indicate that had management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs. XXX, Rs. XXX and Rs. XXX, respectively.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the 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:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty[44] related to the outcome of the lawsuit filed against the Company by XYZ Company. Our opinion is not qualified in respect of this matter.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.

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[44] In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

2. As required under provisions of section 227(3) of the Companies Act, 1956, we report that:

   a. We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;

   b. In our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][45];

   c. The Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][46];

   d. Except for the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in subsection (3C) of section 211 of the Act;

   e. On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

   f. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by

[45] To be included if relevant.
[46] To be included if relevant.

the Company.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[47])
Membership Number
Place of Signature
Date

[47] Partner or Proprietor, as the case may be.

Illustration 10:

Circumstances include the following:

- Audit of a complete set of consolidated general purpose financial statements of a parent company prepared under accounting principles generally accepted in India, as required for compliance with SEBI's regulatory requirement, which is a fair presentation framework.
- The terms of the group audit engagement reflect description of management's responsibility for the financial statements in SA 210 (Revised).
- The report includes an Other Matter paragraph in respect of the auditor's responsibility in respect of subsidiaries not audited by him but which form part of the consolidated financial statements under report.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of ABC Company Limited

We[48] have audited the accompanying consolidated financial statements of ABC Company Limited ("the Company") and its subsidiaries, which comprise the consolidated Balance Sheet as at March 31, 20XX, and the consolidated Statement of Profit and Loss and consolidated Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation of these consolidated financial statements that give a true and fair view of the consolidated financial position, consolidated financial performance and consolidated cash flows of the Company in accordance with accounting principles generally accepted in India; this includes the design, implementation and maintenance of

[48] As there is no reporting on 'Other Legal and Regulatory Requirements', there is no necessity of including the heading 'Report on the Financial Statements' above the introductory paragraph.

internal control relevant to the preparation and presentation of the consolidated financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and presentation of the consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion and to the best of our information and according to the explanations given to us and based on the consideration of the reports of the other auditors on the financial statements of the subsidiaries as noted below, the consolidated financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the consolidated Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the consolidated Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and

(c) in the case of the consolidated Cash Flow Statement, of the cash flows for the year ended on that date.

Other Matter[49]

We did not audit the financial statements of certain subsidiaries, whose financial statements reflect total assets (net) of Rs. XXXX as at March 31, 20XX, total revenues of Rs. XXXX and net cash outflows amounting to Rs. XXXX for the year then ended. These financial statements have been audited by other auditors whose reports have been furnished to us by the Management, and our opinion is based solely on the reports of the other auditors. Our opinion is not qualified in respect of this matter.

For XYZ and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation[50])
Membership Number
Place of Signature
Date

[49] This matter is given in "Other Matter" paragraph as it is currently permitted in India for an auditor to sign off a consolidated audit opinion, even where he has not performed a substantial part of the audit himself.
[50] Partner or Proprietor, as the case may be.

Appendix IV

Illustrative Qualified Opinion Paragraphs

Illustration 1:

Basis for Qualified Opinion

As more fully explained in the note X of Schedule XX to the financial statements, the Company has not accrued interest in respect of outstanding inter corporate deposits of Rs xxx million which as at March 31, 20XX amounts to Rs. xx million. Had this interest been accrued the net loss for the year would have been Rs xx million as against the reported net loss of Rs xx million), accumulated losses as at March 31, 20XX would have been Rs xx million as against the reported figure of Rs xx million, and current liabilities as at March 31, 20XX would have been Rs xx million as against the reported figure of Rs xx million.

Qualified Opinion

In our opinion, *except for the effects of the matter described in the Basis for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Company as at March 31, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 2:

Basis for Qualified Opinion

As detailed in Note XXX to the financial statements, pursuant to the Scheme of Arrangement, PQR Inc., USA, a wholly owned subsidiary of the Company whose financial statements reflect total assets of Rs xx cr (US$ xx converted at US$ 1 = Rs 45) as at March 31, 20XX was merged with the Company on the basis of unaudited financial statements which have not been verified by us.

Qualified Opinion

In our opinion, *except for the effects of the matter described in the Basis for Qualified Opinion paragraph*, the financial statements give a true and fair view of the financial position of ABC Company as at March 31, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 3:

Basis for Qualified Opinion

As stated in Note XX, Schedule XX the Company has paid Rs XX lakhs as remuneration to managing and other directors, which is in excess of the limits prescribed under the Companies Act, 1956. Had the Company accounted for the remuneration in accordance with law, the loss after tax for the year would have been lower and loans and advances would have been higher by Rs XX lakhs.

Qualified Opinion

In our opinion, *except for the effects of the matter described in the Basis for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Company as at March 31, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 4:

Basis for Qualified Opinion

In respect of performance defaults made by the Company during the year in complying with XYZ Act the competent authority under the said Act has levied compensation, interest and penalty aggregating to Rs xxx cr on the Company. The Company has neither contested nor provided for this liability in the financial statements. Had this liability been accounted, the Company's profit before tax would have been lower by Rs xxx cr, its current tax expense lower by Rs xxx cr, its current liabilities *higher by Rs xxx and reserves and surplus lower by Rs xxx cr.*

Qualified Opinion

In our opinion, *except for the effects of the matter described in the Basis for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Company as at March 31, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Report on Other Legal and Regulatory Requirements

(c) *Except for the effects of the matter described in the Basis for Qualified Opinion paragraph,* in our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books;

(*d*) *Except for the effects of the matter described in the Basis for Qualified Opinion paragraph*, in our opinion, the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

Illustration 5:

Basis for Qualified Opinion

As stated in note (x) of Schedule XX to the financial statements, for recognizing profit on contracts, stage of completion is determined as a proportion that contract costs incurred for the work performed upto the closing date bear to the estimated total costs. Further, as stated in that note, expected loss on contracts is recognized when it is probable that the total contract costs will exceed the total contract revenue. For this purpose, total contract costs are ascertained on the basis of contract costs incurred and cost to completion of contracts which is arrived at by the management based on current technical data, forecast and estimate of net expenditure to be incurred in future including for contingencies etc., which being technical matters have been relied on by us. Revisions in projected profit/loss arising from change in estimate etc., are reflected during the course of work in each accounting *period in which the revisions have been made. The effect of these revisions has not been disclosed separately in the accounts, as the amounts thereof cannot be accurately determined.*

Qualified Opinion

In our opinion, *except for the effects of the matter described in the Basis for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Company as at March 31, 20XX, and of its financial performance and its cash flows for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 6:

Bases for Qualified Opinion

(a) Under the provisions of the Finance Act, 1994 relating to Service Tax read with the Notification No.15/2005 - Service Tax dated 7/06/2005, any service provided or to be provided to its members by any Club for a subscription or any other amount is taxable. Accordingly, entrance fees received from the members are liable to service tax. However, no service tax has been collected or paid by the Club for the period upto XXth December, 20XX on entrance fees received from the members. Had service tax of Rs. XXX been provided for on the entrance fees referred to above, the General Reserve as at 30th June, 20X1 would have been lower by Rs. XXX and the General Reserve as at 30th June, 20XX would have been lower by Rs. XXX and Current Liabilities as at 30th June, 20X1 would have been higher by Rs. XXX and Current Liabilities as at 30th June, 20XX would have been higher by Rs. XXX.

(b) As stated in Note xx of Schedule "C" to the financial statements, the Club has accrued Commitment Fee of Rs.XXX in respect of sponsorship by PQR Limited of the TTT Event. Since the agreement referred to in the aforesaid Note does not provide for entitlement of the Club to the Commitment Fee irrespective of the cancellation of the agreement or non happening of the event, in our

opinion Rs.XXX should not have been accounted in the Income and Expenditure Account. As a result, the Excess of Income over Expenditure for the year ended 30th June, 20X1 is overstated by Rs. XXX, the General reserve as at 30th June, 20X1 is overstated by Rs. XXX and Current Liabilities as at 30th June, 20X1are understated by Rs. XXX.

Qualified Opinion

In our opinion, *except for the effects of the matters described in the Bases for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Club as at June 30, 20X1, and of its financial performance for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 7:

Bases for Qualified Opinion

(a) As stated in Note B-3 of Schedule X to the financial statements, no provision has been made for penalty that may be payable under section 598 of the Companies Act 1956 for non- compliance with the provisions of the Act as the amount cannot be ascertained.

(b) The confirmation from Head Office for the balance of Rs XXX as at March 31, 20X1 (Rs XXX as at March 31, 20XX) was not available for our verification. Accordingly, we are unable to comment on the balance in Head Office Account as at the year-end and the consequential effect, if any, on the expenses incurred for the year and/or on the assets/ liabilities of the Liaison Office.

Qualified Opinion

In our opinion, *except for the effects of the matters described in the Bases for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Limited as at June 30, 20X1, and of its financial performance for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 8:

Bases for Qualified Opinion

1. *According to the information and explanations given to us, in the opinion of the management there is no need of any provision to be made for impairment of its intangible assets (namely goodwill and customer relationships) which are being carried in the books at a written down value of Rs. XXX (Previous year Rs.XXX). Refer Note no. XX of Schedule Q, Part III. However we have not been able to corroborate the Management's contention that there is no need for any provision for impairment loss in respect of these intangible assets. Accordingly we are unable to comment on the necessity or otherwise to provide for an impairment loss in respect of these intangible assets. The effect of the non-provision of the impairment loss on assets, if any, cannot be quantified. A similar qualification had been given in the previous year's auditor's report.*

2. *As stated in note no. XX of Schedule Q, Part III, balances outstanding (net amount receivable Rs.XXX) in respect of PQR India Pvt. Ltd, are subject to confirmation and reconciliation, if any.*

Qualified Opinion

In our opinion, *except for the effects of the matters described in the Bases for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Limited as at March 31, 20XX, and of its financial performance for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956

Illustration 9:

Basis for Qualified Opinion

We draw attention to note X of schedule XX of the financial statements wherein the management has explained its reasons for preparing the financial statements on a going concern basis. As at 30 September 20XX, the current liabilities exceed its current assets by Rs. XXX and the entity has incurred cash loss amounting to Rs. XXX during the period. These factors raise *substantial doubt as to the Company's ability to continue as going concern and therefore, may not be able to realise its assets and discharge its liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts and classification of liabilities that may be necessary if the Company is unable to continue as a going concern.*

Qualified Opinion

In our opinion, *except for the effects of the matters described in the Basis for Qualified Opinion paragraph,* the financial statements give a true and fair view of the financial position of ABC Limited as at March 31, 20XX, and of its financial performance for the year then ended in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

Illustration 10:

Basis for Qualified Opinion

As stated in Note XX to the financial results, as per the policy followed by the Company for preparation of quarterly results, the sugar off-season expenditures amounting to Rs. XXX lacs and Rs. XXX lacs for the quarter and half year ended September 30, 20X0 respectively have been deferred for inclusion in the cost of sugar to be produced in the remaining part of the financial year. Had the Company charged expenditure so incurred to the accounting period in which such expenses were incurred, the decrease in stock in trade would have been higher by Rs. XXX lacs and Rs. XXX lacs for the quarter and half year ended September 30, 2010 respectively, and loss after tax would have been higher by Rs. XXX lacs and Rs. XXX lacs for the quarter and half year ended September 30, 20X0 respectively.

Qualified Opinion

In our opinion, except for the matters referred to in the *Basis for Qualified Opinion paragraph*, nothing has come to our attention that causes us to believe that the accompanying Statement prepared in accordance with the Accounting Standards referred to in Section 211 (3C) of the Companies Act, 1956 and other recognised accounting practices and policies has not disclosed the information required to be disclosed in terms of Clause 41 of the Listing Agreement with the stock exchange, including the manner in which it is to be disclosed, or that it contains any material misstatement.

Illustration 11:

Basis for Qualified Opinion

The Company has not accounted for excise duty demands aggregating to Rs.XXX raised against it during the quarter ended 30 September 20X0, for which it is in the process of examining the merits of the claims and seeking legal advice in order to consider filing appeals with appellate authorities.

Qualified Opinion

Based on our review conducted as stated above in paragraph 2, nothing has come to our attention other than the possible effect of the matter referred to in *the Basis for Qualified Opinion paragraph*, that causes us to believe that the accompanying Statement, prepared in accordance with the Accounting Standards referred to in Section 211 (3C) of the Companies Act, 1956 and other recognised accounting practices and policies, has not disclosed the information required to be disclosed in terms of Clause 41 of the Listing Agreements with the stock exchanges, including the manner in which it is to be disclosed, or that it contains any material misstatement.

Illustrative Emphasis of Matter Paragraphs

Illustration 12:

Emphasis of Matter

We draw attention to Note X(i) and X(ii) to the financial statements which describe the execution application filed in the H'ble Bombay High Court by aggrieved selling shareholders of the acquired entity against the deduction made by the Company from deferred purchase consideration in respect of payments it had to make to the Income Tax authorities in respect of demands against the acquired company for periods prior to acquisition, and the execution proceedings initiated by the Company against the selling shareholders for recovery of amounts due to it pursuant to the selling shareholders' obligation to indemnify the Company against tax demands raised on the acquired entity for years prior to the effective date of acquisition. Our opinion is not qualified in respect of this matter.

Illustration 13:

Emphasis of Matter

We draw attention to Note XX to in Schedule XX of the financial statements which provides details with regard to the identification and adjustment during the year of the amount of impairment of fixed assets amounting to Rs. xx cr (net of tax) and certain expenses amounting to Rs. xx cr against Business Reconstruction Reserve. This reserve was created under the Scheme of Arrangement u/s 391 to 394 of the Companies Act 1956 approved by the Honourable High Court of Mumbai vide its Order dated XXth June, 20XX by transferring the balance standing to the credit of its Securities Premium Account for adjusting certain expenses as defined in the Scheme. Our opinion is not qualified in respect of this matter.

Illustration 14:

Emphasis of Matter

1. We draw attention to Note XX in Schedule XX of the financial statements relating to exercise of option by the Company to recognise gains and losses arising on fluctuation of foreign exchange rates on long term monetary items, to assets or to a reserve as detailed in the Note, consequent to the amendment to Accounting Standard 11, "The Effects of Changes in Foreign Exchange Rates", resulting in the profits for the year being higher by Rs xxx million and its consequential impact on the reserves and surplus and carrying cost of assets as detailed therein.

2. We further draw attention to Note YY in Schedule XX of the financial statements relating to change in method of recognizing the impact of foreign currency fluctuations on effective hedging instruments in accordance with principles of hedge accounting set out in Accounting Standard 30, "Financial Instruments – Recognition and

Measurement", having no impact on the profits for the year.

Our opinion is not qualified in respect of these matters.

Illustration 15:

Emphasis of Matter

We draw attention to Note XX of Schedule XX to the financial statements stating that the Company has paid Rs xx cr under protest against claims of Rs xx cr for expenses which the Company has disputed in matters that are in various stages of litigation. Pending resolution of these disputes by the relevant courts, these expenses have been accounted for in the financial statements based on the management's expectation of the amounts due. Our opinion is not qualified in respect of this matter.

Illustration 16:

Emphasis of Matter

We invite attention to Note No. X of Schedule XX – Notes to the Financial Statements, regarding impairment of fixed assets wherein, due to the highly technical nature of the plant and machinery, we have relied on the estimates and assumptions made by the Company's internal technical department which we *prima facie* found to be reasonable in arriving at the recoverable value of the fixed assets at the Bhandup cash generating unit of the Company. Our opinion is not qualified in respect of this matter.

Illustration 17:

Emphasis of Matter

We draw attention to Note No. X of schedule XX to the financial statements regarding approval of the Central Government in respect of certain transactions for the rendering of services to the parties covered under Section 297 of the Companies Act, 1956 for the period up to December 31, 20XX, which the Company has applied for and is pending approval from the authorities. Our opinion is not qualified in respect of this matter.

Illustration 18:

Emphasis of Matter

In view of their technical nature, we have placed reliance on technical/ commercial evaluation by the management in respect of categorization of wells as exploratory, development and producing, allocation of cost incurred on them, depletion of producing properties on the basis of the proved developed hydrocarbon reserves, liability for abandonment costs, liabilities under NELP for under-performance against agreed Minimum Work Programme and allocation of depreciation on process platforms to transportation and facilities. Our opinion is not qualified in respect of this matter.

Illustration 19:

Emphasis of Matter

Refer note no X of Notes to the Financial Statements in Schedule XX regarding the Scheme of Demerged Undertaking. The Company took over the demerged undertaking of PQR Ltd. under the Composite Scheme of Arrangement sanctioned by the Hon'ble High Court of Gujarat by Order dated 1st March, 20XX. The appointed date for this purpose was 1st December, 20XX and the effective date is 7th March, 20XX. Three parties have filed an appeal against this Order before the Division Bench of the Hon'ble High Court of Gujarat and their appeal, which has been admitted, is pending. The Company has given effect to the above Scheme subject to the Hon'ble High Court's decision in the said appeal. Our opinion is not qualified in respect of this matter.

Illustration 20:

Emphasis of Matter

We draw attention to Note X in Annexure II to the abridged financial statements and also Note XX in Schedule 'M' to the complete set of financial statements regarding deductions made/ amounts withheld by some customers aggregating to Rs. 605,083 thousand (Previous year Rs. 461,224 thousand) on various accounts which are being carried as sundry debtors. The Company is also carrying accrued income of Rs. 95,455 thousand (Previous year Rs. 95,455 thousand) relating to these customers. The ultimate outcome of the above matters cannot presently be determined although the Company is of the view that such amounts are recoverable and hence no provision is required there against. Our opinion is not qualified in respect of this matter.

Illustration 21:

Emphasis of Matter

We draw attention to Note XX of Schedule XXB to the financial statements regarding non-disclosure of the impact of fair value method of accounting on net results and Earnings Per Share as required by the Guidance Note on accounting for employee share- based payments issued by the Institute of Chartered Accountants of India. Our opinion is not qualified in respect of this matter.

Illustration 22:

Emphasis of Matter

We draw attention to: (a) Note 5 on the Statement, which explains the circumstances under which no obligation under a Share Purchase agreement has yet arisen in terms of Accounting Standard 29, in relation to the sale of investments of equity shares in XYZ Limited made during the previous year ended 31st March, 20X0; and (b) Note 4 on the Statement regarding provision made for diminution, other than temporary, in value of investments, which is considered to be adequate for the reasons stated in the said Note. Our opinion is not qualified in respect of these matters.

Illustration 23:

Emphasis of Matter

We draw attention to Note 6 to the Consolidated Financial Statements regarding investments in certain subsidiaries aggregating Rs. XXX lacs which are yet to break even. At reporting date, the Company's share of cumulative losses in these subsidiaries is Rs.XXX lacs against which provision for diminution of Rs. XXX lacs is considered as adequate by the management, based on business plans. Our opinion is not qualified in respect of this matter.

Illustration 24:

Emphasis of Matter

(a) We draw attention to Note No. XX of Schedule YY regarding debit to Goodwill of the loss arising on transfer of the Export Business Undertaking to ABC Private Limited and adjusting such Goodwill against the balance in the Securities Premium Account in terms of the Scheme of Arrangement as approved by the High Court of Bombay. Had such loss not been adjusted against Securities Premium Account as permitted under the Order of the High Court but debited to the Profit and Loss Account as per the generally accepted accounting principles, the net loss before tax of Rs. XXX would have resulted into a net loss before tax of Rs. XXX and the loss carried to Balance Sheet would have been Rs XXX in stead of Rs XXX.

(b) We also draw attention to Note No. CC of Schedule YY regarding investments in a wholly owned subsidiary whose net worth is eroded and the consequent possibility of impairment of the equity investment of Rs XXX made and non-recovery or partial recovery loan of Rs XXX given to it by the Company. For reasons explained in the said Note, including the subsidiary's future business plans and growth prospects, such impairment if any is considered to be temporary in nature and no provision is considered necessary in the accounts of the Company.

Our opinion is not qualified in respect of these matters.

Illustration 25:

Emphasis of Matter

We invite attention to Note no. X of Schedule XX-X of the financial statements regarding the cancellation of investment in XXX equity shares of ABC Limited aggregating Rs XXX and the issuance of XXX transferable warrants to the Company, both pursuant to a court approved composite scheme of 'Reduction cum Arrangement' between ABC Limited and its shareholders (including the Company). As stated in the Note, the Company has obtained independent legal counsel's opinion that no tax liability arises on the reduction cum arrangement. On that basis, no tax liability is recognised in respect thereof. Our opinion is not qualified in respect of this matter.

Illustrative Disclaimer of Opinion Paragraph

Illustration 26:

Bases for Disclaimer of Opinion

(a) We have not been able to obtain sufficient appropriate audit evidence with regard to the recoverability of Sundry Debtors, particularly having regard to: (i) the aggregate amount of debtors outstanding for a period exceeding six months being Rs. XXX (ii) debtors in respect of sales during the period aggregating Rs. XXX being fully unrecovered, and (iii) the debtors outstanding at the commencement of the financial year aggregating Rs. XXX being yet to be recovered to the extent of Rs. XXX.

(b) There was also a limitation of scope on the audit carried out by us since while observing the physical verification of stock-in-trade carried out by the Management during the period, individual items aggregating Rs. XXX per the books of account were not produced to us for physical verification. Accordingly, we were precluded from fully performing our audit procedures in this regard.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

6
Implementation Guide to Standard on Auditing (SA) 230, Audit Documentation

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Foreword

Standards on Auditing issued by the Institute of Chartered Accountants of India are critical in ensuring and enhancing quality in audit engagements. It therefore becomes essential that the auditors properly understand and implement the Standards on Auditing in their audit engagements.

Implementation Guides to Standards on Auditing are an important tool for the auditors for applying the principles enunciated in these Standards in real life audit scenarios.

We all know, audit documentation has always been a critical component of an audit process as it evidences the work done by the auditor. I am happy that the Auditing and Assurance Standards Board has brought out this Implementation Guide on SA 230, “Audit Documentation” for the benefit of the members.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for his proactive initiatives in bringing out guiding literatures on auditing standards and other technical literature on auditing. I hope that these publications will promote understanding and implementation of the Standards among the members.

March 4, 2013 | **CA. Subodh Kumar Agrawal**
New Delhi | President, ICAI

Preface

Robert H Montgomery, a noted authority in auditing, in his book, "Montgomery's Auditing (1912)" said, "*The skills of an accountant can always be ascertained by an inspection of his working papers.*" More than a century has gone by but his words have not lost their relevance. On the contrary, over the years, given the amount of litigation that the auditors have had to face world over, these words have gained significance.

With the ever increasing complexities in the business models and the humungous spread in the global presence of businesses supported by technology, the job of the auditors has become much fraught with professional risks. Professional bodies like the Institute of Chartered Accountants of India (ICAI) are bringing out technical pronouncements in the form of Standards and other guiding literature to help the auditors perform audits in the most effective and efficient manner. It is, however, imperative that the auditors maintain adequate and appropriate audit documentation as an evidence of the work that they perform.

Standard on Auditing (SA) 230, Audit Documentation, issued by ICAI lays down the basic principles that the auditors need to bear in mind while undertaking audit documentation. The basic objective of bringing out this Implementation Guide on SA 230 was to help the members understand those principles appropriately and apply them in practice. The Implementation Guide explains the requirements of the Standard in a question and answer form. It also contains checklists of documentation requirements under the various SAs as also case studies from real life audit situations pertaining to audit documentation and their possible solutions.

At this juncture, I wish to place on record my deep gratitude to CA. S Narasimhan, Chennai and his team comprising CA Janani V and CA Padma T who, despite their extremely pressing professional and other preoccupations, volunteered to write this Implementation Guide and share their valuable experience and knowledge for the benefit of the members, at large.

I am also thankful to CA. Subodh K Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their support to the activities of the Auditing & Assurance Standards Board.

I also wish to place on record my gratitude for my colleagues on the Board during 2012-13 when the Implementation Guide was envisioned as well as my colleagues at the Board for the current term 2013-14, *viz.*, CA. Naveen ND Gupta, Vice Chairman, AASB, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shriniwas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhana Krishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary and CA. Vijay K Gupta for their support and guidance to the Board.

I am sure that the Implementation Guide would be immensely useful to the members.

February 25, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing & Assurance Standards Board

Contents

Foreword

Preface

Chapter 1: Summary of the Standard 641

Chapter 2: Introduction 644

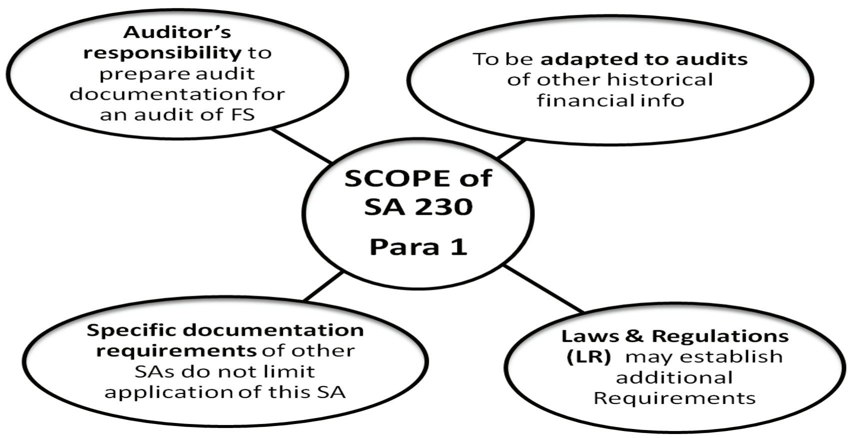
Chapter 3: FAQs Relating to SA 230... 647

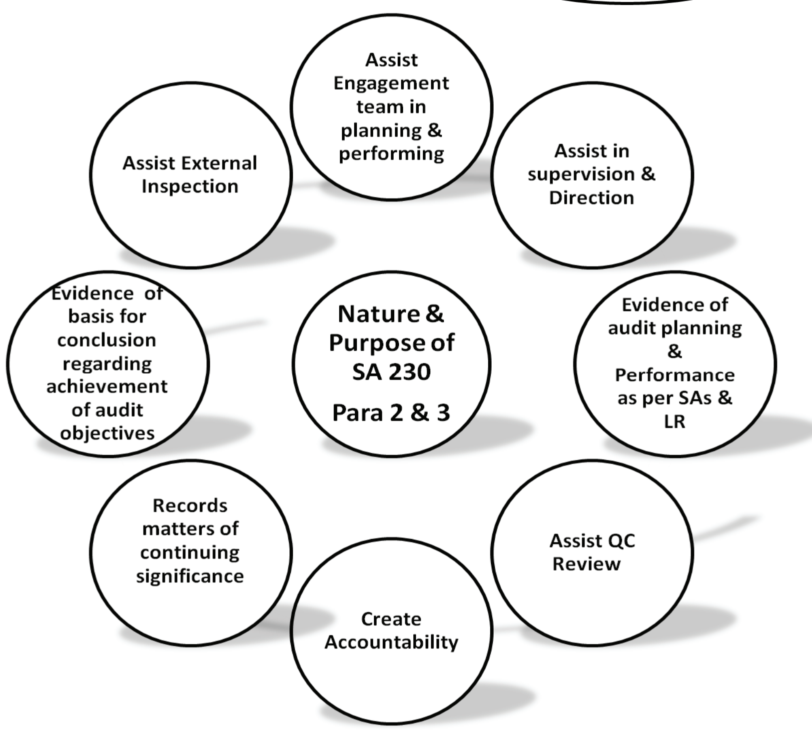
Chapter 4: Checklist 684

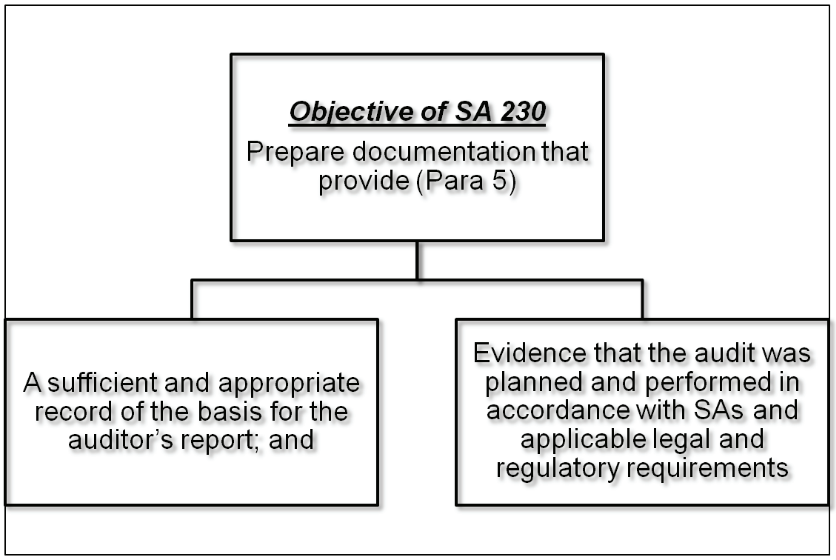
Chapter 5: Case Studies 687

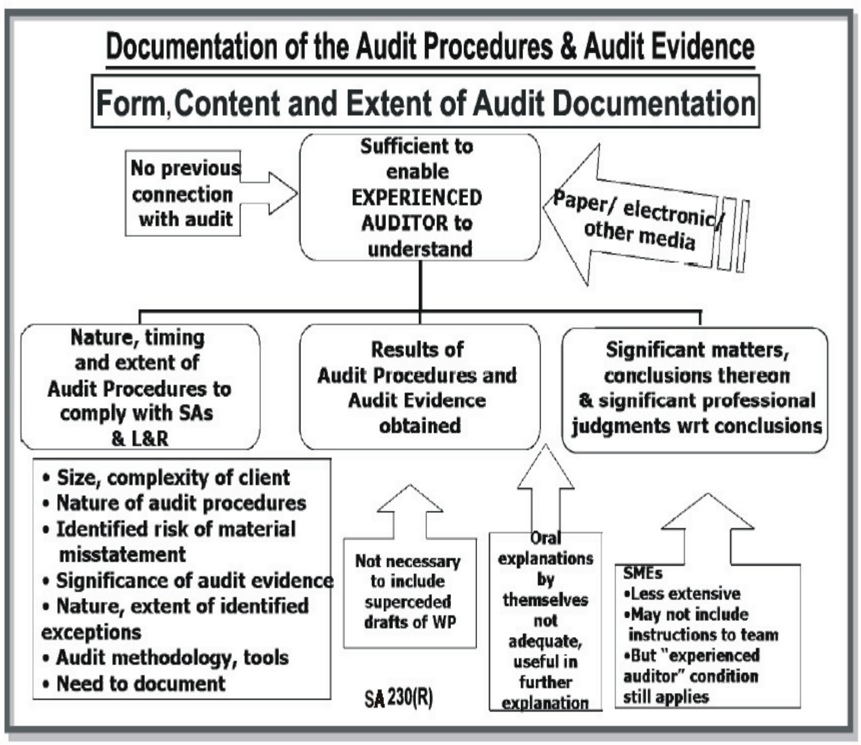
Appendix: Illustrative Working Paper Format 700

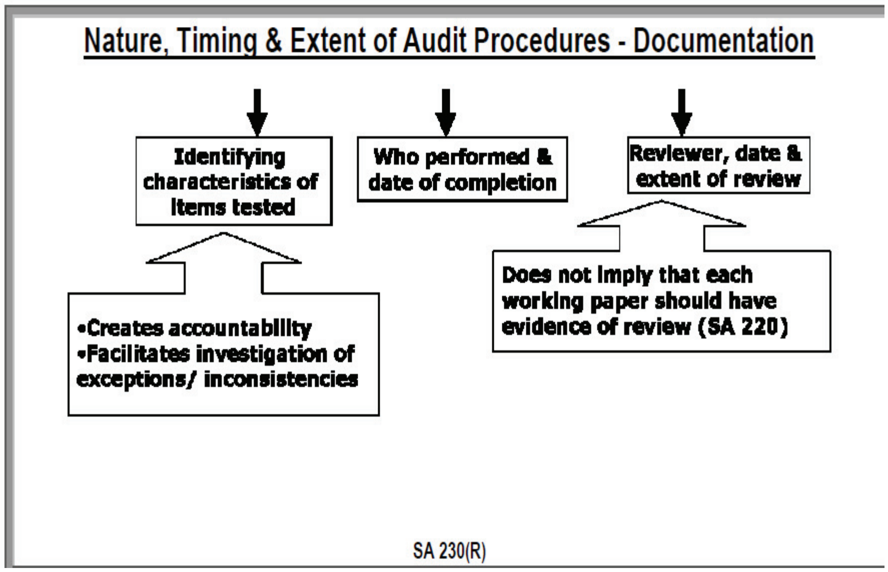
Chapter 1
Summary of the Standard






Objective of SA 230
Prepare documentation that provide (Para 5)
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


Documentation of the Audit Procedures & Audit Evidence
Form, Content and Extent of Audit Documentation
No previous connection with audit
Sufficient to enable EXPERIENCED AUDITOR to understand
Paper/ electronic/ other media
Nature, timing and extent of Audit Procedures to comply with SAs & L&R
Results of Audit Procedures and Audit Evidence obtained
Significant matters, conclusions thereon & significant professional judgments wrt conclusions
• Size, complexity of client
• Nature of audit procedures
• Identified risk of material misstatement
• Significance of audit evidence
• Nature, extent of identified exceptions
• Audit methodology, tools
• Need to document
Not necessary to include superceded drafts of WP
Oral explanations by themselves not adequate, useful in further explanation
SMEs
•Less extensive
•May not include instructions to team
•But "experienced auditor" condition still applies
SA 230(R)


Nature, Timing & Extent of Audit Procedures - Documentation
Identifying characteristics of items tested
Who performed & date of completion
Reviewer, date & extent of review
•Creates accountability
•Facilitates investigation of exceptions/ inconsistencies
Does not imply that each working paper should have evidence of review (SA 220)
SA 230(R)

Chapter 2
Introduction

Concept of Documentation

2.1 Audit, according to Spicer and Pegler, "*may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and the Profit or Loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books, and if not, in what respect he is not satisfied*."

2.2 Though the above definition addresses various aspects of an audit, one of the most important and relevant issues stemming out of this definition is that the auditor needs to **"satisfy himself** that the Balance Sheet (and Profit and loss a/c) is properly drawn up…", "… **according to best of his information and explanations given to him**…", "… and if not, "**in what respect he is not satisfied"**.

2.3 An auditor, during the course of his audit may come across various materials in the form of deeds, agreements, contracts, invoices, vouchers, etc which are the supporting materials to evidence the happening of an event/transaction. These are the basis for him to satisfy (or to not satisfy) himself as to whether the Balance Sheet gives a true and fair view of the state of the affairs of the business.(and the Profit and loss a/c of the profit or loss)

2.4 A document is any material which provides evidence of work performed, action taken or the happening of an event. It may be in paper or electronic form. Examples of documents include work papers, signed agreements, videos, pictures, spreadsheets, transcripts, correspondences, etc.

2.5 Oxford dictionary defines documentation *"as material that provides official information or evidence or that serves as a record; the process of classifying and annotating texts, photographs, etc"*

2.6 ISA 230 issued by the International Auditing and Assurance Standards Board defines audit documentation as *"The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used".*

2.7 SA 230 (Revised) issued by the Institute of Chartered Accountants of India has adopted the same definition.

2.8 Hence, "document", in the context of audit refers more to that which is required to be maintained by an auditor to record his findings during the course of the audit.

Why is Documentation Important?

2.9 Documentation is considered the backbone of an audit. The work that the auditor performs, the explanations given to the auditor, the conclusions arrived at, are all evidenced by documentation. Poor documentation depicts poor performance in an audit. The auditor may have executed appropriate audit procedures, however, if there is no documentation to prove, it is equal to having not done any work at all. Improper and incomplete documentation, at times, may even put the auditor in embarrassing situations!

2.10 Documentation is essential because:

- It helps in planning an audit
- It assists supervision and review
- It results in better conceptual clarity, clarity of thought and expression
- It facilitates better understanding and helps avoid misconception
- It supports and evidences work performed and compliance with standards

Form and Content of Documentation

2.11 The form and content of audit documentation should be designed to meet the circumstances of the particular audit. It should satisfy the requirements of the governing standards and substantiate the conclusions arrived at by the auditor.

2.12 The form and content of documentation depends on various factors such as:

- Risk assessment
- Materiality
- Sampling methods, etc

2.13 Documents are segregated into those forming part of the PAF (Permanent Audit File) and CAF (Current Audit File). Permanent audit file contains those documents, the use of which is not restricted to one time period, and extends to subsequent audits also. E.g. Engagement letter, Communication with previous auditor, Memorandum of Association, Articles of Association, Organization structure, List of directors/partners/ trustees/ bankers/lawyers, etc. On the other hand, a current audit file contains those documents relevant for that time period of audit.

2.14 Typical documentation spans the following:

- Understanding the entity
- Time and cost budgets
- Audit programme
- Risk assessment
- Team discussion
- Working papers pertaining to every significant area
- Conclusions
- Communication with those charged with governance
- Completion
- Manager/Partner review points
- Quality/Engagement quality control review

2.15 In general, a working paper should contain the following:

- Risk and controls relevant to the area
- Assertions to be tested and satisfied
- Substantive and analytical procedures performed
- Persons performing/reviewing the work
- Dates on which the work was performed/reviewed
- Extent of review
- Documents prepared by client

2.16 Audit documentation may be in the form of physical papers or in electronic form, more commonly referred to as hard copy and soft copy respectively.

Chapter 3
FAQs Relating to SA 230

Q 1. What is the scope of Revised SA 230?

A 1. Revised SA 230 deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of Revised SA 230. Laws or regulations may establish additional documentation requirements.

Q 2. What is the nature and purpose of audit documentation?

A 2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:

(a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

As per paragraph 11 of SA 200 (Revised), 'Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing', in conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

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

Q 3. What are the purposes which may be served by audit documentation?

A 3. Audit documentation serves a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220 (Revised). As per SA 220 (Revised),'Quality Control for an Audit of Financial Statements', responsibility of the engagement partner shall include the responsibility for direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and the auditor's report being appropriate in the circumstances, and responsibility for reviews being performed in accordance with the firm's review policies and procedures. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.
- Enabling the engagement team to be accountable for its work.

- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Q 4. What is the effective date of Revised SA 230?

A 4. Revised SA 230 is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Q 5. What is the objective of the auditor under Revised SA 230?

A 5. 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.

Q 6. What do you mean by audit documentation?

A 6. The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used). It may be noted that there could be documents provided by client (PBC) which are used to do audit and document checking notes. Then such PBC will not be part of audit documentation unless checking notes are also documented by auditors on the PBC. In those cases, work papers should be clearly marked as PBC.

Q 7. What do you mean by audit file?

A 7. One or more files, in physical or electronic form, meaningfully arranged containing the records that comprise the audit documentation for a specific engagement.

Q 8. What do you mean by experienced auditor?

A 8. An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

- Audit processes;
- SAs and applicable legal and regulatory requirements;
- The business environment in which the entity operates; and
- Auditing and financial reporting issues relevant to the entity's industry.

Q 9. How would the timely preparation of sufficient and appropriate audit documentation help the auditor?

A 9. The timely preparation of sufficient and appropriate audit documentation helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Q 10. What would be the Form, Content and Extent of Audit Documentation?

A 10. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements;
- The results of the audit procedures performed, and the audit evidence obtained; and

- Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

Q 11. What are influential factors for the form, content and extent of audit documentation?

A 11. The form, content and extent of audit documentation depend on factors such as:

- 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.

Q 12. How should the audit documentation be recorded?

A 12. Audit documentation may be recorded on paper or on electronic or other media.

Q 13. What are the examples of the audit documentation?

A 13. Examples of audit documentation include the following:

- Engagement letter
- Audit programmes defined, with details of work carried out and results filled, including planning memorandum
- Analyses of various account balances through comparatives and corroborative.
- Issues memoranda.

- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.
- Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements).

Audit documentation, however, is not a substitute for the entity's accounting records.

Q 14. What would the auditor not include in the audit documentation?

A 14. The auditor need not include in audit documentation:

- Superseded drafts of working papers and financial statements,
- Notes that reflect incompleteness,
- Preliminary thinking,
- Previous copies of documents corrected for typographical or other errors, and
- Duplicates of documents.

Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Q 15. What would be the audit documentation in case of Smaller Entities?

A 15. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, determined in accordance with SA 320(Revised), ‘Materiality in Planning and Performing an Audit’, assessed risks, significant matters noted during the audit, and conclusions reached.

Q 16. If the auditor complies with SA 230, will the result be sufficient and appropriate audit documentation?

A 16. In principle, compliance with the requirements of this SA will result in the audit documentation being sufficient and appropriate in the circumstances. Other SAs contain specific documentation requirements that are intended to clarify the application of this SA in the particular circumstances of those SAs.

Q 17. Do the specific documentation requirements of other SAs limit the application of SA 230?

A 17. No, the specific documentation requirements of other SAs do not limit the application of this SA.

Q 18. What will be the consequence, if there is no audit documentation requirement in any SA?

A 18. The absence of a documentation requirement in any particular SA is not intended to suggest that there is no documentation that needs to be prepared as a result of complying with that SA. Documentation appropriate to the circumstance needs to be maintained.

Q 19. Is it necessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file?

A 19. No, audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  - For example, there may be no single way in

which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.

- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:
- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to

them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.

- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.
- SA 240 (Revised) provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.

It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Q 20. What are the examples of significant matters?

A 20. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- Matters that give rise to significant risks. As defined in SA 315, significant risks mean an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

Q 21. What are the important factors in determining the form, content and extent of audit documentation of significant matters?

A 21. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Q 22. Give examples of circumstances in which, it is appropriate to prepare audit documentation relating to the use of professional judgment?

A 22. Some examples of circumstances in which, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross- references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor's.

Q 23. What should the auditor record in documenting the nature, timing and extent of audit procedures performed?

A 23. The auditor should record:

- The identifying characteristics of the specific items or matters tested;
- Who performed the audit work and the date such work was completed; and
- Who reviewed the audit work performed and the date and extent of such review.

SA 220 (Revised) requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Q 24. What purposes do recording the identifying characteristics serve?

A 24. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source,

the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period April 1 to September 30, starting with report number 12345 and selecting every 125th report).

- For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

Q 25. What all should the auditor document?

A 25. 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. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Q 26. What should the auditor document if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter?

A 26. The auditor shall document how the auditor addressed the inconsistency. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Q 27. What will the auditor do when it is necessary to depart from a relevant requirement in a SA?

A 27. The auditor should document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure, if, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in a SA. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objective of the auditor. Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

Q 28. Under which situation is a documentation requirement not necessary?

A 28. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases where:

- The entire SA is not relevant [for example, if an entity does not have an internal audit function, nothing in SA 610 (Revised) is relevant]; or
- The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

Q 29. What will be the audit documentation, if, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report?

A 29. The auditor is required to document:

- The circumstances encountered;
- The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- When and by whom the resulting changes to audit documentation were made and reviewed.

Q 30. Give examples of exceptional circumstances – Matters arising after the Date of the Auditor's Report?

A 30. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report. The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in SA 220 (Revised), with the engagement partner taking final responsibility for the changes.

Q 31. Where should the auditor assemble the audit documentation?

A 31. The auditor shall assemble the audit documentation in an audit file.

Q 32. When should the auditor complete the administrative process of assembling the final audit file?

A 32. The auditor should complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. SQC 1 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.

Q 33. Whether the administrative process of completion of the assembly of the final audit file after the date of the auditor's report construes as performance of new audit procedures or the drawing of new conclusions? If not, what are the changes permissible in the audit documentation during the final assembly process?

A 33. No, the administrative process of completion of the assembly of the final audit file after the date of the auditor's report does not construes as performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed, and agreed with the relevant members of the engagement team before the date of the auditor's report.

Q 34. What is the retention period for the audit documentation?

A 34. The retention period for audit engagements, as per SQC 1, 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.

Q 35. What will be the audit documentation in the circumstances where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed?

A 35. The auditor shall, regardless of the nature of the modifications or additions, document:

- The specific reasons for making them; and
- When and by whom they were made and reviewed.

Q 36. Give an example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed.

A 36. Example is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

Q 37. Who is the owner of the audit documentation?

A 37. Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, 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.

Q 38. Provide the specific audit documentation requirements in each SAs?

A 38. The specific audit documentation requirements in the respective SAs are as follows:

SA 220R: Quality Control for an Audit of Financial Statements

Para Ref.	***Issue***	***Documentation Needed***
24.	• Compliance with the Relevant Ethical and	• Issues identified with respect to compliance with relevant ethical requirements and how they were

	independence Requirements. • Acceptance and Continuance of client relationship and audit engagements. • Consultations.	resolved. • Confirmation of independence and documenting the same. • Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions. • Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements. • The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.
25	Engagement Quality Control Review - Timing and Procedures.	The engagement quality control reviewer document: • The procedures required by the firm's policies on engagement quality control review have been performed; and activities performed with respect to this could be documented • The engagement quality control review has been completed on or before the date of the auditor's report; and • The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were

		not appropriate.
A35	Documentation of Consultations	Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of: • The issue on which consultation was sought; and • The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

SA 240R: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Para Ref.	*Issue*	*Documentation Needed*
44	• Understanding the entity & its environment • Assessment of risks of material misstatements	• The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and • The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
45	Responses to assessed risks	• The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the

		assessed risks of material misstatement due to fraud at the assertion level; and • The results of the audit procedures, including those designed to address the risk of management override of controls.
46	Communications	Communications about fraud made to management, those charged with governance, regulators and others.
47	Fraud in revenue recognition	Reasons for concluding the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, Or checks performed and found satisfactory with reference to the procedures

SA 250R: Consideration of Laws and Regulations in an Audit of Financial Statements

Para Ref	***Issue***	***Documentation Needed***
29	• Non - compliance • Discussions	• Identified or suspected non-compliance with laws and regulations. • Results of discussions with : ▪ Management; ▪ those charged with governance (where applicable); and

		▪ other parties outside the entity.
A21	Non compliance	• Documentation may include: ▪ Copies of records or documents. ▪ Minutes of discussions held with management, those charged with governance or parties outside the entity.

SA 260R: Communication with Those Charged with Governance

Para Ref	***Issue***	***Documentation Needed***
19	Oral & written communications to those charged with governance	• Matters required by SA 260R to be communicated are communicated orally, document: ▪ The matter; ▪ When communication was made; and ▪ To whom communication was made. • Matters required by SA 260R to be communicated are communicated in writing, retain a copy.
A49	Oral communication	May include a copy of minutes prepared by client retained as part of audit documentation where those minutes are an appropriate record of the communication.

SA 300R: Planning an Audit of Financial Statements

Para Ref	***Issue***	***Documentation Needed***
11	Planning	• The overall audit strategy; • The audit plan; and • Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
A17-A20	• Overall audit strategy. • Audit plan. • Significant changes made in the above two.	• In respect of overall audit strategy, document: ▪ the key decisions considered necessary to properly plan the audit – scope, timing, conduct of audit; and ▪ communicate significant matters communicated to the engagement team. • May summarize the overall audit strategy in the form of a memorandum. • Documentation of the audit plan is record of planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. • May use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances. • A record of the significant

		changes to the overall audit strategy and the audit plan should document: ▪ resulting changes to the planned nature, timing and extent of audit procedures. ▪ reasons for significant changes were made. ▪ overall strategy and audit plan finally adopted for the audit. ▪ Response to the significant changes occurring during the audit. • In smaller entities a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity.

SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Para Ref	***Issue***	***Documentation Needed***
33(a)	Discussion	• The discussion among the engagement team where required by paragraph 10 of SA 315, and the significant decisions reached: ▪ the susceptibility of the entity's financial statements to material misstatement; and ▪ the application of the

		applicable financial reporting framework to the entity's facts and circumstances.
33(b)	Understanding of each of the aspects of the entity and its environment specified in paragraph 11	• Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. • The nature of the entity, including: ▪ its operations; ▪ its ownership and governance structures; ▪ the types of investments that the entity is making and plans to make, including investments in special purpose entities; and ▪ the way that the entity is structured and how it is financed. • Accounting policies selection and application of accounting policies, including the reasons for changes thereto. • Auditor's evaluation of 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. • The entity's objectives and strategies, and those related business risks that may result in

		risks of material misstatement. • The measurement and review of the entity's financial performance.
33(b)	Understanding of each of the internal control components specified in paragraphs 14-23	• Control environment – Auditor's evaluation of whether: ▪ Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior. ▪ The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control; and ▪ Whether those other components are not undermined by deficiencies in the control environment. • Entity's risk assessment process for : ▪ Identifying business risks relevant to financial reporting objectives; ▪ Estimating the significance of the risks; ▪ Assessing the likelihood of their occurrence; and ▪ Deciding about actions to address those risks. • Management's failure to identify a risk otherwise expected to

		have been identified: ▪ Why that process failed to identify it; and ▪ Evaluation of whether the process is appropriate to its circumstances or determine whether it represent a significant deficiency in internal control with regard to the entity's risk assessment process. • If the entity has not established such a process or has an *ad hoc* process: ▪ Discussion with management regarding whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. • The information system, including the related business processes, relevant to financial reporting, and communication. ▪ 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, within both

		information technology (IT) and manual systems, 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; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form; ➢ How the information system captures events and conditions, other than transactions, that are significant to the financial statements; ➢ The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and ➢ Controls surrounding journal entries, including

		non-standard journal entries used to record non-recurring, unusual transactions or adjustments. • Entity's communication of financial reporting roles and responsibilities and significant matters relating to financial reporting, including: ▪ Communications between management and those charged with governance; and ▪ External communications, such as those with regulatory authorities. • Control activities relevant to the audit: ▪ Understanding of control activities relevant to the audit; and ▪ Entity's response IT risks. • Monitoring of controls: ▪ Entity's major activities to monitor internal control over financial reporting; and ▪ How the entity initiates remedial actions to deficiencies in its controls. • Understanding of the relevance of the Internal Audit Function: ▪ The nature of the internal audit function's responsibilities and how the internal audit function fits in

		the entity's organisational structure; and ▪ The activities performed, or to be performed, by the internal audit function. • Entities having uncomplicated businesses and processes relevant to financial reporting, documentation: ▪ Simple and brief. ▪ Not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. ▪ Document only key elements of understanding. ▪ Extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. ▪ For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.
33(b)	Sources of information from which the understanding was obtained	• Sources of the information used in the entity's monitoring activities. • Basis upon which management considers the information to be sufficiently reliable for the purpose.
33(b)	Risk assessment	

	procedures performed	
33(c)	Risks (in terms of para 24 of the standard)	• Risks of material misstatement identified and assessed: ▪ at the financial statement level; and ▪ at the assertion level.
33(d)	Risks requiring special audit considerations	The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 26-29 of the Standard.

SA 320R: Materiality in Planning and Performing an Audit

Para Ref.	***Issue***	***Documentation Needed***
14.(a) & (b)	Materiality for the financial statements as a whole or materiality level(s) for particular classes of transactions, account balances or disclosures	• Materiality for the financial statements as a whole: ▪ For establishing the overall audit strategy • Materiality level(s) for particular classes of transactions, account balances or disclosures: ▪ Determine materiality level(s) to be applied to particular classes of transactions, account balances or disclosures, which could expected to influence the economic decisions of the users
14 (c)	Performance materiality	• Determine performance materiality: ▪ For assessing the risks of

		material misstatement; and ▪ Determining the nature, timing and extent of further audit procedures.
14 (d)	Revisions as the Audit Progresses	• Revise materiality for the financial statements as a whole or materiality level(s) for particular classes of transactions, account balances or disclosures: ▪ Aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. • If the auditor concludes that a lower materiality than that initially determined is appropriate: ▪ Determine whether it is necessary to revise performance materiality, and ▪ Whether the nature, timing and extent of the further audit procedures remain appropriate.

SA 330: The Auditor's Responses to Assessed Risks

Para Ref	***Issue***	***Documentation Needed***
29 (a)	Overall responses	Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature,

		timing and extent of the further audit procedures performed.
29 (b)	Linkages	Linkage of those procedures with the assessed risks at the assertion level.
29 (c) & A59	Results	• The results of the audit procedures, including the conclusions where these are not otherwise clear. ▪ The form and extent of audit documentation is a matter of professional judgment, and is influenced by: ➢ nature, size and complexity of the entity and its internal control, ➢ availability of information, and ➢ audit methodology and technology used in the audit.
30	Operating effectiveness of controls obtained in previous audits	• Document the conclusions reached about relying on such controls that were tested in a previous audit.
31.		• The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

SA 450 Evaluation of Misstatements Identified during the Audit

Para Ref.	***Issue***	***Documentation Needed***
15 & A25.	Uncorrected Misstatements	• The amount below which misstatements would be regarded as clearly trivial. • All misstatements accumulated during the audit and whether they have been corrected: ▪ Communication with management to correct the misstatement. ▪ Communication with those charged with governance: ➢ Uncorrected misstatements; and ➢ Effect that they, individually or in aggregate, may have on the opinion in the auditor's report. • The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. Auditor should consider: ▪ The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and

		the financial statements as a whole, and the particular circumstances of their occurrence; and ▪ The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. • The auditor's documentation of uncorrected misstatements may take into account: ▪ The consideration of the aggregate effect of uncorrected misstatements; ▪ The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and ▪ The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

SA 540R: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Para Ref	***Issue***	***Documentation Needed***
23(a)	Auditor's conclusion	• The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks.
23(b) and A128	Management bias	• Indicators of possible management bias, if any. ▪ Assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and ▪ Evaluating whether the financial statements as a whole are free from material misstatement.

SA 550R: Related Parties

Para Ref	***Issue***	***Documentation Needed***
28	Related parties	• Names of the identified related parties. • Nature of the related party relationships.

SA 600: Using the Work of Another Auditor

Para Ref	*Issue*	*Documentation Needed*
18	Components and component auditors	• Components whose financial information was audited by other auditors. • Such components' significance to the financial information of the entity as a whole. • Names of the other auditors. • Any conclusions reached that individual components are not material. • Procedures performed and the conclusions reached. • Where component auditor's report is other than unmodified, document how principal auditor has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

SA610R	**Using the Work of Internal Auditors**	
Para Ref.	*Issue*	*Documentation Needed*
13.	Using the specific work of the internal auditors	• Conclusions regarding the evaluation of the adequacy of the work of the internal auditors. • Audit procedures performed by the external auditor on that work to determine its adequacy.

Chapter 4
Checklist

S.No.	Particulars	Yes/No/NA	Remarks/WP Ref
1.	Whether the audit documentation is prepared on a timely basis?		
2.	Whether the audit documentation is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the following? (a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; (b) The results of the audit procedures performed, and the audit evidence obtained; and (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.		
3.	While documenting the nature, timing and extent of audit procedures performed, whether the following was recorded (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		
4.	Whether the document includes 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.		
5.	Where it is identified that information is inconsistent with the auditor's final conclusion regarding a significant matter, whether it is documented as to how the inconsistency was addressed?		
6.	Where it is considered necessary in exceptional circumstances to depart from a relevant requirement in a SA, whether the audit document reflects how the alternative audit procedures performed achieved the aim of that requirement and the reasons for the departure.		
7.	Where in exceptional circumstances, new or additional audit procedures are performed or new		

	conclusions are reached after the date of the audit report, whether the following were documented? (a) The circumstances encountered; (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and (c) When and by whom the resulting changes to audit documentation were made and reviewed.		
8.	Is it ensured that after the assembly of the final audit file has been completed, no deletion or discard of audit documentation of any nature has taken place before the end of its retention period?		
9.	Where it is necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, whether the following were documented? (a) The specific reasons for making them; and (b) When and by whom they were made and reviewed.		

Chapter 5
Case Studies

Case Study 1: Determination of provision (Form and content of documentation)

The client is a software company. During the audit of the accounts for the year ended 31st March 2012, a difference of opinion pertaining to provision for doubtful debts arose. The client had provided Rs. 10 lakhs as provision for doubtful receivables. He is of the opinion that this is sufficient as most of the receivables are from group companies. The auditor challenged this because as per his estimate, it should have been at least Rs. 60 lakhs. After many meetings and arguments, both parties agreed that a provision of Rs. 40 lakhs was appropriate. The audit working papers do not have any record of how the provision was determined. The auditor says that once he was satisfied about the adequacy of provision, he is not required to keep any record on his file.

Is the opinion right?

Analysis and conclusion

As per Para 8 of SA 230, the auditor should prepare audit documentation regarding "Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."

All significant matters arising during the course of the audit need to be documented. Specifically, those pertaining to provisions and estimates where professional judgment is necessary to arrive at a conclusion, should be documented. Some examples of such situations are provision for doubtful debts, useful life of unique technical assets, provision for warranty, etc.

Hence, in the above situation, the auditor and the client have discussed and argued, considering various scenarios, before arriving at a conclusion on the provision for doubtful debts. Issues debated and discussed at the meetings should be documented. The auditor should also have sufficient evidence to support his conclusion which may include breakup of the doubtful debts, subsequent realization, past history of repayments, etc.

Case Study 2: Documentation of wage settlement (Oral communication)

The client has entered into a retrospective wage settlement agreement during the current financial year. The related wage arrears amount to Rs. 100 crores which is above the relevant materiality levels. Necessary adjustments were made in the books of accounts. Consequently, provision for gratuity has also increased significantly. The same has been provided in the books of accounts.

The auditor is of the opinion that, since all the facts of the case, the subsequent decisions and the adjustment in the books have already been orally communicated to those charged with governance; the same need not be documented.

Is this opinion correct?

Analysis and conclusion

As per Para 10 of SA 230, "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."

Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Going by the facts, the case in question is an exceptional item which is to be considered as a significant matter. Hence, though the management/those charged with governance is/are already aware of the issue and its resolution by way of oral discussions, the same will need to be documented. Generally the same may be communicated through the audit committee/ Board Meeting presentation.

Case Study 3: Cross referencing risk and audit program

The audit team, after due discussions, identified and documented the significant risks pertaining to the organization. The team also had a pre-determined standard audit program for every area of balance sheet and profit and loss.

The audit procedures were performed as per the audit program and the same was documented.

However, risk and the program were not cross referenced. The team is of the opinion that the same need not be done.

Analysis and conclusion

As per SA 315,"Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", an auditor needs to discuss amongst the team members, understand the entity and its environments, assess the significant risks of the organization and understand the relevant controls in the entity to mitigate such risks. Risks are identified at the financial statement and the assertion level.

As per para 29 of SA 330, "The Auditor's Responses to Assessed Risks", the Overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed and the linkage of those procedures with the assessed risks at the assertion level should be documented.

In the given case, the audit team has identified the risks and the procedures. However, the procedures have not been linked with the assessed risks. Hence, the documentation is not complete.

Case Study 4: Documentation of responses to assertions

Every account balance in the books of accounts needs to be audited based on certain assertions. These include completeness, accuracy, valuation, etc.

The auditor was auditing the accounts of a hotel. Revenue comprising primarily of room revenue and revenue from food and beverages is an assumed risk. While determining the assertions of revenue, the most important assertion identified was "completeness". Checks pertaining to cut off, etc was done to verify the same. However, the same was not explicitly documented.

Analysis and Conclusion

As per SA 330: The Auditor's Responses to Assessed Risks, the following need to be documented:

- The results of the audit procedures, including the conclusions where these are not otherwise clear.
- The form and extent of audit documentation is a matter of professional judgment, and is influenced by:
    - nature, size and complexity of the entity and its internal control,
    - availability of information, and
    - audit methodology and technology used in the audit.

In the given case, though the risks have been assessed and assertions identified, documentation is not complete if the audit checks in response to assessed risks and conclusion thereof have not been documented.

Case Study 5: Revisions of work papers

The audit team, during the finalization of the audit of a client in the hotel industry, had several revisions in the financial statements. Consequently, the related working papers also underwent numerous changes.

The audit manager is of the opinion that the old papers can be destroyed wherever there were revisions and it is enough to preserve the final version. However, the audit team is of the opinion that all revisions need to be filed for traceability.

Which opinion is right?

Analysis and conclusion

As per Para A22 of SA 230, "The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include: Deleting or discarding superseded documentation."

Hence, old papers which have been revised may be deleted or discarded.

Case Study 6: Audit of inventory (Comprehensiveness and relevance)

During the audit of inventory of a manufacturing company, a working paper had the following details pertaining to finished stock:

Item	Quantity	Rate (Rs.)	Value (Rs.)
A	36,042.80	42.51	15,32,179
B	3,250.00	165.22	5,36,965
C	1,176.50	146.99	1,72,938
D	82.00	2,482.19	2,03,540
E	64.00	1,740.52	1,11,393

As a reviewer identify the missing details.

Analysis and conclusion:

As per Para 9(a), "In documenting the nature, timing and extent of audit procedures performed, the auditor shall record the identifying characteristics of the specific items or matters tested."

The auditor is expected to record all such information which enables an "experienced auditor" to understand the work done and conclusions reached without the help of the engagement team.

As per Para 6(c), an experienced auditor is "An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

i. Audit processes;

ii. SAs and applicable legal and regulatory requirements;

iii. The business environment in which the entity operates; and

iv. Auditing and financial reporting issues relevant to the entity's industry.

Keeping in mind the above, the following essential details are missing in the working paper:

- Unit of Measurement
- Previous year comparative figures
- NRV vs Cost comparison not detailed
- Cost formulae – Current year Vs Previous year
- Excluded costs
- Absorption of fixed overheads
- Quantity reconciliation
- Reference to physical verification paper

The working paper can be called complete only when the above details are incorporated.

Case Study 7: Assembly of final file

The audit team completed the field work and finalization of the audit. Financials and audit report were signed on 10th July 2012. Due to statutory and tax audit pressure, the team was reallocated to another assignment before closure of the audit file. The team attended to the closure of the file after the tax audit season, i.e. 30th September 2012.

Is this in compliance with the requirements of the standard?

Analysis and conclusion

As per Para 14 of SA 230, "The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report."

Para 74 of SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. Para 75 of SQC 1 says "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."

Hence, the file needs to be completed by 10^{th} September 2012.

Case Study 8: The devil called "Microsoft Excel" (Form and Content of documentation)

Working for 2 hours to make a 33MB excel file to a mail friendly size of 886 KB and ensuring that relevant information is not compromised, the auditor was thoroughly dejected trying to fix the problem, without knowing where the problem was.

The auditor was reviewing a report, where significant issues were documented in a word document and related annexures in a spreadsheet. The size of the annexure was 33MB for just 68 sheets. Teams had taken screen shots of ERP sample pages to explain a point (Very good from evidence perspective but not from file size management point of view).

Where is the real problem here?

Analysis and conclusion

After working out permutations and combinations, the problem was successfully identified!

i. Complete dump of transactions for a period as taken from the ERP was pasted in the spreadsheet with few annexures running to 10000 lines!

ii. On the annexures, filters were applied to explain the problems. However, the complete data was sitting in the annexure without relevance. E.g. The observation reported delay in collection over 5 days from due date and the annexure contained the complete debtors ledger dump with at least 30 columns (many of those columns may not be relevant in context) with appropriate filters applied!

Solution -

i. Remove unwanted columns, unwanted rows.

ii. Reduce the image sizes when you copy screen shots into a file.

Documentation in soft copy is good provided a proper trade off is made between Required details and file size.

Case Study 9: Preference share holders redemption (Documentation)

Preference shares issued by A Ltd. in October xx05 are due for redemption on xx10. Preference shares have not been redeemed on due date and negotiations between the parties have not concluded as on audit report date.

The auditor has made a comment on Preference share redemption in Audit report without qualifying audit opinion but has not documented the same in the working papers. Is this correct?

Analysis and conclusion

Preference share redemption is a significant event that will have an impact on cash flows of the company and has been included in "emphasis of matter" paragraph in the audit report. As per para A8 of SA 230, auditor has to document such matters (information on negotiation between preference shareholders and the company) in the working papers.

Case Study 10: Change in risk assessment and audit procedures

A Ltd. Auditors had not considered "Fixed assets" as significant risk area at the Planning stage. During FY 2012, A Ltd. had written off fixed assets with WDV of Rs.10 lacs as these assets could not be traced by management. On further inquiry, auditors identified that fixed assets register was not properly updated and critical information such as quantity and serial numbers were not available in fixed asset register. Auditors revised their audit approach and considered "Fixed assets" as significant risk area and modified their audit procedures pertaining to fixed assets verification.

Should auditors document the reason for considering fixed assets as "significant risk" in working papers and the reason for change in audit procedures in working papers?

Analysis and conclusion

As per para A8 of SA 230, where risk assessment is revised and audit procedures are modified, then such changes need to be considered as a significant matter and documented in audit working papers. As a result, the reasons for considering Fixed assets as significant risk and all observations and procedures pertaining to fixed assets needs to be documented in the working papers.

Case Study 11: Acceptance of salary escalation assumption

Management of A Ltd. expects future salary escalation to be about 8% for purpose of computing gratuity liability and leave encashment liability as per actuarial valuation, whereas weighted average salary increase for FY 2012 was about 16% and 17% for FY 2011. Auditors questioned the management on reasonableness of the salary escalation assumption used for computation of the liability.

Management expects the salary escalation to be less compared to previous years as salary level of all employees are in line with market. Management further provided salary increment expected to be given for all employees on payroll as on balance sheet date. Weighted average salary increase computed based on forecast data given by management is 8%.

Auditors accepted the 8% salary escalation rate but did not document the data and explanation given by the management in working papers. Is this correct?

Analysis and conclusion

Please refer para A9 in SA 230. As salary escalation rate is a significant matter that requires professional judgment, it is critical to document the reason for accepting 8% salary escalation rate in the working papers.

Case Study 12: Purposeful documentation

A firm XYZ was carrying out a government audit. In a government audit, a supplementary report is required to be submitted to the CAG. On review of the report, it was found that for a query requiring the auditor's comments on legal cases, an ageing analysis of the cases had been performed.

Is the same sufficient documentation?

Analysis and conclusion

Documentation must be purposeful.

In the above case, while the auditor had analysed the ageing of the legal cases, information such as the purpose of the case, the amount involved, etc. had not been highlighted and hence becomes insufficient.

Documentation must be done with a purpose and all data does not become information useful in audits.

Case Study 13: Contents of documentation:

While reviewing a work paper on "pre-paid expenses" an auditor noticed that the schedule prepared by the audit team gave the opening balance, debits to the account, credits to the account and closing balance.

Is the same sufficient documentation?

Analysis and conclusion:

Audit documentation highlights the audit performed by the team. The above documentation process would indicate that the team has taken a short cut to perform the audit.

A pre-paid expense schedule should clearly state, in respect of significant items:

1. Name of item;
2. Total amount paid,
3. Period to which it relates,
4. The pre-paid amount as on Balance Sheet date,
5. Period for which prepayment was done; and

6. The pre-paid amount on the same date of the previous year

Auditor should ensure that proper schedules are obtained from client so as to prepare sufficient work papers. Extracts from ledger by themselves are not adequate audit documentation.

Case Study 14: Documentation should be after a lot of thought and application of mind, and done logically and cogently:

On reviewing an audit report, an experienced auditor observed that godown rent cost had increased in the audit period and the reason stated for the same was “Increase in rates or increase in kgs stored”.

Does the same constitute proper documentation?

Analysis and Conclusion:

The use of the word “or” does not make the observation conclusive.

What the writer wanted to convey was probably that in some cases rent is paid on per kg basis and in some cases as fixed rent. Both have increased.

However use of the word ‘or’ makes it looks like a multiple choice question, requiring the reader/reviewer to take his pick.

Part explanation is not correct.

For example, let us say that there an increase in salaries on account of new recruitments and also decrease as some people have left. Auditor should ensure both aspects are covered in explanation. You can’t just use a part explanation because that sufficiently explains the variation.

Do not leave something on ‘materiality’ ground if there is a genuine reason which needs to be explained. This happens when salaries of two departments are there (for both underlying agreement being same and the increase on a/c of the new agreement is 25%) and one (admin. dept) has 25% increase and another (sales dept.) 3% increase, you need to explain both variations as otherwise the real reason why it is 13% will not come out;

Explanations must be with figures and not just facts.

Case Study 15: Complete work papers:

When doing an analytical review, the following was observed by an auditor:

Lease rent: The lease rent has reduced as no. of employees has reduced

Analysis and Conclusion:

Audit documentation must be complete.

Work papers must be such that a qualified person with no previous knowledge of the reviewed company should be able to go through the file himself and review it.

In the above case, upon enquiry, it was understood that in a particular division computers were hired for all employees and as the no. of employees in that division had come down, the no. of computers hired had also come down.

However, the same was not properly highlighted through the work paper.

Case Study 16: Documentation in the eyes of a peer reviewer

The following points were highlighted by a reviewer during the peer review of an audit firm and the auditor's responses to the same.

S.No.	Reviewer	Auditor
1.	Cut off reviews are not documented under revenue	No cut off is applicable in this company.
2.	Going concern – next year projections are not attached or documented	Projected sales are not provided to us.
3.	IT controls are not	Company uses Tally which

	documented	has no controls
4.	Revenue not considered as key /significant/ fraud risk.(in a bank)	No income allocated to us in the Joint auditors' area /responsibilities.
5.	PAR not in file. (Preliminary analytical review)	PAR not relevant as no changes are made to financials during the audit.

Analysis and Conclusion:

Documentation is an essential part of the audit. As per the SA on Audit documentation, an experienced auditor should be able to understand the work papers even without the engagement team being present. The above review points pertain to insufficient documentation and may be handled as follows:

1. **Cut off:** There is no company where cut off is not applicable for revenue. In a manufacturing company it could mean dispatches not billed in the right period; in a software company, this could mean revenue of current year postponed to next year or vice versa.

2. **Going concern:** Looking at next one year projections is essential. If the Company has no projections/budget etc the next year projections needs to be discussed at least orally with CFO etc

3. **IT controls:** Precautions taken if the software does not have controls, has to be documented. E.g. Serial no. control over vouchers, Reconciliation of MIS with company accounts, TB signed by CFO periodically, copy of Tally taken on CD, etc.

4. **Joint audit:** If key branches are audited, revenue is certainly covered and needs to be documented as a risk.

5. **Preliminary analytical review:** This is mandatory. In case there is no change in the figures, one can mention the same in the final analytical review.

Appendix

Illustrative Working Paper Format

XYZ Limited	Audit Firms name
Nature of Assignment	Article Assistants name
HO/Unit:	
For the period___	Date of audit
	Reviewed by:
Area:	
Sub-area:	
Balance as per Balance Sheet:	
Balance as per General Ledger:	
Difference:	
Reason for difference if any:	
Checking Notes:	
Observations:	
Conclusions:	

7

Implementation Guide to Standard on Auditing (SA) 501, Audit Evidence - Specific Considerations for Selected Items

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Foreword

Evidence obtained during a financial audit and recorded in the audit working papers is audit evidence. Specific Considerations for audit evidence relating to inventory, litigation and claims involving the entity, and segment information in an audit of financial statements are dealt in a separate Standard on Auditing (SA) 501, “Audit Evidence –Specific Considerations for Selected Items”, issued by the Institute of Chartered Accountants of India in March, 2010.

SA 501 focuses on audit evidence relating to existence and condition of inventory, completeness of litigation and claims involving the entity, presentation and disclosure of segment information in accordance with the applicable financial reporting framework. It is important to have specific considerations for these selected items of the financial statements as they involve intricacies which may require specific focus and/or procedures of the auditors.

The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India in its endeavour to further facilitate implementation of Standards on Auditing has come out with an Implementation Guide to SA 501 on Audit Evidence- Specific Considerations for Selected Items. I wish to place my appreciation to CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for bringing out this Implementation Guide.

I am confident that this Implementation Guide would prove to be immensely useful to the members and other interested readers.

May 15, 2013 **CA. Subodh Kumar Agrawal**
New Delhi President, ICAI

Preface

Evidence forms the bedrock of the auditor's report on the financial statements. The nature, timing and extent of an auditor's procedures are directed towards obtaining sufficient appropriate audit evidence that supports/ corroborates the various assertions made by the auditee in respect of its financial statements. Having regard to the importance of evidence to an audit engagement, ICAI has issued a suite of Standards focussing on various aspects of audit evidence. For example, the Standard on Audit (SA) 500, *Audit Evidence*, contains the fundamental concepts relating to audit evidence such as what constitutes sufficient appropriate audit evidence, information that can be used as audit evidence, selection of items for testing to obtain audit evidence, inconsistency in or doubts over reliability of audit evidence, etc. In addition, a number of other SAs in the "Audit Evidence" series lay down principles in respect of specific items. For example, SA 505 on External Confirmations, SA 550 on Related Parties, SA 570 that deals with Going Concern, or SA 580 on Written Representations, etc. Similarly, SA 501 deals with special considerations for the auditor while obtaining audit evidence in respect of certain critical items on an entity's financial statements, *viz.,* inventory and litigations and claims involving the entity and segment reporting.

While the Standards lay down the fundamental principles on the relevant aspects of audit, Implementation Guides are brought out to assist the auditors in practical implementation of these principles in real life audit situations. These Implementation Guides are written by experts, presenting these principles, in a simpler language and format. They contain templates, checklists, case studies, etc., as appropriate. These Implementation Guides receive warm acceptance from the practitioners and therefore, help encourage compliance with the Standards among them. Till date the Auditing and Assurance Standards Board has brought out a number of Implementation Guides. The Implementation

Guide to SA 501 is another addition to that growing implementation resource of the Board.

I am extremely grateful to CA. Subhasis Majumdar from Kolkata for sparing time out of his professional and personal preoccupations to write this extremely useful Implementation Guide.

I am also thankful to CA. Subodh Kumar Agrawal, President, ICAI and CA. K Raghu, Vice President, ICAI for their support to the activities of the Auditing and Assurance Standards Board.

I also wish to place on record my gratitude for my colleagues on the Board *viz*., CA. Naveen ND Gupta, Vice Chairman, CA. Rajkumar S Adukia, CA. Jay Ajit Chhaira, CA. Shriniwas Y Joshi, CA. Sanjeev Maheshwari, CA. Dhinal A Shah, CA. Shiwaji B Zaware, CA. M. Devaraja Reddy, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Manoj Fadnis, CA. Sanjiv K Chaudhary, CA. Vijay K Gupta, Shri Gautam Guha, Shri Bhaskar Chatterjee, CA. Niraj Kumar Jhunjhunwala, CA. Sanjay Vasudeva, CA. Ganesh Balakrishnan, CA. Charanjeet Surendra Attra, CA. Harinderjit Singh and CA. Saunak Ray for their support and guidance to the Board. I also wish to place on record my thanks to the special invitees to the Board, *viz*., Prof. Manoj Anand, CA. Vijay Sachdeva, Shri Sunil Kadam and CA. Nilesh S Vikamsey for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Implementation Guide its final shape.

I am confident that this Implementation Guide will help the members understand the requirements involved in SA 501 and sharpen their skill sets in this area.

May 15, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing & Assurance Standards Board

Contents

Foreword

Preface

Snapshot of SA 501 707

Chapter 1: Introduction and Overview 718

Chapter 2: Existence and Condition of Inventory 723

Chapter 3: Completeness of Litigations and Claims Involving the Entity 758

Chapter 4: Presentation and Disclosure of Segment Information 765

Appendices

Appendix 1: Stock Verification Checklist 769

Appendix 2: Recording Cut–off Information............................... 772

Appendix 3: Recording of Test Counts by the Auditor............... 774

Appendix 4: Inventory Balance Confirmation 776

Appendix 5: Letter of General Inquiry to the Entity's Legal Counsel 777

Appendix 6: Letter of Specific Inquiry to the Entity's Legal Counsel 778

Snapshot of SA 501

SA 501 (Revised)

Audit Evidence – Specific Considerations for Selected Items

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

Replaces SA 501(AAS 34), "*Audit Evidence- Additional Considerations for Specific Items"* issued in March 2005.

Overview of SA 501 (R)

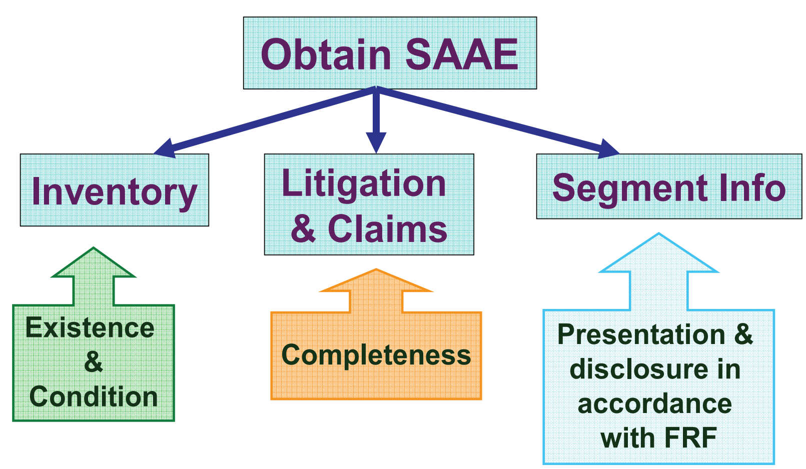
- **Introduction**
  - Scope of this SA.
  - Effective Date.
- **Objective**
- **Requirements & Application**
  - Inventory.
  - Litigation & Claims.
  - Segment Information.

Scope

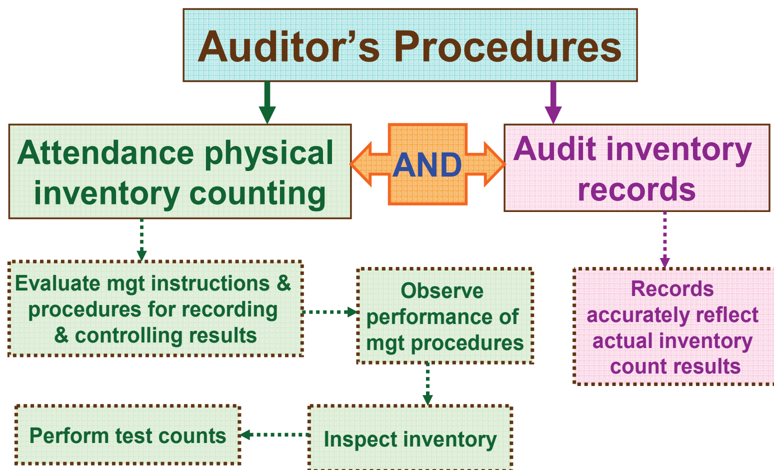
- Deals with specific considerations by the auditor,
- In obtaining SAAE,
- W.r.t. certain aspects of:
  - Inventory.
  - Litigation & claims.
  - Segment information.
- In an audit of financial statements.

SAAE in accordance with SA 330, SA 500 & other relevant SAs.

Auditor's Objectives



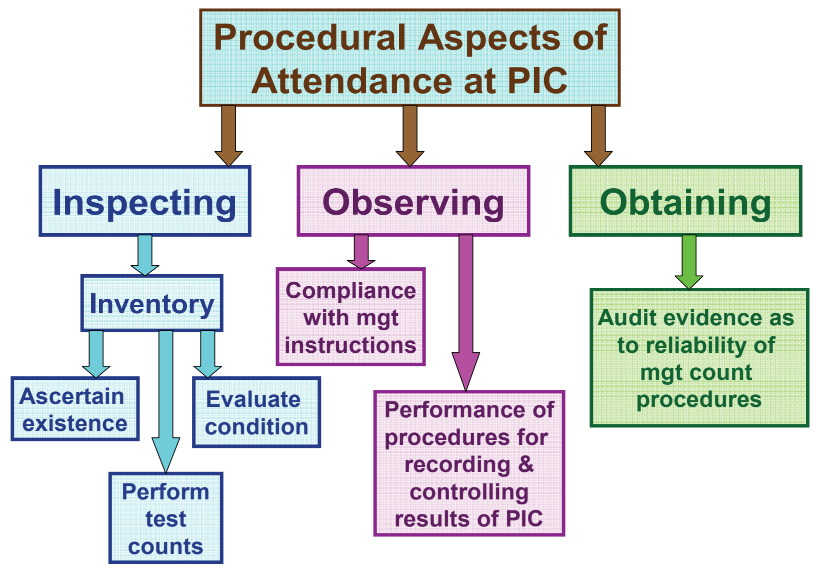
Inventory



- This requirement applies when inventory is material to the financial statements. The sub-procedures under "Attendance at physical inventory counting" to be performed unless they are impracticable.

Attendance at Physical Inventory Count (PIC)

- At least once a year by mgt to:
  - Form basis for FS preparation.
  - Ascertain reliability of perpetual inventory system.
- Planning the Attendance – matters to consider:
  - Nature of Inventory.
  - Stages of completion of WIP.
  - RMM related to inventory.
  - Nature of ICs related to inventory.
  - Expectation wrt adequate procedures & of proper instructions by mgt.
  - Timing of PIC.
  - Whether entity maintains perpetual inventory system.
  - Locations at which inventory is held.
  - Whether assistance of Auditor's Expert is needed.



Evaluating Management Instructions

Matters to consider:

- Application of appropriate control activities.
- Accurate identification of:
  - Stage of completion of WIP.
  - Slow moving items.
  - Obsolete/ damaged items.
  - Items owned by 3rd party.
- Procedures to estimate physical quantities.
- Control over movement of inventory before & after cut-off date.

Observing Performance of Management's Count Procedures

- Mgt's count procedures, e.g., controls over inventory movement before, during and after the count, assists the auditor in obtaining audit evidence that mgt instructions and count procedures are adequately designed and implemented.
- Auditor may obtain copies of cutoff information to assist the auditor in performing audit procedures over the accounting for inventory movements at a later date.

Inspection of Inventory

Assists auditor in:

- Ascertaining the existence of inventory.
  - But not necessarily re ownership.
- Identifying obsolete/ damaged/ ageing inventory.

Perform Test Counts

- Provides evidence re completeness & accuracy of inventory records.
  - E.g., tracing select items from mgt count records to physical inventory & vice versa.
- Assists in performing subsequent audit procedures to determine whether entity's final inventory records accurately reflect actual inventory count results.

PIC After the Date of FS – Additional Procedures

- Obtain SAAE whether changes in inventory between the count date & FS date are properly recorded.
  - Effectiveness of design, implementation & maintenance of controls over change (refer SA 330).
- Perpetual inventory system:
  - Whether records are properly adjusted.
  - Reliability of the entity's perpetual inventory records.
  - Reasons for significant differences between the information obtained during physical inventory count and perpetual inventory records.

- Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

- **Auditor unable to attend PIC**
  - Make/ observe PIC at some other date.
  - Perform audit procedures on intervening transactions.
- **Attendance at PIC impracticable:**
  - Perform alternative procedures to obtain SAAE.
  - If these procedures are not possible, modify audit opinion (Ref SA 705).

- PIC may be impracticable:
  - nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor.
- Unacceptable Reasons:
  - General inconvenience to the auditor.
  - Difficulty, time, or cost involved.
- 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 SAAE about the existence and condition of inventory.
- In other cases, however, it may not be possible to obtain SAAE regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Inventory Under Control of 3rd Party – If material to FS

Obtain SAAE re existence & condition

- Request confirmation from 3rd party as to quantities & condition of inventory held on behalf of entity.

AND/ OR

- Perform inspection or other audit procedures appropriate in the circumstances.

- Where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. E.g.,
    - 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.
    - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
    - Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigation & Claims

- **Inquiry -** of management & others within the entity.
- **Review –** minutes of meetings of TCWG, communication between entity & external legal counsel.
- **Review –** legal expenses account.

If RMM re litigation/ claims is identified, auditor shall **ALSO** communicate directly with entity's external legal counsel.

Direct communication with entity's external legal counsel:

- The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.
- If unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry the auditor may seek direct communication through a letter of specific inquiry.
  - A list of litigation and claims;
  - Where available, mgt's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
  - A request that the entity's external legal counsel confirm the reasonableness of mgt's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.
- In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:
  - The auditor determines that the matter is a significant risk.

  - The matter is complex.
  - There is disagreement between mgt and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

- In accordance with SA 700 (Revised), the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained SAAE on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Need for Modified opinion (SA 705)

- Mgt refuses to permit auditor to communicate/ meet with external legal counsel.
- External legal counsel refuses to respond appropriately/ prohibited from responding.
- Auditor unable to obtain SAAE by performing alternative audit procedures.

Request mgt & where appropriate, TCWG to provide written representations that:

- all known actual or possible L&C whose effects should be considered when preparing FS have been disclosed to the auditor; and
- appropriately accounted for and disclosed in accordance with the applicable FRF.

Segment Information

Obtain SAAE re presentation & disclosure of segment info in accordance with applicable FRF:

- Obtain understanding of methods used by mgt in determining segment info
  - Evaluating whether such methods are likely to result in disclosure in accordance with applicable FRF; and
  - Where appropriate, testing the application of such methods.
- Performing analytical procedures or other audit procedures appropriate in the circumstances.

- Example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information include:
  - Sales, transfers and charges between segments, and elimination of inter-segment amounts.
  - Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
  - The allocation of assets and costs among segments.
  - Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Chapter 1
Introduction and Overview

Introduction

1.1 Unlike most of the other 'Standards on Auditing' (SA) issued under Clarity Project or earlier, which deal with broad aspects of auditing concepts and procedures, SA 501 is quite unique as it focuses on auditing procedures to be performed in relation to certain selected items of the financial statements and in particular only a few assertions in relation to those items.

1.2 Therefore the requirements set out in SA 501, *Audit Evidence – Specific Considerations for Selected Items* (hereinafter referred to as "SA 501") need to be applied in conjunction with other Standards, in particular, SA 330, *The Auditor's Responses To Assessed Risks* and SA 500, *Audit Evidence*. The purpose of SA 501 is to draw the auditor's attention to the selected financial statements account balances and/or disclosures as set out in the objectives below and to establish requirements relevant to obtaining sufficient appropriate audit evidence about them.

1.3 This Guide provides illustrative guidance to facilitate auditors understand and implement the requirements set out in SA 501 by describing the principles in details and enlisting structured audit approach to achieve the objectives of the Standard.

Objectives

1.4 SA 501 deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence with respect to:

(a) Existence and condition of inventory **(Chapter 2)**;

(b) Completeness of litigation and claims involving the entity **(Chapter 3)**; and

(c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework **(Chapter 4)**.

It is noteworthy that SA 501 does not contain any modifications *vis-à-vis* ISA 501.

Effective Date

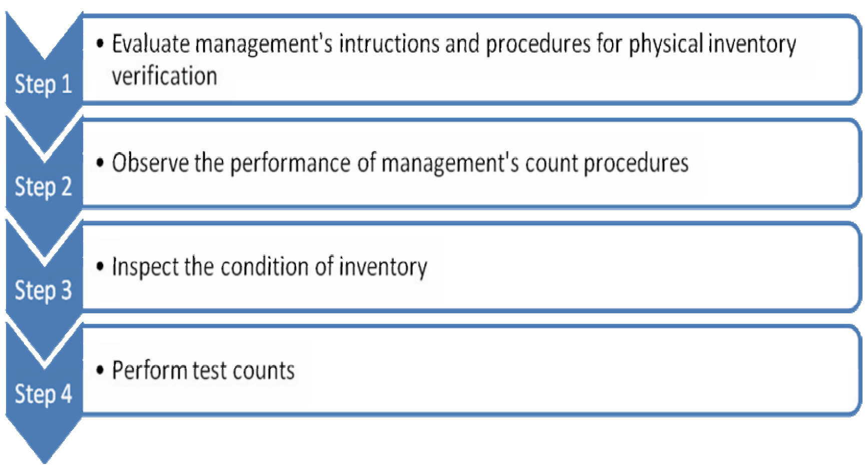
1.5 This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Existence and Condition of Inventories

1.6 In the event where inventory is material to financial statements, the auditor is required to obtain sufficient and appropriate audit evidence in accordance with SA 330, *The Auditor's Responses to Assessed Risks* regarding the assertions associated with inventory, *inter alia*, existence.

1.7 Existence of inventory could be ordinarily verified by way of attendance to management's inventory verification carried out on the date of the financial statements.

1.8 The broad steps/ procedures to be followed in course of physical verification would be as follows:



1.9 In addition, the auditor might come across following three circumstances which would have impact on the audit plan:

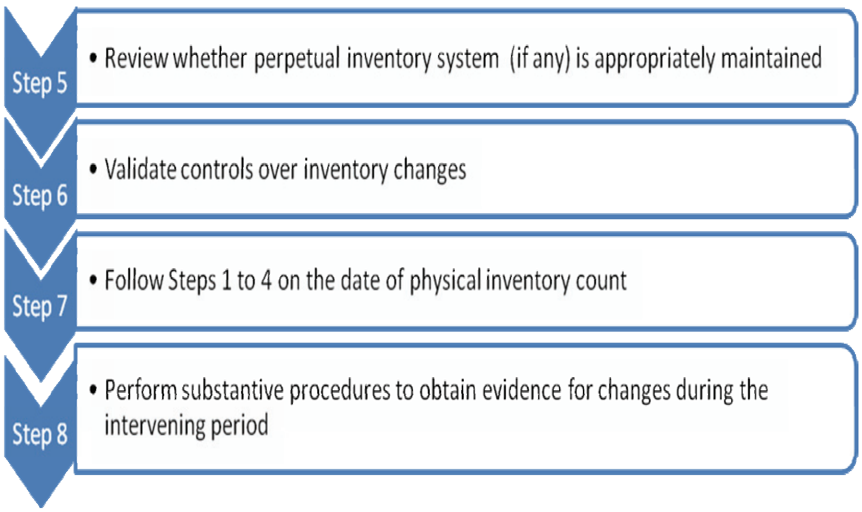
1) Physical inventory count is conducted at a date other than the date of financial statements.

2) Attendance at physical inventory counting is impracticable.

3) Inventory in the custody of a third party is material to the financial statements.

Situation 1

1.10 If the physical inventory count is conducted at a date other than the date of financial statements following additional step would need to be performed:



Situation 2

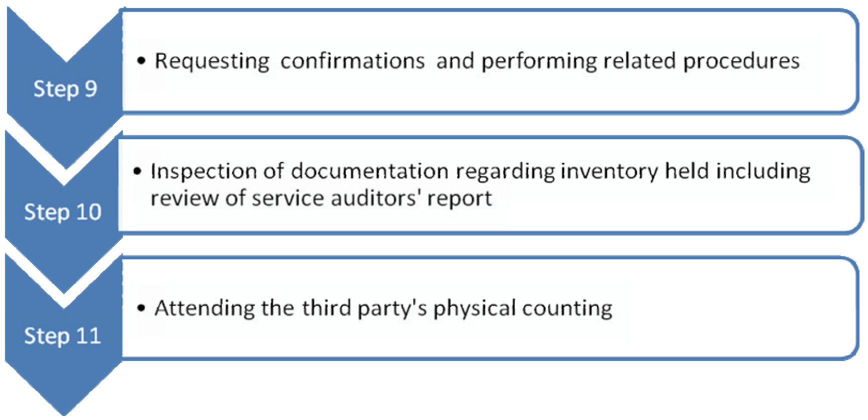
1.11 In the event where attendance to physical inventory count is impracticable due to nature and location of inventory, alternative audit procedures would need to be performed. These would include:

a) Review of the effectiveness of internal controls on inventory to validate the book records and gain comfort on existence by perusing them.

b) Inspection of documents to support purchase of such stock held at the date of financial statements as recorded in the books of the entity and also review of subsequent sale of such items of stock.

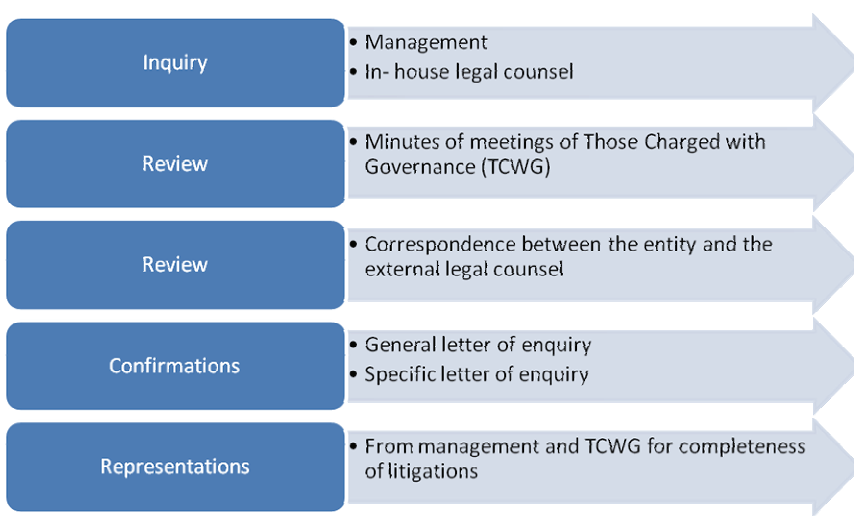
Situation 3

1.12 When inventory held by third parties is material to the financial statements, the auditor needs to perform following audit procedures:



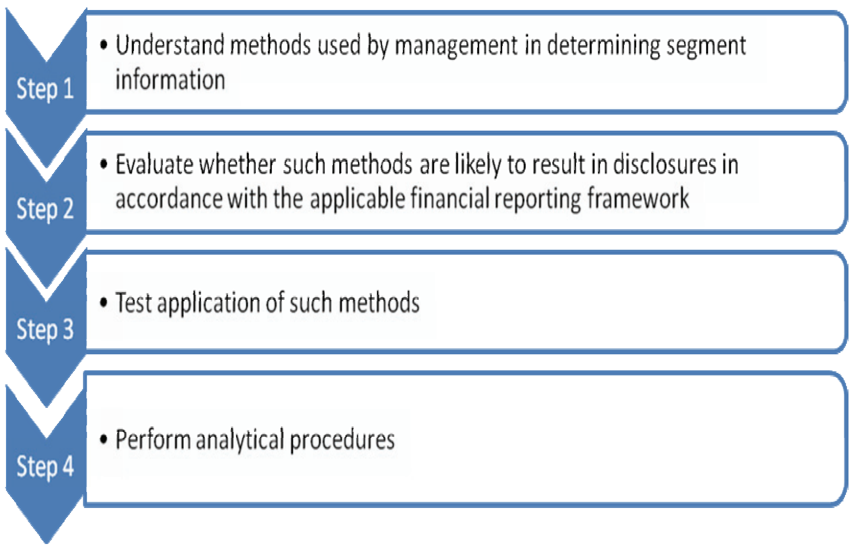
Completeness of Litigation and Claims Involving the Entity

1.13 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. Such procedures include:



Segment Information

1.14 The audit procedures in connection with obtaining evidence regarding the presentation and disclosure of segment information include following steps:



Chapter 2
Existence and Condition of Inventory

Definition of Inventories

2.1 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.

Physical Verification of Inventories

2.2 Since inventories are tangible assets, usually management ascertains the accuracy and completeness of physical quantities of inventories (denoted in numbers, measurements, weighments etc. depending on nature) through physical verification. Such verification/count is carried out at least once a year nearer to or as on the date of the financial statements to serve as a basis for preparation of the financial statements. In order to facilitate such annual stock count, management generally plans to stop stock movements wherever practicable during course of the verification.

2.3 The physical quantity of inventories is not expected to differ from the recorded stock in case records are updated regularly and accurately for all planned stock movements. However discrepancies arise between physical stock and book records on account of following reasons:

- Breakage and wastage due to improper storage/ handling.
- Natural causes such as shrinkage.
- Natural calamities and accidents.
- Pilferage.
- Inaccurate updation of book records by way of omissions. or errors or fraudulent practices.
- Mismatch between issues and receipts.

2.4 The physical verification process enables management to detect such discrepancies and adjust these in the books and records so that the stock balances which form the basis of valuation of inventories in the financial statements are not misstated.

2.5 At times management follows a structured programme of continuous stock verification wherein items of stock are verified several times during the year. Such count usually forms integral part of perpetual inventory system. As there is an element of surprise check in this system of continuous stock-taking, effective control over stock is exercised on a continuing basis. Further perpetual inventory system does not necessitate closing down of the manufacturing process or suspension of receipts and dispatches of stock to facilitate stock-taking. However in view of higher frequency, this method is expensive and is adopted by big concerns only.

Auditor's Responsibilities

2.6 If inventories are material to the financial statements, the auditor designs the audit plan to place reliance on the assertion of existence by attending the physical count carried out by management. Attendance at such inventory count provides corroborative evidence to the existence of such stock and therefore is an elementary audit procedure.

2.7 In course of audit procedures, the auditor broadly uses the following audit techniques:

Inquiry	of management whether instructions are being issued in relation to stock count procedures and for resolution of inconsistencies, if any
Observation	of compliance with management's instructions and ensuring the procedures for recording and controlling results are in line with the laid down guidance

Inspection	of inventories at the site(s) to determine these actually exist in consonance with the description and condition these are recorded in the books
Reperformance	of management's procedures by performing test counts independently
Inspection	of documents by tracing test counts to the final inventory listing considered for valuation

Timing of Audit Procedures

2.8 Usually if such physical count is carried out on the date of financial statements or a date nearer to the date of financial statements, the auditor attends such count as part of his audit plan to perform substantive procedures.

2.9 When management establishes perpetual inventory procedures, the auditor attends such count to evaluate the controls in relation to such process and considers the results of such attendance in determining the audit plan.

Impact on the Audit Plan

2.10 In planning the audit of financial statements as per guidance provided in SA 300, *Planning an Audit of Financial Statements*, the auditor is also required to plan the strategy in relation to the physical verification of inventories.

2.11 Following from that, the auditor is required to be responsive to the assessed risks of material misstatements and accordingly determine the nature, timing and extent of the substantive audit procedures to address risks identified in relation to the assertion of existence of inventories as well as determination of the condition of such inventories.

2.12 In short, the auditor exercises professional judgement to determine whether the assessed risk of misstatement at the assertion level (i.e., existence) is a significant risk and accordingly perform substantive audit procedures to specifically address this risk.

2.13 In order to determine the significance, likelihood and impact of the risk associated with the assertion, the auditor needs to consider matters which could impact the design of the audit plan. Such matters have been mentioned in the following table:

Matters for consideration	Impact on Audit Plan

Nature of inventories	Following attributes of inventories being counted have bearing on the audit procedures to be planned:
	• Categories of inventory – Inventories held by an entity can be of varied types such as :
	    • Raw materials
	    • Stores and spare parts
	    • Work-in-progress
	    • Manufactured finished goods
	    • Trading merchandise
	Specific issues wrt work-in-progress has been stated below.
	• Physical form of inventory – such as solid, liquid or gas. The basis of count and complexities would vary based on the physical form of the inventories.
	• Unit used – The unit of count or measurement or weighment would need to be ascertained and the relation between such unit and the unit used for stock valuation would need to be established. For example,

	liquid (example oil) may be measured using a dipstick in a barrel whereby the height is measured. However the circumference of the container would need to be ascertained to compute the volume of the liquid. Further the mathematical formula to compute the volume of such liquid needs to be validated. • Whether estimation procedures would need to be applied considering the dimensions of inventory or its storage. For example, quantities of coal in piles are estimated based on the dimension as well as the manner in which these are stacked. The basis of estimation is required to be established and understood to determine the reportable count. • Conditions which makes inventory obsolete or unusable – such as medicines which are rendered unusable on account of related expiry dates. In case specific expiry dates are not determined (example perishable items such as food grains), conditions which make such stock obsolete need to be assessed. The auditor is required to have sufficient understanding of the aforesaid aspects prior to attendance to the stock count in order to design the audit plan accordingly and derive requisite assurance from the procedures followed.
Stages of completion of work in progress	Manufacturing may involve multiple processes. Completion of each of these processes entails usage/consumption of

	raw materials/stores and spares which determines the stage of completion. While designing the audit plan, the auditor is required to ascertain the mechanism to determine the stage of completion by reference to the last operations performed. In case such determination is not possible independently, the auditor is required to determine the manner in which such estimate could be made. The auditor would need to evaluate whether use of an expert would be appropriate and sufficient. The controls around recording/updating stock movements (issue slips, stock tags etc.) would need to be considered while determining the stage of completion.
Risks of material statements related to inventory	The inherent risks associated with inventories arising from materiality are fundamental and as such the auditor is required to plan the attendance to stock count keeping in mind: • Value of the inventory at an aggregate level which impacts the considerations of materiality and value at individual locations. Higher coverage in terms of extent of count / locations visited would reduce the risk of material misstatement to an acceptably low level in consonance with the materiality set out for the audit. • Composition of inventories, i.e., number of inventory line items with

	divergent features. If there are multiple types of inventories, the risks associated with each of these need to be individually ascertained and addressed accordingly. • Existence of certain high value items within the stock which could be specifically covered through test counts.
The nature of internal control related to inventory	The internal control framework prevalent and the reliance the auditor places on the same is an important consideration in design of the audit plan. The key control objectives which influence the audit plan are as follows: • Inventory records are recorded with accuracy and completeness in a timely manner (i.e., within the accounting period). • All updates are appropriately authorized. • Differences between quantities received and ordered quantities per purchase orders are reviewed. • The inventory sub-ledgers are updated based on actual physical movements. • Inventory returns are completely and accurately recorded in a timely manner and appropriately authorized. • Material movements within premises *viz.*, raw materials/stores issued for production etc are completely and

	accurately recorded and appropriately authorized. • Inventory shipments are completely and accurately recorded in a timely manner and appropriately authorized. • Shipment activity is reconciled and no discrepancies exist between quantities shipped and quantities billed. • Generation and maintenance of scrap is monitored. • Receipts and shipments are adequately safeguarded. • Inventory held is appropriately safeguarded against loss from pilferage and physical deterioration. In case owing to the nature of inventories, susceptibility to theft exists, access to inventories is restricted and monitored. • Storage facilities are commensurate with nature of inventories and quantities of stock held. • Stock is subjected to periodic or continuous stock taking in terms of laid down programme. The auditor is required to understand and evaluate the controls in respect of the aforesaid processes to design the plan for attendance to stock verification. In case the reliance on controls is considered to be low, the nature and extent of testing would need to be enhanced accordingly.

Whether adequate procedures are expected to be established and proper instructions have been issued for physical inventory count	In order to validate the assertion of existence, management ensures that all items of stock are counted at least once in a year. With a view to ensure that procedures are laid down appropriately and complied with by the staff responsible for the count, management may issue instructions in relation to the stock count. The auditor is required to obtain the instructions issued by management, if any and evaluate them to ensure the key elements in which the counting needs to occur are addressed in such procedures. Related aspects have been covered in details in later part of this Chapter. While observing the count, the auditor ascertains whether the guidance and instructions are being followed by all the count teams.
The timing of physical inventory counting	As per SA 330, *The Auditor's Responses to Assessed Risks*, "Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies." If the physical count of inventories is carried out on the date of the financial statements, the auditor obtains corroborative evidence to address the risk of misstatement in relation to the existence assertion of the inventories held on that date. However, if the timing of the physical inventory count is different from the date of the financial statements, the audit

	procedures would be different. This matter has been covered in later part of this Chapter.
Whether the entity maintains a perpetual inventory system	In case perpetual inventory system is maintained, the auditor places reliance on such procedures based on following factors: • frequency of the count during the year. • completeness on coverage over entire stock during the year. • accuracy and completeness of stock adjustments based on earlier counts during the year. • appropriateness of recording stock movements. In view of continuous stock taking programme, the auditor may evaluate design and implementation of the controls and intended emphasis and reliance on the tests of controls would be higher. Related aspects have been covered in later part of this Chapter.
The locations at which inventory is held	The entity may maintain inventories across multiple units such as: • separate areas within factory premise earmarked for raw materials and finished goods. • different manufacturing units. • different storage facilities. In case stock is held at multiple locations, coverage of locations for the purpose of audit is usually determined

	based on following considerations :- • Value/volume of inventories at individual locations. • Nature of inventories across each of the locations. • Reliance placed by auditor by evaluation of controls around inventory recording in all locations. • Usage of common principles by count teams across locations. • Past experience of auditors in respect of certain locations being susceptible to errors/frauds with regard to inventories. In terms of SA 330, *The Auditor's Responses to Assessed Risks,* "the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively." The auditor would follow such procedures (evaluation of tests of controls and gain assurance from such procedures) in relation with the locations where the auditor does not personally attend the stock count in order to obtain reasonable assurance on existence of stock in such locations. In determining the number of locations to be covered, the auditor may also use sampling techniques enlisted in SA 530,

	Audit Sampling. However if the auditor assesses risk of misstatements on account of susceptibility to errors/frauds experienced in the earlier periods of audit, the auditor shall maintain professional skepticism and plan to increase the coverage in accordance therewith. In such case, the auditor is required to follow the procedures laid down in SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements'.* Such procedures would include consideration of unpredictability in determination of locations by attendance to stock count at different locations or visit on an unannounced basis or target locations which would not otherwise be visited due to the immateriality of stock balance.
Whether the assistance of the auditor's expert is needed	At times on account of unique attributes and nature of the inventories (such as oil, minerals etc.), the skills of an expert might be essential. The guidance of involving an expert is provided in SA 620, *Using the Work of an Auditor's Expert* and key aspects of this SA are elucidated below. The assistance by experts could be provided both by 'management's experts' as well as 'auditor's experts'. In case management uses an expert, the auditor's decision to use independent 'auditor's expert' would depend upon the nature, scope and objectives of the work; extent of influence by management on

	the expert and controls within the entity over the management expert's work. The auditor may agree with the management on using the management's expert or using independent expert based on the prevalent circumstances. Competence (nature and level of expertise to provide assistance in physical verification of inventories), capabilities (abilities of the expert to exercise such competencies in the circumstances of the engagement) and objectivity (possible effect of bias and conflict of interest applicable to the assignment) of the expert significantly affect whether the work performed by the expert will be adequate for audit purpose. These considerations would enable the auditor to plan the nature, extent and timing of supplemental audit procedures. The auditor would need to agree on the nature, scope and objectives of the work, documentation/accessibility to working papers as well as respective responsibilities with the expert. It is also imperative that the confidentiality and other related regulatory requirements applicable to the audit of financial statements also apply to the expert. The auditor is required to evaluate the adequacy of the work performed by the expert. Specific procedures to be performed in this connection would include observation of the procedures

	followed by the expert during the course of physical verification of inventories, inquiries about process/ procedures followed, corroborating evidence through reperformance, confirming with third parties or publicly available data (where possible) as well as discussions with management. Factors when evaluating the relevance and reasonableness of the findings or conclusions of the expert include whether the report is consistent with industry standards, extent of reservations/limitations on use of information provided by the expert and related implications for audit. Where the verification of inventories involves assumptions and methods used by management, the auditor would evaluate whether the expert has adequately reviewed the assumptions and methods in accordance with any industry standards or consistent with assumptions and methods generally accepted within the expert's field. If the auditor is not satisfied with the conclusions of the expert or the results are inadequate for the purpose of audit, the auditor may plan alternative audit procedures by both expert and the auditor. In case the auditor had earlier planned to use the management's expert but considers the results to be inadequate, the auditor may engage independent 'auditor's expert' to support the audit. However if it is not possible

	under any circumstance to obtain requisite audit evidence, the auditor may need to express a modified opinion in keeping with SA 705, *Modifications to the Opinion in the Independent Auditor's Report'.*

2.14 As part of the execution of the audit plan designed in accordance with aforesaid matters, the auditor needs to perform following procedures.

Step 1: Evaluate Management's Instructions and Procedures for Physical Inventory Verification

2.15 Management may issue instructions for the personnel responsible for count to ensure the count procedures are clearly articulated and consistently followed. Such instructions enable the counters to follow uniform approach across all locations in the expected manner and also provide comfort to the auditor to place reliance on the procedures being followed across locations not being visited by auditors.

2.16 In large multi-locational organisations, written instructions are prepared by management and issued in a timely manner. The auditor is required to obtain such instructions and take cognisance of its contents well in advance to evaluate its impact on the nature, extent and timing of audit procedures in relation to attendance at the stock count. In case verbal instructions are provided by management, the auditor is required to enquire and gain understanding of such instructions. The auditor may plan to attend the session when instructions are verbally issued to the counters.

2.17 Ordinarily the auditor expects following elements to be included in the instructions issued by management:-

- *Coverage of locations* – Usually management ensures that all items are counted at least once a year so that monitoring controls designed by the entity around stock recording/existence operate in an effective manner. In case there are multiple locations where stock is held, management would deploy different teams of stock counters so that complete coverage across locations is ensured. If all locations are not included in the annual stock count, the auditor is required to understand and assess how management gains comfort on the existence and condition of stock at such locations not covered by the count.

The details of the locations being covered in the annual stock count therefore needs to be mentioned in the instructions.

- *Arrangement of stock* – Inventories need to be stacked or positioned in a manner to facilitate the count with ease and accuracy. For example, inventories of similar nature and units could be assembled together in advance of the physical count in order to gain efficiency during the count. Further if stock cards are maintained, such cards should be updated and displayed prominently in the stock bays.

  Instructions to the stock keepers to arrange stock properly prior to count also feature in the count instructions.

- *Duration of count*–The date(s)/timing of the count together with the estimated duration when the count is expected to be performed sets out the overall timeframe of the physical verification. In particular, where the size of the entity and volume of stock warrants stock count to continue over multiple days, it is necessary to plan the expected extent of the count in respect of each of the days.

  Such duration and coverage together with intervals need to be included in the count instructions.

- *Persons responsible for various locations and competencies of such staff* – The personnel responsible for physical count should be familiar with the description of the stock and capable of identifying all items of inventories independently. The auditor would take into account competencies of staff based on the team composition for each location. It is also essential that such instructions are communicated to all staff concerned prior to the commencement of count.

  Details of staff concerned (designation wise) could be mentioned in the instructions. Further the auditor is also required to ensure that such count instructions have been duly approved and stock count is planned to be held under appropriate supervision. The names of supervisory staff and escalation matrix for the purpose of stock verification are included in the instructions.

- *Segregation of duties* – In order to maintain objectivity, it is ideal that the counters are independent of those who are responsible for maintaining stock records as well as the stock keepers.

  The auditor ensures this with reference to the staff list referred to above.

- *Coverage / extent of count* – The minimum threshold of the count at each location should be specified in the instructions, in case it is impracticable to count all items of stock on the same day. Under such limitation, the auditor is required to make an assessment on the comfort gained from count procedures and also evaluate controls around perpetual inventory system, if any.

  In case such reduced coverage is planned, this needs to be specified in the instructions.

- *Identification procedures for damaged items of inventory* – The criteria for distinguishing damaged/ defective items from the rest of inventories needs to be established and mentioned in the instructions. It is fundamental to identify all such items conclusively in view of the impact of these items on the inventory valuation which is at lower of cost or net realisable value. The stock counters should also possess the ability to identify such items independently.

  The objective procedures to identify the condition of the inventory and the parameters involved in such assessment should be stated in the instructions in clear terms.

- *Determination of slow moving items* – The criteria for identifying slow moving items within inventories with reference to last date of consumption/ sale (as the case may be) *vis-à-vis* date of manufacture / purchase needs to be stated. Identifying such stock items is fundamental to determine slow moving/ non-moving stock and obsolete stock items and consequential impact on stock valuation at lower of cost and net realisable value.

The ageing criteria to be referenced to identify such stock items should be stipulated in the instructions.

- *Consideration of inventories held on behalf of third parties* – Along with the stock owned by the entity, third party owned stock may also be physically present in the locations of the entity at the time of the physical verification. Such stock includes stock sold but not dispatched, consignor's stock at locations of consignee, components /parts received by the sub-contractor from primary manufacturer for performing further manufacturing process, stock received for repairs etc.

  In order to ensure the accurate count of inventory, such stock should be excluded from count. The instructions should provide guidance on identification of such items during the count. The instructions should also state that such items be physically segregated from the stock owned by the entity.

- *Basis of estimation used* - Due to the nature of inventories, estimations may be used to determine the weighment and measurement of the stock. Such estimation techniques need to be consistently followed and should be in line with the accepted industry standards.

  The instructions should include the basis / assumptions for the estimates so that uniformity can be ensured.

- *Controls around cut-off procedures* – Based on accounting methods followed to recognise ownership of stock by the entity, management would need to include / exclude the items of stock from records maintained and also establish requisite cut off procedures so that all stock held by the entity are subjected to physical count.

  Since such information would have significant bearing in ensuring completeness of stock balance, the related principles need to be indicated in the instructions.

- *Controls over stock movement during stock count* – Usually management ensures stock movement are restricted or temporarily suspended during the course of physical verification. This facilitates to determine the exact quantity of the inventories. In case stock movements (viz., receipts of purchased goods, dispatch for sales or issuance of raw materials to manufacturing facilities) occur simultaneously while physical verification takes place, there may be errors arising from omissions or duplications which would make the count procedures ineffective. Therefore it is preferred to temporarily stop stock movements to perform physical verification in an effective manner.

  However, if stock movement is expected to continue during stock count, the manner, timing and area of such would movement should be planned in advance so that counting procedures are not adversely impacted with the simultaneous movement of stock. The auditor is required to be aware of all related information in advance as an integral part of the instructions.

- *Count recording procedures including accounting for used and unused count records* – Since the counting procedures necessitate recording of the count, it is imperative to determine whether pre-numbered count sheets would be used and how the used/unused count sheets would be collected and accounted for.

  The directives for recording and tracking of the count sheets should therefore be enlisted in the count instructions.

- *Method of summarising count results from the original count sheets / tags* – The count results recorded in rough count sheets by counters at different locations need to be compiled together so that the concise quantity of the inventories could be determined. In particular, the hand written notes and counts need to be aggregated / summarised to facilitate the process. Loss of such papers and recording the information in an unusable / illegible manner would not enable management to finalise the results of the verification.

The procedures to perform such process need to be laid down in the instructions for physical inventory counting. In absence of these instructions, the collation process may be inconsistent across locations and determination of results of physical verification may not be timely.

Evaluation of Instructions

2.18 The auditor ordinarily expects the aforesaid factors to be included in the count instructions depending on the nature of inventories and size of the business. In absence of any of these factors which are relevant for the entity, the auditor is required to enquire of management of the approach to be followed by counters in relation thereto.

2.19 In order to ensure that the count procedures are performed in the desired manner, the auditor might also discuss the features of the instructions with the counters prior to commencement of the verification and agree upon the procedures with management in advance.

Step 2 - Observe the Performance of Management's Count Procedures

2.20 SA 500, *Audit Evidence* defines 'Observation' as "looking at a process or procedure being performed by others. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed."

2.21 Observation is a real time procedure and since it cannot be reperformed at a later stage, the audit strategy in relation thereto needs to be appropriately designed in advance to determine the audit evidence required to be gathered during the process and requisite documentation to record such evidence.

2.22 In course of observation of the performance of management's count procedures, the auditor is required to ensure:

- Management's instructions, if any, in relation to stock count procedures have been complied with.
- In absence of formal instructions, the auditor is required to ensure the procedures followed by the counters address the risks associated with stock count.

2.23 At times, the entity might use computer-enabled hand held scanners to record inventories directly and physical count sheets are not necessary. In such circumstances, the IT general controls and automated controls need to be evaluated to ensure computerised inventory records have correctly updated.

2.24 Suggested checklist which could be used for the purpose of ensuring the appropriateness and completeness of requisite audit procedures in relation to physical verification of inventories has been set out in **Appendix 1** of this Guide.

Cut-off Information

2.25 In addition, the auditor is required to obtain copies of cut off information (both receipts and dispatches) to perform subsequent audit procedures over accounting for stock movements and establish ownership of inventories. Such information is critical to determine accuracy of revenue recognition or ownership of the stock held by the entity on the date of the count.

2.26 Following items need special emphasis while obtaining the cut-off information:

- Stock already sold but not dispatched which would lie within the locations of the entity but would no longer form part of the inventories. The auditor is required to examine the sales invoices and dispatch documents to ensure such stock are excluded from count.
- Stock received at the last moment from suppliers would

form part of inventories (in case the quality / quantity has been accepted) however all related documents (say supplier's invoice) might not be readily available. The auditor is required to examine the inward receipts to ensure such item has been inventorised and counted. In case the stock items are likely to be rejected on account of quality parameters, such stock should be specifically segregated and not included in the stock listing.

2.27 Suggested template to record cut-off information in course of physical count of inventories has been set out in **Appendix 2** of this Guide.

Step 3 - Inspect the Condition of Inventory

2.28 As per SA 500, *Audit Evidence*, inspection is one of the procedures to obtain audit evidence and such procedure includes physical examination of assets. Inspection of tangible assets may provide reliable audit evidence with respect to their existence in the present form.

2.29 However such procedure does not provide any reasonable assurance about the entity's rights on the assets (ownership) or the valuation of the assets. For instance, if an entity holds stock already sold to customers awaiting despatch which is no longer owned by the entity, such stock could be physically present and therefore could be subjected to inspection at such location of the entity however the entity would not have ownership rights of such items of inventory. Similarly, the valuation of inventory determined in accordance with accounting policies followed by the entity would not be ascertained by mere inspection of such stock.

2.30 But inspection of such inventories facilitates assessment of 'condition' of such inventories which has a bearing on the valuation of inventories. 'Condition' would indicate the usability and marketability of the inventories and assessment of these attributes are essential to ensure that the valuation of inventories is not materially misstated. In particular, it is fundamental to identify the damaged / defective stock (example, broken or unworkable items) and obsolete items (example, non moving stock with reference to ageing or perishable items exceeding expiry dates) so that adjustments could be made to value such stock at net realisable value (which might be lower than cost on account of non-usable condition).

2.31 SA 501 requires the auditor to obtain sufficient appropriate audit evidence about the existence and 'condition' of inventory. 'Condition' is not an assertion in terms of SA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and 'condition' is also not equivalent to 'valuation' although there is a direct correlation between 'condition' and 'valuation' as mentioned above. However 'valuation' of inventories is beyond the scope of the Standard therefore the principles surrounding valuation are not covered in this Guide.

2.32 Stock verification enables the auditor to determine, as far as the auditor is able to ascertain, the condition of the inventory held. Assessing apparent condition of stock provides the auditor with an opportunity to assess any distinct requirement for devaluation of stock.

2.33 At times the condition of the stock may not be ascertainable by mere observation by the auditor. Also on account of the nature of stock it may not be possible for the auditor to determine the condition of inventories in some cases. In both these circumstances, the auditor may involve an expert in line with guidance provided in SA 620, *Using the Work of an Auditor's Expert*.

Discrepancies Noted during Count

2.34 It is imperative to ensure that the stock records reconcile to the stock so counted in terms of both the quantity as well as condition. In case adjustments are required due to shortage / surplus / change in condition, the auditor is required to ensure that such discrepancies are noted / collated and adjusted in the inventory records. Such adjustments may occur immediately prior to the completion of the inventory verification or may happen at a later date depending on the accounting systems and approval process followed by the entity.

2.35 In this regard, the auditor is also required to assess whether any inherent weakness is identified in this process which may have a bearing on the financial statements. If any major control weakness is identified in course of the verification, the auditor may consider whether to report the same separately.

Step 4 - Perform Test Counts

2.36 Based on the audit plan, the auditor would determine the extent of coverage during the stock count and test checks to be performed to independently obtain reliance on such procedures. Such reperformance of the management's procedures would in effect supplement the observation on the management's count procedures and in turn provide additional corroborative evidence to the auditor.

2.37 In this regard, the test count would have to be carried out in following manner:

a) *Recounting items of inventory recorded as 'counted' by management.* Such test counts provide evidence that counting has been performed with accuracy. This is an elementary procedure to support existence of stock and provide reliance on the recordings on the count sheets by the counters.

   In case the auditor notes that results of independent recount of stock does not agree with management's count, such discrepancy (which might arise due to inappropriate understanding and application of instructions / methods, omissions/ duplications, issues with overall control over the count etc) needs to be resolved on a real time basis. In case rectification is necessary to be made to the management's records or it is felt that there are fundamental errors with following instructions, the auditor is required to assess whether any reliance could be placed on the entire count procedures. In such case, the auditor may consider the option of requesting management for a fresh recount to get reasonable assurance on the accuracy of the count.

b) *Independently counting items from floor and tracing the same to management's count records* – Apart from recounting certain items as mentioned above which supports the assertion of accuracy, the auditor is also required to ensure the listing used for the purpose of the counting is complete. This can be validated through independent counting of certain items on the floor and tracing them back to the count sheets.

In case such an item counted is not found in the listing or results of the count does not agree with the count sheets, the auditor would need to assess whether the population being considered for such count (represented by the inventory listing) is complete and therefore would bring the facts to the notice of the counters immediately. These would have to be reconciled as these might pertain to stock held on behalf of third parties, items on repair etc. However instances of genuine omissions might indicate that the inventory records are not reliable.

2.38 Both these aforesaid procedures enable the auditor to validate different assertions and are essential to meet the objectives of the count. The auditor cannot plan to obtain reasonable assurance on the existence of inventories just on the basis of observation of the count carried out by the management. The test checks performed in this manner provides evidence to this effect.

2.39 SA 501 does not suggest the number of stock items to be counted either way; the auditor is required to apply professional judgement to determine the number of test counts. Based on the criteria influencing the count (such as number of locations, counters, stock items etc.), the auditor might distribute the aggregate test counts across these criteria so that coverage across all such attributes is considered. Each such distinguishing parameter might have different risk considerations associated with them and would need to be addressed separately in terms of coverage. In case of homogeneous population, the entire stock balance could be considered as a single unit.

2.40 When the auditor requires higher degree of evidence in support of the existence, the number of test counts would need to be increased commensurately. The auditor might use audit sampling techniques in accordance with SA 530, *'Audit Sampling'* to determine the sample size to be counted and satisfy on a real-time basis that the procedures as designed have been followed and the results are recorded with accuracy and completeness.

2.41 Sample format to record test counts by the auditor has been set out in **Appendix 3** of this Guide.

2.42 Certain decisions might need to be taken in course of the stock verification depending on the circumstances on a real time basis and therefore it is imperative that the audit team attending the stock count is appropriately experienced and skilled to exercise such professional judgement.

Completion of the Count Procedures

2.43 Prior to the completion of the count process, the auditor might also obtain following:

- Representation from counters and their supervisors that instructions issued by management in connection with stock verification have been followed.

- Signed copies of management's final and completed physical inventory count records which the auditor would use subsequently to determine the entity's final inventory records accurately reflect actual inventory count results.

Tracing counts to final inventory records used for stock valuation

2.44 In course of the substantive audit procedures performed subsequently, the auditor is required to ensure that inventory counted during physical verification is accurately and completely recorded in the final inventory listing. The extent of such subsequent testing would depend on the related controls and the level of assurance the auditor seeks from such tests.

2.45 The procedure could be performed in following manner:-

- Trace certain items from the count sheets to the final inventory listing to ensure accuracy.

- Trace certain items from the final inventory listing to count sheets to ensure completeness. 2.46In case discrepancies are noted either way, the auditor is required to inquire management of the reasons and get the final inventory listing updated in all respects.

Physical inventory Count is Conducted at a Date Other the Date of the Financial Statements

2.47 For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may happen irrespective of when:

- Management determines inventory quantities by an annual physical inventory counting.

- The entity maintains a perpetual inventory system.

Steps 5 to 7 - Perpetual Inventory System

2.48 Where a perpetual inventory system is maintained, an entity would use periodical counts to ensure all items of inventory are counted at least once during the year and some items (particularly high value ones) are counted several items during the year. Such periodical counts provide assurance to the management about the existence of stock on an ongoing manner and no major surprise from shortage / surplus on physical verification occurs at the date of financial statements. Such procedure form part of the control framework management intends to set up. In accordance with such plan, the differences which are noted during the periodical physical counts are investigated and reconciled on a timely manner and adjusted in the accounting records.

2.49 Testing the effectiveness of the periodical counts where perpetual inventory records are maintained is therefore a predominantly a test of control. While performing the test, the auditor performs following:

- Evaluate controls over the perpetual inventory process, i.e., recording of stock movements on timely manner.
- Testing whether the discrepancies in periodical stock count during the year has been reconciled and adjusted on a timely manner.
- Attendance to certain counts and observing the procedures followed.

2.50 In course of determining the extent of testing of such controls, the auditor is required to take cognisance of:

- Completeness and frequency of perpetual inventory system covering all items of stock / locations.
- Effectiveness of the count procedures, *viz.*, approved plan for counts, availability/compliance with instructions, capabilities / objectivity of counters, procedures followed, records maintained (count sheets, results).
- Reliability of the entity's perpetual inventory records.
- Appropriateness of adjustments including reconciliation process and relative approval mechanism.

2.51 In some cases, the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively. In such case, the reliance expected to be placed on the process would diminish accordingly and substantive audit procedures in form of tests of details would have to be performed.

Step 8 - Additional audit procedures if physical verification is held at a date other than date of financial statements

2.52 In case the annual stock count is performed at a date other than the date of financial statements, the auditor is required to perform substantive procedures to ensure that the stock balances reflected at the date of financial statements are in consonance with the balances counted at the time of the physical verification. The auditor needs to assess the reliance to be placed on the controls over inventory movements and perform procedures to verify movements during the interim period between the date of the stock count to the date of the financial statements.

2.53 It is fundamental to evaluate the operating effectiveness of controls during the intervening period to determine the extent of testing through use of audit sampling techniques or otherwise. The inherent and fraud risks and susceptibility of errors assessed based on past experience would also need to be considered. The effectiveness of the process would also be dependent on the time gap between the interim assessment of existence and the date of the financial statements.

2.54 In terms of reperformance, the movements of stock in nature of receipts and issues during the intervening period need to be adjusted to derive the expected closing balance of inventories at the date of the financial statements. Such reperformance and verification of underlying information with sufficient appropriate audit evidence (purchase and sales documentation) would provide reasonable assurance on the stock balance reported at the date of financial statements.

2.55 Adjustments of such nature could occur in following manner:

a) If the stock count is held prior to the date of the financial statements and physical balances need to be roll-forward, the adjustments would be :

	Balance physically verified as on date of stock count
Add:	Receipts from the date of stock count to the date of financial statements
Less:	Issues from the date of stock count to the date of financial statements

	Expected stock balance as on date of financial statements

b) If the stock count is held subsequent to the date of the financial statements and physical balances need to be roll-back, the adjustments would be :

	Balance physically verified as on date of stock count
Add:	Issues from the date of stock count to the date of financial statements
Less:	Receipts from the date of stock count to the date of financial statements
	Expected stock balance as on date of financial statements

2.56 Based on aforesaid calculations, the auditor would be able to determine the expected stock balance at the date of the financial statements. In case differences are noted between such derived stock balance and the stock listing used by management for the purpose of financial statements, the auditor would request management to reconcile the difference.

Attendance at physical inventory count is impracticable

2.57 In certain circumstances, attendance at physical inventory counting may not be feasible. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. However such instances would be exceptional as ordinarily it would be possible for the auditor to attend such count.

2.58 In case of multi-location audit (i.e., when inventories are held in multiple locations), the auditor would determine the extent of coverage in terms of locations where attendance is necessary based on assessed risks.

2.59 While considering rationale for not attending physical count, the auditor should merely not consider general inconvenience or difficulties in arranging staff to attend counts in multiple locations. SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Standards on Auditing* clarifies that "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". SA 200 further states that "there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise. Consequently, it is necessary for the auditor to plan the audit so that it will be performed in an effective manner."

2.60 However if attendance is actually impracticable, alternative audit procedures are performed to ensure that alternative audit evidence is obtained to ensure validation of existence of inventories in appropriate conditions.

2.61 Such audit procedures include:

- Evaluation of control design in respect of inventory process and testing whether such controls have operated effectively during the period of audit. Such controls would encompass the processes around purchase and sales which eventually impact the stock balance held at the date of the financial statements.
- Verification of documentation supporting purchases and subsequent sale of specific inventory items. These procedures would indirectly provide evidence that stock balance which was not physically verified actually existed as on the date to enable subsequent sales and indirectly support and corroborate the assertion of existence.

2.62 Extent of such testing would be determined based on the materiality of the inventories not being subject to physical count, risks of non-existence envisaged based on past experience and the control environment prevalent in the entity.

When sufficient appropriate audit evidence is not obtained

2.63 However, in some rare instance, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventories and the aforesaid alternative audit procedures cannot be performed effectively. This would happen when the reliance on controls around the procurement process is not strong and the inventories held at the end of the period of audit might not have been sold in the subsequent period and no other evidence exists to support existence of the inventories. In such infrequent occasions, the auditor may consider implications in keeping with SA 705, *Modifications to the Opinion in the Independent Auditor's Report.*

Inventory under the Custody and Control of a Third Party

2.64 On certain occasions, stock could physically be held under the custody of parties other than the entity which owns the stock. Instances when such situations arise could be as follow:

- Bonded warehouses and godowns for storage purpose.
- Sub-contractors for manufacturing process.
- Consignees for sale.
- Clearing and forwarding agents.
- Stock sent to manufacturer for repair or servicing.

2.65 In these circumstances, the entity owning the stock has limited control on the physical custody of the stock. The locations where such inventories are held are also different from that of the entity. The auditor ordinarily has no direct access to these items of stock and generally does not attend the physical count of inventories held in such locations. Under such circumstances, the auditor is required to obtain alternative audit evidence to support the existence of inventories.

2.66 An effective audit procedure to obtain reasonable assurance in this regard is through obtaining confirmations from the third party who is the custodian of such stock. SA 505, *External Confirmations* outline the requirements and provides guidance for performing external confirmation procedures. Related guidance in this regard has been described below.

Step 9 - Salient Features of Confirmations Process

- *Requesting confirmations* - Such auditing procedures would include requesting information of inventory balances from the third parties physically holding the stock. These could be generally through positive external confirmation requests asking the third party to reply directly to the auditor, either by indicating the confirming party's agreement with the inventories balances stated in the confirmation requests, or by asking the confirming party to provide information of stock held by them. The extent of coverage for such procedure could be determined by using the principles laid down in SA 530, *Audit Sampling*.

  Suggested template which auditor could use for requesting such information has been set out in **Appendix 4** of this Guide. The template has been designed in order to request positive confirmation of balance held by third parties. The auditor is required to customise the template in case he plans to send a negative confirmation request (a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request).

- *Limitation on circularisation of confirmations* – In case management does not allow the auditor to send a confirmation request to the third parties holding stock on behalf of the entity, such refusal may be considered as a limitation on audit evidence the auditor may wish to obtain and may be indicative of fraud in certain cases. The auditor is therefore required to inquire as to the reasons for the exclusion of those third parties and validate the reasonableness of the reasons.

- *Responses and results* – If the third parties respond to the auditors directly and the information provided thereby is in agreement with management records, the auditor may consider this is sufficient appropriate audit evidence. However in case of unreliable / contradictory responses as well as non-responses, the auditor may need to gather evidence through alternative procedures as stated below. In this connection, the auditor may also need to evaluate whether a fraud risk factor exists in accordance with SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements.*

Steps 10 to 11 - Additional Audit Procedures

2.67 Depending on the circumstances, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party.

2.68 Examples of other audit procedures include:

- 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. Such test would enable the auditor to assess whether any reliance could be placed on the information provided by the third party.

  SA 402, *Audit Considerations Relating to an Audit Using A Service Organisation* sets out guidance in relation to the assurance the auditor can place on the design effectiveness and operating effectiveness of controls at service organisation.

- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts and dispatch notes. Based on the reliance placed on control framework, examination of records would provide greater comfort to the auditor on the existence of inventories held by third parties. The auditor would have to determine the level of comfort required and reliability of evidence while performing such procedure.

- Requesting confirmation from other parties when inventory has been pledged as collateral. Such situation would arise where the inventories are collaterally held by banks/ lenders who provide financial assistance to the entity and independent stock audits are held to corroborate the assertion of existence/ valuation on a periodical basis.
- Arranging for another auditor to attend, the third party's physical counting of inventory, if practicable in accordance with SA 600, *Using the Work of Another Auditor*.
- If practicable, the auditor can attend the stock verification carried out at the third party locations and observe the count / perform other audit procedures. This would enable the auditor to corroborate the inventory balance independently. Such consideration would however depend on the requisite access to such locations at which such inventories are maintained by third parties and presence of management representatives along with the auditors.

Chapter 3
Completeness of Litigations and Claims Involving the Entity

Litigations and Claims

3.1 Every entity is required to be compliant with the legal and regulatory requirements it is subjected to. Further every entity also needs to adhere to the terms and conditions of the major contractual obligations it has entered into in course of its business.

3.2 In relation to the above, there may be a number of litigations and claims involving the entity, for example, disputes with tax authorities on claims against the entity or litigations by regulatory authorities on legislative matters or lawsuits for breach of contractual arrangements. In view of the nature and magnitude of such claims, at times these individually or in aggregate may have material effect on the financial statements.

3.3 *SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* provides guidance relevant to the auditor's considerations of litigations and claims requiring accounting estimates or related disclosures in the financial statements (for example, accounting estimates on amount and timing of cash flows being dependent on the uncertainty around judgement in a litigation).

Completeness of Litigations and Claims

3.4 SA 501 states that the objective of the auditor is to obtain sufficient appropriate audit evidence regarding the completeness of litigations and claims involving the entity.

3.5 In order to ensure this, the auditor is required to gain understanding of the regulatory framework within which the entity operates and be aware of the developments within business operations using the guidance provided in SA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.*

3.6 Based on such preliminary assessment, the auditor is required to perform the following steps at a minimum to identify the litigations against the entity:

Inquiry of management	The auditor needs to seek information from the management about existence of claims and litigations against the entity and obtain a list from management which has been considered for the purpose of preparation of financial statements. Such queries need to be made to both financial and operational management. There could be lawsuits against the entity which would have no financial implications. In such cases the auditor would inquire of management how such assessments have been made. The auditor also needs to assess how the lawsuits are reported to management and evaluate the controls around such process of identifying claims. While performing such audit procedure, the auditor would be able to ascertain whether the litigations considered by management (in particular the financial staff who are responsible for accounting and disclosure of such litigations) are accurate and complete in all respects. In this connection, the auditor may also obtain copies of significant contractual arrangements entered into by the entity including arrangements for banking, loan and guarantees. The auditor is required to review such documents to identify whether potential non-compliance of the related covenants could result in litigation against the entity. The auditor is required to ensure that the accounting implications of the litigations have been duly considered. For this purpose, the auditor would need to assess the probable outcome of each such litigation through appropriate inquiry and review of corroborative documents. The

	probable outcome would play a key role in accounting and disclosure of such litigations in terms of the applicable financial reporting framework.
Inquiry of in-house legal counsel	In case the entity maintains an internal legal cell or engages an in-house legal counsel who oversees and handles litigations against the entity, the auditor may be able to obtain the comprehensive list of all claims from such counsel. In case tax related matters are separately handled by in-house tax department within the entity, the auditor would need to probe the facts from such cell. In case there are discrepancies between the list considered by management and the list maintained by the in-house counsel, the auditor is required to gain comfort over the process of transmission of relevant information to the finance department.
Reviewing minutes of meetings of Those charged with governance	Generally all key matters including major litigations the entity is involved in are brought to the notice of Those charged with governance by the management. The summary of discussions and decisions taken in the meetings of Those charged with governance are recorded in the minutes of the related meetings. The auditor is required to inspect the minutes of all such meetings held during the period of financial statements and subsequent period thereof to ascertain the completeness of the list of litigations. In case the auditor identifies references of litigations in the minutes of meetings which are not included in the list provided by management, the auditor is required to inquire the management as well as Those charged with governance for clarifications.
Reviewing	In case the entity appoints external legal

correspondence between the entity and its external legal counsel	counsel to represent the entity in litigations and other legal matters, the auditor is required to inspect the correspondence between the entity and the legal counsel. The auditor would be able to gain understanding and perspective of the matters including the terms of reference, the progress made so far as well as probable outcome of the litigations by reviewing these correspondence.
Reviewing legal expense accounts	Another test which the auditor would be able to perform to identify the litigations is through review of the legal expenses incurred by the entity. The auditor may scrutinise legal expenses accounts and trace the expenses incurred to the supporting documents, i.e., invoices from external legal counsels. The auditor would be able to gain comfort on the existence of relationship with any legal counsel by way of such procedure. However such procedure would be required in case the auditor places less reliance on the audit evidence obtained from all the aforesaid procedures.
Obtaining management representations	The auditor is also required to request written confirmation from management and 'Those Charged with Governance' in keeping with SA 580, *Written Representations* that all known actual or possible litigations and claims which have impact on the financial statements have been disclosed to the auditor and have also been accounted for / disclosed in accordance with applicable financial reporting framework.

Communication with the Entity's External Legal Counsel

3.7 Subsequent to aforesaid procedures, the auditor may identify risks of material misstatements around litigations and claims, for example, in case it is envisaged that the probable outcome of the litigation may have significant financial consequence including impact on going concern assumption. In certain cases on account of inconsistent information provided by management, the auditor may not have adequate comfort on the completeness of list of litigations provided by management. Under such circumstances, the auditor may evaluate whether direct communication with the external legal counsels are necessary for the purpose of the audit.

3.8 Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims have been properly identified and management's estimates of the financial implications of such litigations, including cash flows and costs, are reasonable.

3.9 For the purpose of identifying external legal counsel, any legal counsel who handles legal matters of the entity needs to be considered. These might even include counsels who are infrequently used by the entity.

Procedures of Direct Communication with External Legal Counsel

3.10 In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry.

3.11 For this purpose, a letter of general inquiry requests the entity's external legal counsel to inform the auditor of the following:

- any litigation and claims that the counsel is aware of.
- an assessment of the probable outcome of the litigation and claims.
- a reliable estimate of the financial implications, including costs involved.

3.12 Suggested template of a general enquiry letter to the entity's external legal counsel is included in **Appendix 5** to this Guide.

3.13 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.

3.14 For this purpose, a letter of specific inquiry includes:

- a list of litigation and claims as provided by management;
- where available, management's assessment of the probable outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- a request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

3.15 Illustrative template of a specific enquiry letter has been set out in **Appendix 6** of this Guide.

Evaluation of Responses Received from Legal Counsels

3.16 Estimates and disclosures considered by management relative to the litigations and claims need to be validated based on responses received from legal counsels in form of the letters of general / specific enquiry.

3.17 For this purpose, the responses would need to be understood properly and disclaimers with reference to scope of work performed as well as representations made by the counsels would have to be comprehended with clarity to assess the actual circumstances. In case of ambiguous responses, further information might need to be sought through a letter of specific enquiry if comfort need to be placed on the response.

3.18 In case the opinion expressed by the legal counsel is inconsistent with other information / evidence available in relation to such litigation, such contradictions need to be resolved with assistance from management. In such circumstance, the auditor may consider meeting the legal counsel together with management's representatives. Further, the auditor may consider personal meetings to discuss the outcome and implications of the lawsuit with legal counsel when:-

- The matter poses to be of significant risk.

- The matter is complex.
- There is disagreement between management and the entity's external legal counsel.

Timing of the Response

3.19 In accordance with SA 700, *Forming an Opinion and Reporting on Financial Statements*, the auditor is required to date the auditor's report 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. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel to take appropriate cognisance of any subsequent events which might have a bearing on accounting and disclosure requirements. While determining whether updated information is required, the auditor is required to consider whether the likelihood of interim developments are probable or remote and the significance as well as impact of the developments in the intervening period. Therefore the time gap between the date of response received and the date of the audit report is critical to determine this aspect.

Unable to Communicate or Meet Legal Counsel

3.20 If the auditor faces restrictions from management to communicate with the legal counsel (through letters of enquiry or meetings as deemed necessary), the auditor is required to consider whether there is a limitation in performing audit procedures. Further, the auditor may be unable to obtain sufficient appropriate audit evidence since the legal counsel does not respond the enquiries of the auditor appropriately. In both cases, the auditor is required to consider the impact on the auditor's opinion as required by *SA 705, Modifications to the Opinion in the Independent Auditor's Report*.

Chapter 4
Presentation and Disclosure of Segment Information

Segment Information

4.1 Ordinarily information about different types of products or services of an enterprise and different geographical locations where the entity operates are collectively known as segment information. Such information is relevant to assessment of risks and returns of a diversified and multi-locational entity.

4.2 Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements.

Auditor's Responsibilities

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

Audit Procedures

4.4 In order to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework, the auditor is required to perform the following procedures:

Obtaining an understanding of the methods used by management in determining segment information	The auditor would need to primarily gain understanding about the operations of the entity using the guidance provided under *SA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.* Understanding of the operations of the

	entity and its encompassing regulatory framework would assist the auditor to identify the divergence in risks and returns of the different operations of the entity which are distinguishable in terms of products or services it provides or the geographical locations it is connected with. This would eventually enable the auditor to understand the methods used by management in determining segment information. The auditor would also need to be familiar with the internal reporting framework prevalent in the entity which is used by management to ascertain such information.
Evaluating whether such methods are likely to result in appropriate disclosures in conformity with the applicable financial reporting framework	The auditor would need to assess whether the methods deployed by management is sufficient and appropriate to provide comfort to management that the presentation and disclosure requirements as set out in the applicable financial reporting framework could be adhered to. Such evaluation would predominantly be performed through inquiry of management regarding the mechanism and methods adopted. Certain key aspects which may be relevant in this connection would be procedures followed by management regarding adjustments of:- • Sales, transfers and charges between segments • Elimination of inter-segment amounts. • Comparisons with budgets and other expected results, for example, operating profit as a percentage of sales.

	• Allocation of assets and costs among segments. • Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.
Testing the application of such methods	In case the auditor is satisfied with design of the methods deployed by management in order to present and disclose segment information in accordance with applicable financial reporting framework, the auditor is required to verify the application of such methods. Such tests would include tests of controls around the internal reporting structure within the entity, and evaluation of supporting documentation/calculations to determine segment information. The overall segment information needs to reconcile with the financial statements in aggregate and internal adjustments as stated above are also required to be made ensuring accuracy and completeness of all aspects. In case the methods are not consistent with previous reported periods, the auditor needs to validate reasonableness of the proposed change and also consider whether any additional disclosure is required to reflect such change.
Performing analytical procedures or other audit procedures	The auditor is not required to perform audit procedures that would be necessary to express an opinion on standalone basis in respect of presentation and disclosure of segment information. This requirement affects the risks associated with the disclosure and enables the auditor to place significant reliance on analytical

	procedures to obtain requisite evidence in relation thereto. This is supported by *SA 330, The Auditor's Responses to Assessed Risks*, which states that "if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence". In terms of *SA 520, Analytical Procedures* the term "analytical procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount." Ordinarily performance of such procedures would be able to provide sufficient appropriate audit evidence to the auditor. In exceptional cases, where the reliance on controls around internal reporting framework operative in the entity is low, the auditor may need to perform further procedures to gain comfort on the presentation and disclosure of segment information reported in the financial statements.

Appendix 1

Stock Verification Checklist

Name of the entity:

Year / period ended:

Location:

Date of count:

Categories of stock:

Basis and unit of count/ weighment / measurement of stock:

Particulars of counters / supervisors to count:

	Questionnaire	**Yes / No / NA**	**Remarks**
1.	Has management issued instructions for stock verification? If yes, has auditor obtained a copy and evaluated the instructions?		
2.	Does the physical verification cover all items of stock? If no, how does management gain comfort on existence of such uncounted stock items?		
3.	Are the stock items arranged properly to ensure effective count? If no, how would the counters ensure accuracy and completeness of stock?		
4.	Are the stock items easily identifiable?		

	If not, what procedures would the counters follow?		
5.	Are the counters independent of persons maintaining stock records and those who handle stock movements? If not, are there any issues anticipated due to inadequate segregation of duties?		
6.	Are there stock movements during the course of the count? If yes, what controls exist over omissions and duplications during count?		
7.	What procedures are followed by the counters to record the count together with description (if any)? If there are multiple count sheets, what controls are in place for distribution and collation of count sheets?		
8.	Are there items of stock within the location which are held on behalf of third parties? If yes, have such items been excluded for the purpose of stock count?		
9.	Have slow moving and non-moving items of stock been identified and counted?		
10.	Have defective, damaged and obsolete items of stock been identified and counted?		
11.	Does the entity have work-in		

	progress? If yes, how is the stage of completion and materials held for internal consumption determined?		
12.	Has cut-off information for last receipt and issues noted?		
13.	Has the auditor independently counted a sample of items from the count sheets to floor and another sample from floor to the count sheets?		
14.	Are there any uncounted stock items lying in the location? If yes, have they been accounted for?		
15.	Have the management's instructions been followed?		
16.	Are any apparent weaknesses in control environment around stock movement / storage noted?		
17.	In case of any discrepancies, has the auditor immediately followed up with the supervisor to stock count and reconciled the same?		
18.	In course of observations and test counts, is the auditor satisfied that the documentation of physical count represent the description/quantity/ condition of stock?		

…………………………………

(Signature of audit team member attending stock verification)

Appendix 2

Recording Cut–off Information

Receipts

Last Goods Receipt Note (GRN) Reference	Date	Description	Quantity	Physically verified – Yes / No?	Supplier Invoice Reference – (where available)

The auditor is required to ensure that the stock received prior to the noted GRN (including the above) has been inventorised in the proper accounting period and stock received subsequent to the aforesaid GRN has been accounted for in the subsequent accounting period.

Internal Issues to Manufacturing Process

Last Material Issue Note Reference	Date	Description	Quantity	Physically verified – Yes / No?	Consumption records updated – Yes / No?

The auditor is required to ensure that issue of materials for consumption during manufacturing process has been accounted for in the appropriate accounting period with reference to the Material Issue Note.

Dispatches

Last Sales Invoice Reference	Date	Description	Quantity	Excluded from stock if held within premises – Yes / No?	Challan reference (where available)

The auditor needs to ensure that the sales recorded prior to the above invoice (including the same) has been considered for revenue recognition in the appropriate accounting period and revenue recognition in respect of subsequent invoices is considered in the next accounting period.

Appendix 3

Recording of Test Counts by the Auditor

Items selected from inventory listing and physically recounted along with management's stock counters

<table>
<tr><th>Count sheet reference</th><th>Descrip-tion per inventory listing</th><th>Identification mark (part number etc)</th><th>Unit</th><th>Location (where applicable)</th><th>Quantity counted</th><th>Comm-ents (Condi-tion etc)</th></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td rowspan="5">These need to agree with manage-ment's count to ensure accuracy</td><td></td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td></tr>
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<tr><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

Items independently counted from floor and traced back to management's count sheet

<table>
<tr><th>Description per invent-ory listing</th><th>Identifica-tion mark (part number etc)</th><th>Unit</th><th>Location (where applica-ble)</th><th>Quant-ity count-ed</th><th>Count sheet refer-ence</th><th>Comments (Condition etc)</th></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td rowspan="2">Stock counted needs to</td><td></td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

					be traced back to the count sheets to ensure comple-teness	

Appendix 4

Inventory Balance Confirmation

[*Date*]

[Particulars and Address]

Dear Sirs

As an audit requirement, you are requested to confirm the following list of stock items held by you on our behalf as on…(date of financial statements) directly to our auditors…(Name and Address of the auditor)

Description of stock	**Quantity**
xxxx	yyyy

Please confirm this on the attached copy of this letter by signing and duly returning it to our auditors. If the balance stated does not agree with your books and records please provide the data as per your records, including balances not listed above.

We thank you in advance for your cooperation in complying with this request.

Yours faithfully

....

(Signature and particulars of management representative)

Appendix 5

Letter of General Inquiry to the Entity's Legal Counsel

[*Date*]

[Name of Counsel and Address]

Dear Sirs

As an audit requirement, you are requested to provide the following information directly to our auditors…..(Name and address of the auditor):

a) List of litigations and claims involving us as on……(date of financial statements) for which legal advice or representations have been sought from you.

b) Evaluation of the outcome of the aforesaid litigations and claims and whether the likelihood of potential favourable judgement in our favour is probable or remote.

c) Your estimate of the financial implications of the lawsuits.

We thank you in advance for your cooperation in complying with this request.

Yours faithfully

....

(Signature and particulars of management representative)

Appendix 6

Letter of Specific Inquiry to the Entity's Legal Counsel

[*Date*]

[Name of Counsel and Address]

Dear Sirs

As an audit requirement, we have made assessment of the outcome of the litigations and claims against us in respect of which we have sought your legal advice and representations.

List of lawsuits	Assessment of outcome	Financial implications and estimated costs
xxxx	yyyy	zzzz

You are requested to evaluate the reasonableness of our assessments and confirm the same directly to our auditors..… (Name and address of the auditor). In case the aforesaid list is considered incomplete or incorrect as per your records, please provide additional information directly to the auditor.

We thank you in advance for your cooperation in complying with this request.

Yours faithfully

....

(Signature and particulars of management representative)

8
Implementation Guide to Standard on Auditing (SA) 570, Going Concern

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Foreword

Auditing Standards issued by the Institute of Chartered Accountants of India are important in ensuring quality in audit engagements. On the one hand they codify the best practices in the area of audit and thereby help the auditors enhance the value added by an independent audit. On the other hand, they are the performance benchmarks against which the performance of the auditors is measured by the stakeholders in the financial reporting process. It is therefore necessary that the auditors properly understand and implement these Standards in their audit engagements.

Implementation Guides to Auditing Standards are an important tool in the hands of the practitioners to appropriately understand the exacting requirements of these Standards and help them implement the Standards in an appropriate manner to meet the objectives which they are designed to achieve.

'Going Concern' is an important concept in the context of preparation and presentation of financial statements as well as the audits of financial statements. The Institute had issued a Standard on Auditing dealing with the concept of 'Going Concern' as back as in 1998. The Standard was revised in the year 2008. I am happy that the Auditing and Assurance Standards Board has brought out this Implementation Guide to Revised Standard on Auditing (SA) 570, 'Going Concern'. I am sure the Implementation Guide would be able to address the practical difficulties, if any, being faced by the members in implementing this Standard on Auditing.

I compliment CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board, committee members and officers of the Board for their efforts in developing and issuing guiding literature on auditing standards and other technical literature on auditing.

January 15, 2013 — **CA. Jaydeep Narendra Shah**
New Delhi — President, ICAI

Preface

Going concern is a critical assumption underlying the preparation and presentation of financial statements and is a major cause of concern alike for the internal stakeholders in an entity, like management, employees, etc., as well as the external stakeholders such as the vendors, investor community and the regulators. Many legislations, therefore, specifically require the auditor to directly or indirectly assess and report on the appropriateness of the going concern assumption or assess the impact of certain transactions on the going concern of the entity. For example, the Companies (Auditor's Report) Order, 2003 specifically requires the statutory auditor to report whether disposal of a substantial part of the assets has affected the going concern of a company. Similarly, the reporting requirement under CARO 2003 with respect to erosion of net worth and incurrence of cash losses is also aimed at assessing the financial health and as a corollary, the going concern of a company.

While SA 570, Going Concern, issued by ICAI contains fundamental principles that the auditors need to bear in mind while assessing the going concern assumption. The task is, none the less, challenging and requires careful application of, among other things, professional skepticism and judgment by the auditors, particularly so in situations of economic uncertainty/ downturn wherein there could be serious disagreements with the preparers of financial statements on the going concern issue.

Having regard to the above, I am happy to place in your hands this Implementation Guide to Standard on Auditing (SA) 570¸Going Concern. The Implementation Guide, developed by a team of experts in the area of auditing, provides a very practical and easy to follow approach to going concern assessment in the forms of questionnaire, templates and case studies, etc.

At this juncture, I wish to place on record my sincere thanks to CA. Ganesh Balakrishnan, Hyderabad and his team comprising, Ms Swati Naik and Mr Ratan Kumar for taking time out of their professional and personal priorities to develop this Implementation Guide.

I also wish to thank CA. Jaydeep N Shah, President, ICAI as well as CA. Subodh K Agrawal, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

I am also grateful to the members of the Auditing and Assurance Standards Board, *viz.*, CA. Shiwaji Bhikaji Zaware, Vice Chairman, CA. Amarjit Chopra, CA. Anuj Goyal, CA. G. Ramaswamy, CA. Jayant P. Gokhale, CA. J. Venkateswarlu, CA. Naveen N.D. Gupta, CA. Nilesh S. Vikamsey, CA. Pankaj Inderchand Jain, CA. Pankaj Tyagee, CA. Rajendra Kumar P., CA. S. Santhanakrishnan, CA. V. Murali, Shri Gautam Guha, CA. Raj Agrawal, CA. Vinay Balse, CA. Purshotam Gaggar, CA. Pramod S. Shingte, CA. Partha Sarathi De for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, *viz.*, Prof. Manoj Anand, CA. B. Padmaja, CA. Amit Roy, Shri Sunil Kadam, CA. Khurshed Pastakia, CA. Gopal Mahadevan, CA. Anil Sharma, CA. N. D. Gupta, CA. Raj Kumar Aggarwal, CA. Jaideep Bhargava, CA. Shashi Gupta and CA. Santosh Gupta for their support to the Board.

I am sure that the readers would find this Implementation Guide useful and shall be happy to have their feedback on the same.

January 15, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

Contents

Foreword

Preface

Snapshot of Revised SA 570 785

Chapter 1: Introduction and Overview 797

Chapter 2: The Implementation Guidance and Suggested Questionnaire 800

Chapter 3: Template for Checklists for Testing Going Concern Assumption 810

Chapter 4: Practical Case Studies and Illustrative Examples 818

Snapshot of Revised SA 570

Revised SA 570

Going Concern (GC)

Effective for audits of financial statements for periods beginning on or after April 1, 2009

Replaces SA 570 (AAS 16), “Going Concern”, issued in September 2001.

Overview of SA 570

- **Introduction**
  - Scope
  - Effective Date
- **Objectives**
- **Requirements**
  - Risk Assessment Procedures and Related Activities
  - Evaluating Management’s Assessment
  - Period Beyond Management’s Assessment
  - Additional Audit Procedures when Events or Conditions are Identified
  - Audit Conclusions and Reporting
  - Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists
  - Use of Going Concern Assumption Inappropriate
  - Management Unwilling to Make or Extend Its Assessment
  - Communication with Those Charged with Governance
  - Significant Delay in the Approval of the Financial Statements
- **Application & Other Explanatory Material on these Aspects**

Scope of this SA

Auditor's responsibility in Audit of FS

With respect to management's use of GC Assumption

In Preparation & Presentation of FS

GC Assumption

- Entity is viewed as continuing in business for the foreseeable future.

Responsibilities of Management

- GC - a fundamental principle in preparation of Financial Statements
- Management to make a specific assessment of GC Assumption
- Judgment about inherently uncertain future outcome of events/conditions
  - Period- at least 12 months from date of FS
  - Based on – Information available at particular point of time
  - Affected by –Size & Complexity of entity, Nature & Condition of business

Responsibilities of Management

- The financial reporting framework may require the mgt to make an assessment of the entity's ability to continue as a GC and prepare the financial statements on a GC basis unless the management intends to liquidate the entity or cease operations, or has no realistic alternative but to do so. In case in other financial reporting framework, there is no such explicit requirement for the mgt., mgt. is still required to prepare and present FS on GC basis.
- Appropriate disclosure together with the reason thereof, in case the FS are not prepared on a GC basis.
- The detailed requirements may also be set out in law or regulation.

Responsibilities of Auditor

Obtain Sufficient Appropriate Audit Evidence (SAAE) about appropriateness of management's use of GC assumption

Conclude whether there is material uncertainty about entity's ability to continue as GC

Absence of any GC uncertainty reference in Auditor's report not to be viewed as guarantee to entity's ability to continue as GC

Auditor's Objective

- **Obtain SAAE:**
  - about appropriateness of use of GC Assumption in preparation & presentation of FS.
- **Conclude, based on evidence:**
  - whether a material uncertainty exists that may cast significant doubt on entity's ability to continue as GC.
- **Determine**
  - implications for the auditor's report.

Risk Assessment Procedures- I

- Determine events/conditions that cast doubt on entity's ability to continue as GC:
  - Financial, Operating, Other.
- Auditor to remain alert throughout audit for these events /conditions.
- Smaller Entities:
  - Ability to withstand or respond quickly but may lack resources to sustain operations.
  - Risk of possible loss of principal supplier, major customer, key employee, right to operate under a license or withdrawal of support by banks or lending agencies.

Examples of Events/ Conditions

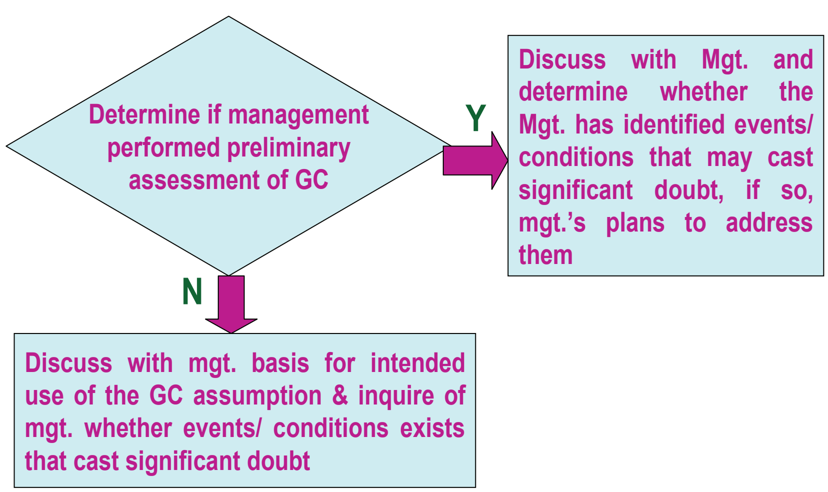
- Financial
  - Net liability or net current liability position.
  - Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
  - Indications of withdrawal of financial support by creditors.
  - 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
  - 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
  - Non-compliance with capital or other statutory requirements.
  - 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.

Procedures under SA 315 and SA 330 need to be followed.

Risk Assessment Procedures- II



Evaluating Management's Assessment

- Evaluate management's assessment of entity's ability to continue as GC.
- Assessment period:
  - Cover same period as that used by management as per the FRF.
  - Or longer period if required by law/regulation.
  - If period less than 12 months from the date of FS then request management to extend it to at least 12 months from that date.
- Consider whether assessment includes all relevant information of which auditor is aware as result of audit.

1. Auditor is not responsible for rectifying the lack of analysis by mgt. to support its assessment for concluding whether management's use of the going concern assumption is appropriate in the circumstances. 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 mgt.'s use of the going concern assumption in the preparation of the financial statements is appropriate in the circumstances.
2. Evaluation may include:
   - Evaluation of the process management followed to make its assessment
   - Assumptions on which the assessment is based and management's plans for future action
   - Whether management's plans are feasible in the circumstances.

Smaller Entities

- Evaluate management's assessment of entity's ability to continue as GC:
  - Discuss medium and long-term financing of entity with management – *consistent with auditor's understanding*.
  - Assess supporting documentation.
- Evaluate owner-manager's ability to meet the obligation under support arrangement.

Period beyond Management's Assessment

- Inquire of management as to its knowledge of events/conditions beyond period of management's assessment.
- If events/conditions identified - request management to evaluate potential significance.
- No responsibility to perform any other audit procedure except inquiry.

Additional Audit Procedures - I

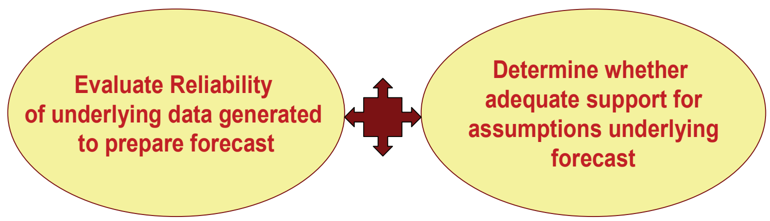
- Request mgt. to make GC assessment if not yet performed.
- Evaluate mgt's plans for future actions *(e.g., restructuring, expenditure reduction)*:
  - outcome likely to improve situation.
  - feasible in the circumstances.
- Consider whether any additional facts/information available since date of mgt assessment.

Additional audit procedures may include the following:

- 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.

Additional Audit Procedures - II

- Analysis of cash flow forecast prepared by the entity



- Request Written Representations from mgt. or, where appropriate, TCWG regarding plans for future action and their feasibility

The Period of Management's Assessment

- In addition to the procedures required to evaluate mgt's plans for future actions, the auditor may compare:
  - The prospective financial information for recent prior periods with historical results; and
  - The prospective financial information for the current period with results achieved to date.
- Where management's assumptions include continued support by third parties and such support is important to an entity's ability to continue as a GC, auditor may need to
  - consider requesting written confirmation from those third parties; and
  - obtain evidence of their ability to provide such support.

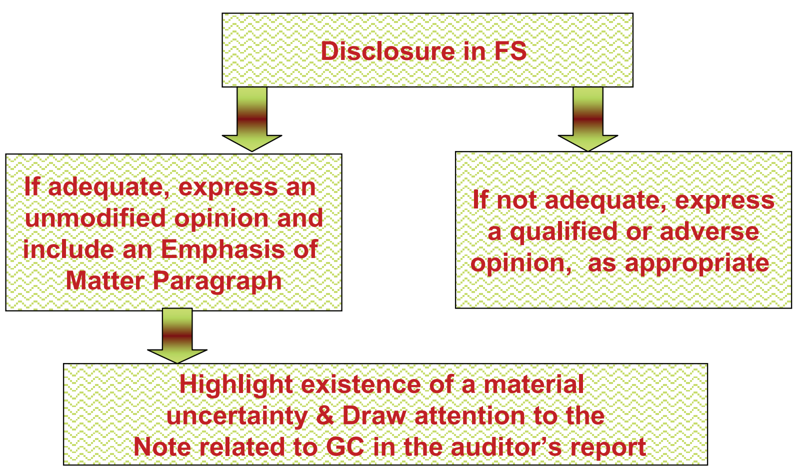
Audit Conclusions and Reporting

- Conclude whether in Auditor's judgment **material uncertainty** exists related to events/conditions which individually/collectively casts significant doubt on GC assumption.
  - Material uncertainty – Magnitude of potential impact & likelihood of occurrence is such that, in auditor's judgment, appropriate disclosure of nature and implications of uncertainty is necessary for disclosure of true and fair view.

Use of GC assumption appropriate but material uncertainty exists- I

- Determine whether FS:
    - Adequately describe principal events/conditions that cast significant doubt on entity's ability to continue as GC & Mgt's plans to deal with these events/conditions.
    - Disclose clearly that there is material uncertainty.
- Entity may be unable to realise its assets and discharge its liabilities in the normal course of business.

Use of GC assumption appropriate but material uncertainty exists-II



In situations involving multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of adding an Emphasis of Matter paragraph.

Use of GC Assumption Inappropriate

- If FS prepared on a GC basis but, in auditor's judgment, use of GC assumption in FS is inappropriate:
  - Express an adverse opinion.
- If mgmt is required/elects to prepare FS – then FS may be prepared on an alternative basis (e.g. liquidation basis).
  - Express unmodified opinion along with emphasis of matter paragraph highlighting alternative basis provided disclosure is adequate.

Management unwilling to Make or Extend its Assessment

- Failure to obtain SAAE.
- Management unwilling to make or extend assessment of entity's ability to continue as GC:
  - Consider implications for the auditor's report.
- Qualified opinion or Disclaimer of opinion.

Communication with Those Charged with Governance

- Unless all TCWG involved in managing entity, communicate with TCWG events/conditions that cast significant doubt on GC assumption:
  - Whether events/conditions constitute material uncertainty.
  - Whether use of GC assumption appropriate in preparation and presentation of FS.
  - Adequacy of related disclosures in FS.

Significant Delay in Approval of FS

Significant Delay in approval of FS by mgt. or TCWG after date of FS

↓

Auditor to inquire reasons for delay

↓

If delay related to events/conditions relating to GC assessment, auditor to perform additional audit procedures and consider effect on auditor's conclusion regarding existence of material uncertainty

Chapter 1
Introduction and Overview

1.1 The purpose of this Implementation Guidance is to provide practical guidance on implementation of the principles enunciated in the Standard on Auditing (SA) 570 (Revised), Going Concern, issued by the Institute of Chartered Accountants of India.

This SA 570 (Revised) is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.2 Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements and going concern is one of those fundamental accounting assumptions. They are usually not specifically stated because their use is accepted and assumed. A disclosure is necessary if they are not followed. However, if the entity's management is required, or elects, to prepare financial statements when the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an alternative basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the alternative basis is an acceptable financial reporting framework in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein but may consider it appropriate or necessary to include an Emphasis of Matter paragraph (Refer Q 10 in Chapter II below for details) in the auditor's report to draw the user's attention to that alternative basis and the reasons for its use. (Refer paragraph A26, SA 570).

1.3 The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidating or curtailing materially the scale of its operations. An entity's continuance as a going concern for the foreseeable future is assumed in the preparation of financial statements in the absence of significant information to the contrary. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified, the amounts and classification of assets and liabilities in the financial statements may need to be adjusted. A few examples of situations of going concern are as under:

(i) An oil and gas firm operating in Nigeria is stopped by a Nigerian court from carrying out operations in Nigeria. The firm is not a going concern in Nigeria, because it has to shut down operations because of the said directions from the court.

(ii) A nationalized refinery is in cash flows problems but the government of the country provided a guarantee to the refinery to help it out with all payments, the refinery is a going concern despite poor financial position, since it has a support of the country's government.

(iii) A bank is in serious financial troubles and the government is not willing to bail it out. The Board of Directors has passed a resolution to liquidate the business. The bank is not a going concern.

(iv) A merchandising company has a current ratio below 0.5. A creditor of Rs. 5 crores demanded payment which the company could not make. The creditor requested the Court to liquidate the business and recover his debts and the court grants the order. The company is no longer a going concern.

However, under each of these cases, the auditor needs to review the underlying facts so as to conclude on the use of going concern assumption for the preparation of financial statements.

1.4 The importance of 'going concern' assumption in the preparation of financial statements can be gauged from the fact that a number of important laws and regulations impose specific responsibilities on managements as well as auditors in relation to going concern. For example, Section 217(2AA) of the Companies

Act, 1956 *inter alia* requires the Directors to make a specific assertion in their Directors' Responsibility Statement under this section that the directors have prepared the annual accounts on a going concern basis. Similarly, clause 49 of the Listing Agreement envisages the Audit Committee had to review with management that the annual financial statements before submission to the board, focusing on the going concern assumption. In so far as the auditors are concerned, sub-clause (c) of clause (1) of paragraph 4 of the Companies (Auditor's Report) Order, 2003 (CARO, 2003) requires the auditor to specifically report whether the 'going concern' has been affected where the company has disposed off a substantial part of its fixed assets during the year. The auditor is therefore required to examine the reasons for disposal of a substantial part of the fixed assets and to give his opinion on whether the reporting of the financial statements on going concern concept is proper. Further, certain other clauses of CARO, 2003 may also be considered as indicators of appropriateness of going concern, for example, clause (x) of paragraph 4 requires the auditor to report whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than 50% of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year.

Similarly, Clause (xvii) of paragraph 4 requires the auditor to report whether the funds raised on short term basis have been used for long term investment.

1.5 This Implementation Guide provides a framework to assist in determining whether the use of going concern basis in preparation of the financial statements and the related disclosures are appropriate and in making balanced, proportionate and clear disclosures.

Chapter 2
The Implementation Guidance and Suggested Questionnaire

2.1 The going concern assumption is a fundamental principle in the preparation of financial statements. This Implementation Guide provides information and background material in relation to going concern considerations covering broadly the following areas:

- Accounting framework
- Auditing management's assessment of going concern
- Events or conditions that may cast significant doubts about the entity's ability to continue as a going concern
- Determining the implications for the auditor's report when reporting in accordance with the Standards on Auditing (SA) 570 (Revised)
- Consultation within audit team and with the client/management/audit committee
- Reviewing interim financial information in accordance with the Standard on Review Engagements

2.2 The following questionnaire could be relevant whilst testing the going concern assumption.

Q.1 **Who is responsible to assess going concern assumption?**

Ans.1 The assessment of an entity's ability to continue as a going concern is the responsibility of the entity's management. The auditor needs to evaluate management's assessment of the entity's ability to continue as a going concern.

Q.2 **Over what period is going concern assessed?**

Ans.2 In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor covers the same period as that used by management.

If management's assessment of the entity's ability to continue as a going concern covers less than twelve month from the date of the financial statements as defined in SA 560, Subsequent Events, the auditor requests management to extend its assessment period to at least twelve months from that date.

Q.3 **What factors are taken into account by the management when assessing the entity's ability to continue as a going concern?**

Ans.3 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. For that reason, financial reporting frameworks normally require an explicit management assessment specify the period for which management is required to take into account all available information.
- 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.

Q.4 **What evidence does Management normally consider when assessing the entity's ability to continue as going concern?**

Ans.4 The evidence includes:

- Cash flow projections that show an ability to pay debts as and when they fall due after factoring realistic assumptions in the current market conditions.
- If current conditions deteriorate further, detailed business plans covering the period under consideration.
- Support for the entity's ability to obtain new funding upon the maturity of existing funding arrangements.
- Evidence that debt covenants have been assessed and any risk of breaching them has been managed, such that they do not provide significant risk.
- Management may consider having support of 'Support Letter' fro m the parent company for financial support for the next twelve month, as required, from the date of the latest balance sheet.
- In an unlikely situation, Support Letter may be given by the government or any other financial situation as well; however, this is a rare phenomenon. A standard template of Support Letter is given in Annexure II.

Q.5 **What are the auditor's responsibilities under going concern assumptions?**

Ans.5 The auditor's responsibilities are:

- To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statement;
- To conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

Q.6 **What should auditor do if Management has not performed a preliminary assessment?**

Ans.6 In such a situation, the auditor needs to:

- discuss with management the basis for the intended use of the going concern assumption
- 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.

Further, the auditor should remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Q.7 **How should auditor evaluate management's assessment of going concern?**

Ans.7 In evaluating management's assessment of going concern assumption, the auditor would cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. The period of assessment would be of at least twelve month from that date of the financial statements. In case it is less than that, the auditor would request the management to cover at least a 12 months period.

The auditor's procedures for evaluating management's assessment of going concern would also include:

- Ensuring management's assessment includes all relevant information of which the auditor is aware as a result of the audit.
- Inquiring of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.

Q.8 **What are the Additional Audit Procedures to be performed When Events or Conditions that may cast significant doubt on the going concern assumption Are Identified?**

Ans.8 In such a scenario, the auditor needs to perform additional audit procedures to obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists. In doing so, the auditor would also need to take into consideration, the mitigating factors, if any. These procedures include:

- Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- 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 action.
- Evaluating the reliability of the underlying data generated to prepare the forecast.
- Determining whether there is adequate support for the assumptions underlying the forecast.
- Considering whether any additional facts or information have become available since the date on which management made its assessment.
- Requesting written representations from management regarding their plans for future action and the feasibility of these plans.

Q.9 **What should auditor do when use of Going Concern Assumption is Appropriate but a Material Uncertainty Exists?**

Ans.9 In such a situation, the disclosure made by the entity in its financial statements become very important. The auditor should, therefore, determine whether the financial statements:

- Adequately describe 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
- 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.

For the above purpose the fact whether the information explicitly draws the readers' attention to the possibility that the entity may be unable to continue realizing its assets and discharging its liabilities in the normal course of business, would be an important factor for the auditor.

Q.10 **What are the auditor's reporting responsibilities if the auditor concludes that adequate disclosure is made in the financial statements in the scenario given in Q.9 above?**

Ans.10 In such a situation the auditor would express an unmodified opinion on the financial statements. However, his report would also need to include an Emphasis of Matter Paragraph. This Emphasis of Matter paragraph would:

- Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern.
- Draw attention to the note in the financial statements that discloses the matters.

An example of such wording for paragraph that may be included on '**Emphasis of Matter for modification in the auditors' report**' has been given below in Annexure – I, Part A.

Note – while making conclusion on putting 'Emphasis of Matter for modification in the auditors' report, this Q 10, shall be read in conjunction with point no. 3 in Chapter I above.

Q.11 **How should auditor report if in the scenario mentioned in Q.9 above, adequate disclosure in respect of material uncertainty for going concern assumption is not made in the financial statements?**

Ans.11 In the absence of adequate disclosures in the financial statements in respect of existence of material uncertainty relating to going concern assumption, the auditor would need to express a qualified or an adverse opinion, as may be appropriate, in terms of principles enunciated in SA 705, "Modifications to the Opinion in the Independent Auditor's Report". The auditor's report should clearly state that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

Examples for paragraph to be included in audit report for; Qualified opinion and Adverse opinion, have been given below in Annexure – I, Part B.

Q.12 **What should auditor do if Use of Going Concern Assumption is Inappropriate?**

Ans.12 If in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, and auditor is of the opinion that accounts cannot be prepared on the going concern basis due to existing facts then the auditor shall express an adverse opinion.

For example

1. Company have opted to avail the "Easy Exit Scheme, 2011" pursuant to General Circular no. 6/2010 issued by the Ministry of Corporate Affairs (MCA) dated 03.12.2010 read with Section 560 of the Companies Act, 1956, and still prepares the accounts on going concern assumption without disclosing the facts in the financial statements. In such circumstances auditor would need to issue an adverse opinion.

2. The company's financing arrangements expire and amounts outstanding are payable on 30 August 20x2. The

company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. In such circumstances auditor would need to issue an adverse opinion

Refer Annexure – I for audit report format.

Q.13 **What should auditor do if Management is Unwilling to Make or Extend Its Assessment?**

Ans.13 If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor should consider the implications for the auditor's report. The auditor might have to issue a Qualified opinion on account of limitation of scope.

Q.14 **What should be communicated to Those Charged with Governance (TCWG) and when?**

Ans.14 Unless all those charged with governance are involved in managing the entity, the auditor needs to communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance includes the following:

- Whether the events or conditions constitute a material uncertainty.
- Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements.
- The adequacy of related disclosures in the financial statements.

Generally, a meeting of the audit committee is not held in the interim except when it meets to approve the quarterly results and/

or annual financial statement. At that meeting auditors' report (with the going concern matter) should be placed before Those Charged With Governance. However, if considered, appropriate, the auditor may communicate with Those Charged With Governance before such a meeting of the Audit Committee.

Q.15 **What should the auditor do if there is Significant Delay in the Approval of Financial Statements?**

Ans.15 In such cases, the auditor should inquire as to the reasons for the delay. If delay relates to events or conditions relating to the going concern assessment, the auditor should perform additional audit procedures as necessary as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty, as listed in paragraphs 16 and 17 of SA 570.

Q.16 **Does disclosure in terms of revised Schedule VI has any impact on going concern implication in Financial Statements?**

Ans.16 The manner of auditor's evaluation of a company's going concern assumption would not be effected due to changes in the disclosure in the financial statements on account of the Revised Scheduled VI. However, disclosure in terms of revised Schedule VI makes it easy for the reader of the financial statements to understand the rationale for their preparation on going concern basis. Some examples for such disclosure requirements are enumerated hereunder:-

(1) The revised Schedule VI requires specific disclosures for default in repayment of loans and interest. The revised Schedule VI does not require separate disclosure for other defaults, e.g., default in compliance with debt covenants. However, a company should consider the impact of such default on current and non-current classification and going concern implications;

(2) The revised Schedule VI introduces a number of other additional disclosures. Key examples are:

a. Rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital,

b. Terms of repayment of loans and period,

c. In each class of investment, details regarding names of the bodies corporate, indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities, in whom investments have been made and the nature and extent of the investment made in each such body corporate (showing separately partly-paid investments).

d. Aggregate provision for diminution in value of investments (separately for current and long-term investments)

Chapter 3
Template for Checklists for Testing Going Concern Assumption

An entity's continuance as a going concern for the foreseeable future is assumed in the preparation of financial statements in the absence of significant information to the contrary. Accordingly, 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. If this assumption is unjustified, the amounts and classification of assets and liabilities in the financial statements may need to be adjusted. A detailed analysis for testing of related indicators regarding uncertainty of going concern consideration is briefly enumerated in the below checklist:

Going-Concern Consideration Program

	Particulars	Going concern indicator present (Yes/No/Not Applicable and References, if any)
A:	**Going Concern Considerations**	
1.	Consider whether there is a risk that the entity will not continue as a going concern for the foreseeable future: **Consider Financial Indications** • Recurring operating losses • Working capital deficiencies • Continuing negative cash flows from	

business activities • Excessive reliance on short-term borrowings to finance long-term assets • Adverse key financial ratios • Inability to pay creditors on due dates • Default on loans or similar agreements • Restrictions on usual trade terms • Restructuring of debt • Arrears or discontinuance of dividends • Excessive or obsolete stock • Need to seek new sources or methods of financing, or fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment • Need to dispose of substantial assets.	
Consider Operating Indications • Loss of key management or staff • Work stoppages or other labor difficulties • Substantial dependence on the success of a particular project or on a particular asset • Excessive reliance on the success of a new product • Uneconomic long-term commitments • Loss of a major market or principal supplier • Loss of a key franchise, license, or patent.	
Consider Other Indications • Noncompliance with capital or other statutory requirements • Pending legal proceedings or similar matters that might jeopardize an entity's ability to operate • Changes in or establishment of new legislation or government policy	

	• Technical developments that render a key product obsolete.	
B:	**Consideration of Management's Assessment**	
1.	Evaluate management's assessment of the entity's ability to continue as a going concern. (The auditor should consider the same period as that used by management in making its assessment under the applicable financial reporting framework. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should request management to extend its assessment period to twelve months from the balance sheet date.)	
2.	Inquire of management as to its knowledge of events or conditions and related business risks beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern.	
3.	Evaluate the information obtained above in conjunction with other information obtained throughout the audit that may impact auditor's assessment of the appropriateness of the going concern assumption.	
C:	**Consideration of Management's Plans**	
1.	If, after considering the identified conditions and events in the aggregate, the auditor believes that continuance as a going concern may be questionable, he/she should consider management's plans for dealing with the adverse effects of the identified conditions and events, and assess the likelihood of	

	effective implementation thereof.	
2.	Obtain information about management's plans and consider whether it is likely that the adverse effects will be mitigated for the foreseeable future. Evaluate the likelihood of effective implementation of such plans. Plans that the auditor would consider and discuss with management may include: • Plans to dispose of assets • Plans to borrow money or restructure debt • Plans to reduce or delay expenditures • Plans to increase revenues more than increases in related costs and expenses • Plans to increase ownership equity.	
3.	Consider the bases on which the plans have been prepared, giving consideration as to whether they conform with facts already known and to available independent evidence.	
4.	Carry out additional procedures to update information obtained earlier. Such procedures may include:	
	• Analysis and discussion of cash flow, profit, and other relevant forecasts with management	
	• Review of events after the balance-sheet date for items affecting the entity's ability to continue as a going concern	
	• Analysis and discussion of the entity's latest available interim financial statements	

	• Review of the terms of debentures and loan agreements and determination whether any have been breached	
	• Reading of minutes of the meetings of shareholders, board of directors, and other important committees for reference to financing difficulties	
	• Request for information on relevant material legal matters from the entity's legal counsel	
	• Confirmation of the existence, legality, and enforceability of arrangements to provide or maintain financial support with related and third parties, and assessment of the financial ability of such parties to provide additional funds	
	• Consideration of the entity's position concerning unfilled customer orders	
	• Obtaining written representation from management concerning plans for future action whose outcome is expected to mitigate the situation.	
5.	Obtain written confirmation of the corresponding representations by the management.	
6.	When prospective financial information is particularly significant to management's plans, consider, based on the auditor's knowledge of the entity, its business and management, the adequacy of support for significant assumptions underlying that information. Compare the prospective data for recent prior periods with historical results and the prospective data for the current period with results achieved to date.	

	Consider the reliability of the entity's system for generating such information and give particular attention to assumptions that are: • Material to the prospective financial information • Especially sensitive or susceptible to change • Inconsistent with historical trends.	
D	**Management Representation**	
1.	When additional disclosures are made in the financial statements relating to the entity's ability to continue as a going-concern, obtain a specific management representation stating that the disclosures contain all of the pertinent facts.	
2.	Consider whether particular matters need to be represented by management related to the considerations of the entity's ability to continue as a going concern.	
E	**Consideration of Effects on the Financial Statements**	
1.	If, after considering management's plans, the auditor concludes that the going-concern question is not satisfactorily resolved, the auditor would consider the possible effects on the financial statements and ensure the adequacy of the related disclosure. The disclosure should:	
	• Describe the principal conditions and events that raised doubt about the entity's ability to continue as a going concern for the foreseeable future.	
	• Describe the possible effects of such	

	conditions and events and management's evaluation of the significance of those conditions.	
	• Describe any mitigating factors and the management's plans (including relevant prospective financial information).	
	• State that there are doubts that the entity will be able to continue as a going concern and, therefore, may be unable to realize its assets and discharge its liabilities in the normal course of business.	
	• State that the financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or to amounts and classification of liabilities that may be necessary should the entity be unable to continue as a going concern.	
2.	If the auditor concludes that the going-concern assumption is appropriate because of mitigating factors (in particular management's plans for future action), evaluate the need for disclosure of the principal conditions and events that initially caused the substantial doubt. Disclosure considerations include the possible effects of such conditions and events and any mitigating factors, including management's plans.	
F:	**Consultation**	
1.	If the auditor concludes that an entity's continuance as a going concern for the foreseeable future is questionable, consider consultation within the firm to consider	

	management's plans or representations and financial statement effects.	
G:	**Accounting Policies and Disclosures**	
1.	Consider whether the presentation of the financial statements conforms with professional standards and the applicable legal or regulatory requirements. Consider whether: • Material transactions or items may require separate disclosure.	
	• Accounting policies used in the financial statements are appropriate and are consistent with prior periods.	
	• Balances and associated footnote disclosures are presented in accordance with the accounting policies.	
H:	**Conclusion:** • Based on the tests performed and responses as noted above, a conclusion may be drawn that going concern assumption is appropriate. • Also give reference to the type of audit report that may be issued based on the conclusion drawn under this section (Refer Annexure – I for audit report format).	

Chapter 4
Practical Case Studies and Illustrative Examples

Section A – Case Studies

Case Study 1: Going Concern Audit Report

You are the manager responsible for performing hot reviews on audit files where there is a potential disagreement between your firm and the client regarding a material issue. You are reviewing the going concern section of the audit file of Sunshine Ltd, a client with considerable cash flow difficulties, and other, less significant operational indicators of going concern problems. The working papers indicate that Sunshine Ltd is currently trying to raise finance to fund operating cash flows, and state that if the finance is not received, there is significant doubt over the going concern status of the company. The working papers conclude that the going concern assumption is appropriate, but it is recommended that the financial statements should contain a note explaining the cash flow problems faced by the company, along with a description of the finance being sought, and an evaluation of the going concern status of the company. The directors do not wish to include the note in the financial statements.

Identify and discuss the implications for the audit report if:

(i) the directors refuse to give the disclosure note.

(ii) the directors agree to give the disclosure note.

Suggested Response

i) The Directors refuse to give the disclosure note:

The audit report should contain a qualified or an adverse opinion due to the disagreement. The auditors need to make a decision as to the significance of the non-disclosure of the uncertainty surrounding going concern assumption. If it is decided that without the note the financial statements are not fairly presented, and could be considered misleading, an adverse opinion should be expressed.

ii) The Directors agree to give the disclosure note:

If the directors agree to give the disclosure note, it should be reviewed by the auditors to ensure that it is sufficiently detailed. In evaluating the adequacy of the disclosure in the note, the auditor should consider whether the disclosure explicitly draws the reader's attention to the possibility that the entity may not be able to continue as a going concern in the foreseeable future. The note should include a description of conditions giving rise to significant doubt, and the directors' plans to deal with the conditions. If the disclosure is considered adequate, then the opinion should not be qualified. The auditors should, however, consider adding an emphasis of matter paragraph to highlight the existence of the material uncertainties, and to draw attention to the note to the financial statements. The emphasis of matter paragraph should firstly contain a brief description of the uncertainties, and also refer explicitly to the note to the financial statements where the situation has been fully described. The emphasis of matter paragraph should re-iterate that the audit opinion is not qualified. However, it could be the case that a note has been given in the financial statements, but that the details are inadequate and do not fully explain the significant uncertainties affecting the going concern status of the company. In this situation the auditors should express a qualified opinion. The auditor, however, may also consider expressing an adverse opinion, if it is warranted under the circumstances based on the Auditor's professional judgment.

Case Study 2: Going Concern Audit Report

XYZ Inc. is a manufacturer of televisions. The domestic market for electronic goods is currently not doing well, and therefore many entities in this business are switching to exports. As per the audited financial statements for the year ended March 31, 20XX, the entity had net losses of Rs.120 million. At March 31, 20XX, its current assets aggregate to Rs.1,200 million and the current liabilities aggregate to Rs.1,500 million. Due to expected favorable change in the government policies for the electronic industry, the entity is projecting profits in the coming years. Furthermore, the shareholders of the entity have arranged alternative additional sources of finance for its expansion plans and to support its working capital needs in the next 12 months.

Required:

Should XYZ Inc. prepare its financial statements under the going concern assumption?

Suggested Solution

In this case, the two factors that raise doubts about the entity's ability to continue as a going concern are:

- The net loss for the year amounting to Rs.120 million.
- The working capital deficiency (current liability of Rs.1,500 million Less: current assets of Rs.1,200 million) of Rs.300 million existing at the balance sheet date.

However, there are two mitigating factors:

- The arrangements made by the shareholders to fund the entity's expansion and working capital needs; and
- Projected future profitability due to expected favourable changes in government policies for the industry the entity is operating in.

Based on these sets of factors, it may be possible for the management of the entity to argue that the going concern assumption is appropriate and that any other basis of presentation of financial statements would be unreasonable at the moment. However, if matters deteriorate further instead of improving, then in the future another detailed assessment would be needed to ascertain whether the going concern assumption is still valid and accordingly suitable disclosure may be made in the financial statements and the same shall be considered by the auditor *vis a vis* need to give Emphasis of Matter Paragraph or, Qualified or Adverse Opinion, as the case may be.

Section B – Other Illustrative Examples

Illustrative Examples of the Auditor's Assessment of Whether Evidence Provided by Those Charged With Governance, Concerning the Attention They Have Paid to the Period One Year From the Date of the Financial Statements, is Sufficient.

The examples given below are illustrative only. The purpose of the examples is to illustrate the application of the SA 570 to assist in clarifying their meaning in a number of commercial situations. These examples focus on particular aspects of the situations illustrated and are not intended to be a comprehensive discussion of all the relevant factors that might influence either the management's or auditor's assessment of the appropriateness of the going concern basis. As the auditor would need to exercise judgment in the circumstances described, it is possible that different auditors may arrive at different conclusions. These examples neither modify nor override the related Standards on Auditing.

Example 1 - A small company producing specialized computer application software

Corollary from the auditor's risk assessment (Read with paragraph 10-11 of SA 570)

This owner managed company employs a few highly trained and highly paid computer system designers to design application software for use by transportation enterprises, such as airlines and bus companies, in preparing their timetables and fare structures. Few companies are engaged in this field and the supply of suitably trained staff is limited. The system designers, who met at University, have been with the company since its formation. They all have an equity interest in the company.

Although the company has only been in existence for five years it has established a reputation for excellence in its field. Its reputation derives from the skill and expertise of its individual employees rather than from anything attaching to the company itself.

A significant amount of time is spent by the designers in pure research activities for developing new products. In addition, the time needed to develop individual systems relating to an established product can be considerable. In addition to designing new systems, the company maintains those systems that it has installed, on a contractual basis and undertakes training courses in the use of the systems for the employees of its customers.

The company is thinly capitalized and relies primarily on advances from its customers supplemented by short term bank borrowings for its day to day cash requirements.

The company employs a part time book-keeper to prepare the financial statements, cash flow forecasts and maintain the books of account.

The company has usually been in a position to choose which contracts it accepts and has not had difficulty in recovering its costs. The company is not economically dependent on any one transportation enterprise.

The company updates each month a rolling cash flow projection with a six month time horizon. The company does not prepare projections for a longer period as it perceives its management need is to be able to manage effectively its short term cash flow. The company has negotiated a line of credit with its bankers which it would be able to utilize to overcome short term cash shortages.

Assessment by the auditor When the auditor assesses whether the directors have, in assessing going concern, paid particular attention to a period of one year from the date of the financial statements, the auditor:

(a) Reviews the cash flow forecasts for the six month period from the date of the financial statements; and

(b) Enquires the directors about the steps they have taken to assess the appropriateness of the going concern basis for the subsequent six month period.

The directors inform the auditor that they do not consider there is any need for cash flow forecasts to be prepared beyond six months because:

- The cash flow forecasts show a net cash inflow for the period;
- They have reviewed in detail the assumptions implicit in the forecast with the bookkeeper and concur with them;
- The company has a significant back-log of orders which will occupy half of the designers for at least the next year;
- The company is actively tendering for both systems design and maintenance contracts in the United Kingdom and Europe and is considering expanding into the Americas;
- The company has recently renewed its arrangements with its bankers for a further year;
- The design employees seem to be settled and stimulated and there is no reason to believe that they will leave the company in the foreseeable future; and
- In the unlikely event that the company did not win many of the tenders it could modify its existing expansion plans which have been necessitated by an increase in maintenance contracts. Rather than employ new staff to undertake this work existing staff could be reassigned to it.

The auditor concludes that the directors have paid particular attention to the period ending one year after their approval of the financial statements.

Example 2 - An enterprise in the fashion (or seasonal) industry

Corollary from the auditor's risk assessment (Read with paragraph 10-11 of SA 570)

This company employing 1,000 people designs and manufactures ladies fashion wear. Its business is seasonal and it presents two major collections per year: one in the spring and one in the autumn.

The company has attracted established designers and they are regarded as one of the leading manufacturers.

Almost all of the company's sales orders are received from the major retailers when they show their collections. Although some of the garments are manufactured prior to the showing of the collection, a majority of them will be manufactured in the four months immediately following the showing.

The company's finance director is a qualified accountant with a staff of six persons. Because of the seasonal nature of the business, the company prepares its detailed budgets and cash flow forecasts until the end of the next season. The company's year-end is 30th June and the directors expect to approve the financial statements during October. Detailed cash flow forecasts are only available upto the end of February in the following year, i.e., a period of only four months from the approval of the financial statements.

The company which has been marginally profitable over the last few years has a small line of credit with its bank but is financed primarily through the factoring of its debtors.

Assessment by the auditor

When the auditor assesses whether the directors have, in assessing going concern, paid particular attention to a period of one year from the date of the financial statements the auditor would:

(a) Review the cash flow forecasts for the four month period from the date of the financial statements; and

(b) Then enquire of the directors the steps they have taken to assess the appropriateness of the going concern basis for the subsequent eight month period.

The directors inform the auditor that they do not consider there is any need for additional cash flow forecasts to be prepared beyond the end of February in the following year because:

- The cash flow forecasts show a net cash inflow for the period and the present cash position is strong because of a recent sale of debtors from the present collection;
- The directors have reviewed in detail the assumptions implicit in the forecast and concur with them;
- The designers are working on the next collection and they believe, based on discussions with some of the retailers, that they have some good general ideas which will appeal to their customers if translated into imaginative detailed designs;
- Discussions with the major retailers indicate that they expect demand to be high next season;
- The company's relationship with its factor is good and they do not expect any difficulties in selling their debtors in the future;
- The company anticipates no major capital expenditures in the next twelve months. Most of the machinery is less than five years old and in any event is financed by lease arrangements rather than by purchase; and
- The company has recently renewed its arrangements with its bankers for a further year.

The auditor concludes that the directors have paid particular attention to the period ending one year after their approval of the financial statements.

The auditor concludes that the directors have not paid particular attention to the period ending one year after the approval of the financial statements

The two examples above illustrate that the auditor may conclude that the directors have paid particular attention to the period ending one year after the approval of the financial statements, even though they have not prepared cash flow forecasts for that period.

The auditor may conclude differently in other situations that the directors have not paid particular attention to the period ending one year after the approval of the financial statements. If this is the case, the auditor needs to consider the impact on the auditor's report which may be either:

(a) The auditor may conclude that there is a significant level of concern about the entity's ability to continue as a going concern (but the auditor does not disagree with the use of the going concern basis). In which case the directors include a note to the financial statements and the auditor includes an emphasis of matter paragraph when setting out the basis of their opinion (in accordance with paragraph 21 of the SA 570); or,

(b) The auditor may conclude that the directors have not paid particular attention to the period ending one year from the date of approval of the financial statements but there is no significant level of concern. Then if the directors:

    (i) Refer to the period paid particular attention to, in the annual report, the auditor need not refer to the period in the basis of opinion; however

    (ii) If the directors do not refer to the period paid particular attention to, the auditor would do so in the auditors' report in accordance with paragraph 22 and A 27, of SA 570 ; or

(c) The auditor may conclude that the directors have not taken adequate steps to satisfy themselves that it is appropriate to adopt the going concern basis. Accordingly, there is a limitation of scope which gives rise to a qualified or adverse opinion in the auditor's report in accordance with paragraph A 21 to A 24, of SA 570.

Example 3 - A big company in manufacturing industry, at start up stage with certain facilities in project stage

Corollary from the auditor's risk assessment (Read with paragraph 10-11 of SA 570)

This company is a subsidiary of a multinational group and has two manufacturing plants, located at different places. The company employing around 3,000 people in both the units directly on its payroll and further deployed around 10,000 people through various contractors. The employment of the people considered to be in equal proportion among the two units. One unit (Unit A) of the company manufactures product which is a raw material for the other unit (Unit B).

The company has made huge investments for establishing facilities at both the units running in thousands of million dollars. For Unit A, the company is facing lot of hurdles and construction of facilities at the unit had to stop due to various related statutory and environmental clearances from certain authorities. However, the construction work at Unit B is completed and it is in running condition post trial run based on purchased raw material from other sources from domestic and international market, since there are uncertainty for the start of construction work at Unit A in next six month and further expects to get the production from Unit A within twelve month from the date of start of construction work. The company is hopeful that within the next six months, all the pending statutory and environmental clearance would be obtained for smooth operation. Until then and till the commencement of production at Unit A, the management expects that Unit B would continue its operation in this manner based on procured raw materials though it is costlier than the in-house production of raw materials.

Assessment by the auditor

When the auditor evaluates whether the management have, in assessing going concern, paid particular attention to a period of one year from the date of the financial statements the auditor:

(a) Reviewed the cash flow forecasts for the twelve month period from the period end date for the financial statements; and

(b) Then enquired the management the steps it has taken to assess the appropriateness of the going concern basis for the subsequent periods.

The management informed the auditor that they do not consider there is any need for additional cash flow forecasts to be prepared beyond the end of twelve month period from the period end date for the financial statement for current year because of:

- The cash flow forecasts that show a net cash inflow for the period and the present cash position is strong because of a recent sale of debtors.
- Sanction of large long term loans from the lead banker with repayment terms starting in next 3-4 years.
- Infusion of long term loans from certain group company with repayment terms starting in next 3-4 years.
- Conversion of payment for creditors into long term buyer's credit facilities from the banks with option to rollover for maximum period available as per banking rules (e.g., three years from the date of shipment).
- Sanction of bill discounting limit with the bankers for the sale contracts.
- Various long term sale contracts in place.

Based on the above facts, there may not be a *prima facie* going concern issue. However, there may still be significant uncertainties in execution of the management's plan. In such scenarios, the auditor may conclude that the management has taken adequate steps to satisfy itself that it is appropriate to adopt the going concern basis and may feel it appropriate to include a detailed note in the notes to accounts as part of the financial statements. Further, the auditor should give 'Emphasis of Matter Paragraph in the auditors' report'. Refer Part A in Annexure – I for a format of such Emphasis of Matter Paragraph in the auditors' report.

Example 4 –A company in sugar industry

There are several aspects which differentiate Sugar Industry from any other normal manufacturing industry. Some of the peculiar aspects are as follows:

- Cyclicality in the business
- Government control on sugarcane procurement and several stringent regulations on pricing of sugar and sugarcane
- Manufacturing process
- Sales pattern (mostly unorganised despite huge consumption)

Corollary from the auditor's risk assessment (Read with paragraph 10-11 of SA 570)

The most peculiar aspect of sugar industry is its being seasonal in nature and cyclical variations. The sugar industry goes through a period of loss (when excess sugarcane is produced) and profit (when there is shortage of sugarcane). Such cycle can be understood with the following table.

Sugar Industry – profit and loss making cycle

Increased sugarcane produce Increase in sugar recovery Higher sugar production Increased availability of the sugar in retail markets Decline in sugar price Reduced profitability Delayed payment to farmers High sugarcane arrears Low area under cultivation		Period of losses
Low sugarcane produce Decline in sugar recovery Low sugar production Increase in retail sugar prices Improved profitability Prompt payment to growers Increased cash availability with growers Increase in area under cultivation		Period of profits

The cycle time normally ranges from 4 to 5 years. To reduce the effect of this cycle, now-a-days most of the new units are set-up with a cogeneration of power and distillery unit, so that they can be profitable even when the sugar unit is making loss.

Thus considering these peculiar aspects, it is important that any auditor conducting audit of a sugar industry should clearly understand the details of these processes so as to be able to conduct effective audit and to obtain sufficient appropriate audit evidence regarding compliance with the provisions of applicable laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. Also to perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a significant impact on the functioning of the entity and conclusion drawn on their judgment for using the going concern assumption in the auditors' report. Refer Annexure – I in this guide for the format of various types of audit reports that may be used based on facts as applicable to the specific situation.

Annexure - I

An illustrative template for the format of auditors' report under different scenarios as illustrated in this Guide (e.g., in Q. No. 10 and Q. No. 11 in Chapter II):

Part A: An example of such wording for paragraph that may be included on 'Emphasis of Matter in the auditors' report' is given below:

"Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of Rs. ZZZ during the year ended March 31, 20X2 and, as of that date, the Company's current liabilities exceeded its total assets by Rs. YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern."

Part B: An example of such wording for paragraph that may be included in a qualified or adverse opinion, as appropriate in the auditors' report:

(i) Qualified opinion

An example of such wording for paragraph that may be included on qualified opinion in the auditors' report for 'Disagreement on Required Disclosures relating to Going Concern is given below:

"Basis for Opinion

The Company's financing arrangements expire and amounts outstanding to the tune of Rs. …………are payable on March 31, 20X2. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern, and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Opinion

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X2;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date."

Adverse opinion

An example of such wording for paragraph that may be included on adverse opinion in the auditors' report for 'Disagreement on Required Disclosures relating to Going Concern' is given below:

"Basis for Opinion

The Company's financing arrangements expired and the amount outstanding to the tune of Rs. ……….was payable on March 31, 20X2. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern, and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Opinion

In our opinion, because of the omission of the information mentioned in the preceding paragraph, the financial statements do not give the information required by the Companies Act, 1956, in the manner so required and also do not give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at March 31, 20X2; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date; and

(c) in the case of the cash flow statement, of the cash flows for the year ended on that date."

Annexure - II

Illustrative Format of Support Letter is given below:

On the Letter-head of the Parent Company (XYZ Limited)

Date: March 31, 20XX

M/s ABC Limited

Address: XXXX, India

Dear Sirs,

Sub: Letter of Support for financial assistance to M/s ABC Limited for ongoing projects and operations

We, XYZ Limited ('the Parent Company') confirms that we will provide financial support to M/s ABC Limited ('the Company') in order to meet the shortfall in its fund requirements over banks and other borrowings to meet out the projects which are in progress and other liabilities including loans from other group companies (if any), for a period of not less than 12 months from the date of financial closure of accounts of the Company for the year ended March 31, 20XX.

This letter is being issued at the request of M/s ABC Limited in respect of support for closure of their audit for the year ended March 31, 20XX.

Thanking you,

Yours truly,

Authorized Signatory

9

Implementation Guide to Standard on Auditing (SA) 720, The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements

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Foreword

The Institute of Chartered Accountants of India is the regulator of the accountancy profession in India. As a part of its regulatory functions, it issues auditing standards which are performance benchmarks for the auditors. To enhance the global acceptability and proficiency of the Indian auditors, the auditing standards issued by the Institute are based on the International Standards issued by the International Auditing and Assurance Standards Board (IAASB).

It is essential that auditing standards issued by the Institute are properly understood and applied in true spirit by the members so as to enhance the audit quality. Accordingly, the Institute, in addition to bringing out auditing standards, also develops guiding literature on those standards for the members. Implementation Guides to auditing standards are an important tool for the auditors to understand and implement these standards in an appropriate manner. Implementation Guides also provide solutions to the practical problems being faced by the auditors in implementing these standards in real life situations.

I am happy that the Auditing and Assurance Standards Board has been issuing a number of Implementation Guides to the Auditing Standards for the benefit of the members. This Implementation Guide to Standard on Auditing (SA) 720, 'The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements' is one such Guide in the series.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board and his team of other committee members and officers for their initiatives in bringing out guiding literature on auditing standards for the benefit of the members. I also look forward to more such Implementation Guides from the Auditing and Assurance Standards Board.

January 8, 2013 | **CA. Jaydeep Narendra Shah**
New Delhi | President, ICAI

Preface

As a part of its efforts to create awareness among the members about the various new/revised Standards on Auditing issued under the Clarity Project, the Auditing and Assurance Standards Board has been bringing out Implementation Guides to these Standards on Auditing. This Implementation Guide on SA 720, "The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements" is one such Guide in the series. The Guide provides practical implementation guidance on various aspects relating to other information in an easy and lucid language.

I am extremely grateful to CA. Harinderjit Singh, Gurgaon and CA. Ridhima Dubey, Gurgaon for squeezing time out of their pressing professional and personal preoccupations for preparing the draft of the Guide.

At this juncture, I wish to express my sincere thanks to, CA. Jaydeep N. Shah, President, ICAI as well as, CA. Subodh Kumar Agrawal, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, viz., CA. Shiwaji Bhikaji Zaware, Vice Chairman, CA. Amarjit Chopra, CA. Anuj Goyal, CA. G. Ramaswamy, CA. Jayant P. Gokhale, CA. J. Venkateswarlu, CA. Naveen N.D. Gupta, CA. Nilesh S. Vikamsey, CA. Pankaj Inderchand Jain, CA. Pankaj Tyagee, CA. Rajendra Kumar P., CA. S. Santhanakrishnan, CA. V. Murali, and Central Government nominee, Shri Gautam Guha and also to the co-opted members at the Board, viz., CA. Raj Agrawal, CA. Vinay Balse, CA. Purshotam Gaggar, CA. Pramod S. Shingte, CA. Partha Sarathi De for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, viz., Prof. Manoj Anand, CA. B. Padmaja, CA. Amit Roy, Shri Sunil Kadam, CA. Khurshed Pastakia, CA. Gopal Mahadevan, CA. Anil Sharma, CA. N. D. Gupta, CA. Raj Kumar

Aggarwal, CA. Jaideep Bhargava, CA. Shashi Gupta and CA. Santosh Gupta for their support to the Board. I also wish to thank the Secretariat of the Auditing and Assurance Standards Board for their efforts in giving the Guide its final shape.

I am sure that the members and other interested readers would find this Implementation Guide useful. I also eagerly look forward to the feedback of readers on the publication.

January 7, 2013
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

Contents

Foreword

Preface

Snapshot of SA 720 841

Chapter 1 : Background 846

Chapter 2 : Frequently Asked Questions (FAQs)................. 848

Appendix A : Flowcharts... 861

Appendix B : Case Studies 863

Snapshot of SA 720

SA 720

The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements

Effective for Audits of financial statements for periods beginning on or after April 1, 2010

This is a new standard.

Overview of SA 720

- **Introduction**
  - Scope
  - Effective date
- **Objective**
- **Definitions**
- **Requirements**
  - Reading Other Information (OI)
  - Material Inconsistencies
  - Material Misstatement of Fact

Application & Other Explanatory Material on these aspects

Scope

- Deals with auditor's responsibility wrt **other information (OI)** in documents containing:
  - audited financial statements; and
  - auditor's opinion thereon.
- **Unless** any specific requirement in an engagement:
  - Auditor's opinion does not cover OI.
  - Auditor has no specific responsibility to determine whether OI is properly stated.
- **BUT, read the OI** since:
  - inconsistencies vis-a-vis audited FS undermines the credibility of the audited FS.

- The operating factor is that the "other information" should be in the document containing audited FS as well as auditor's opinion thereon.

Documents Containing Audited FS

- Refers to :
  - Annual reports (or similar documents)

    ⇩

  - Issued to owners (or similar stakeholders)

    ⇩

  - Containing audited FS and Audit Report

Auditor's Objective

- Respond appropriately:
  - where such other information could undermine credibility of audited FS and Audit Report.

Definitions

Other Information (OI)

- Financial & non-financial information, Included by law/ regulation/custom, in documents containing audited FS and Audit Report.

  Examples:
  - Report by management / TCWG.
  - Financial summaries/ highlights.
  - Financial ratios.
  - Selected quarterly data.
- Does not include:
  - Press release/transmittal memorandum accompanying the documents containing audited FS.
  - Information contained in analyst briefings.
  - Information on entity's website.

Inconsistency

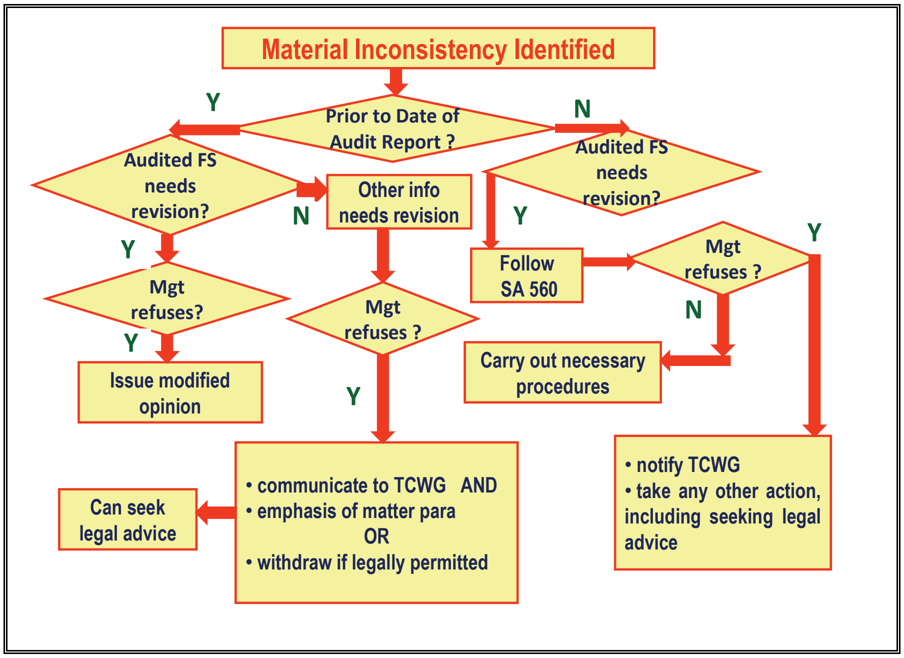
- OI that contradicts information contained in audited FS.
- May raise doubt about:
  - audit conclusions drawn from audit evidence obtained earlier.
  - Basis of audit opinion on FS.

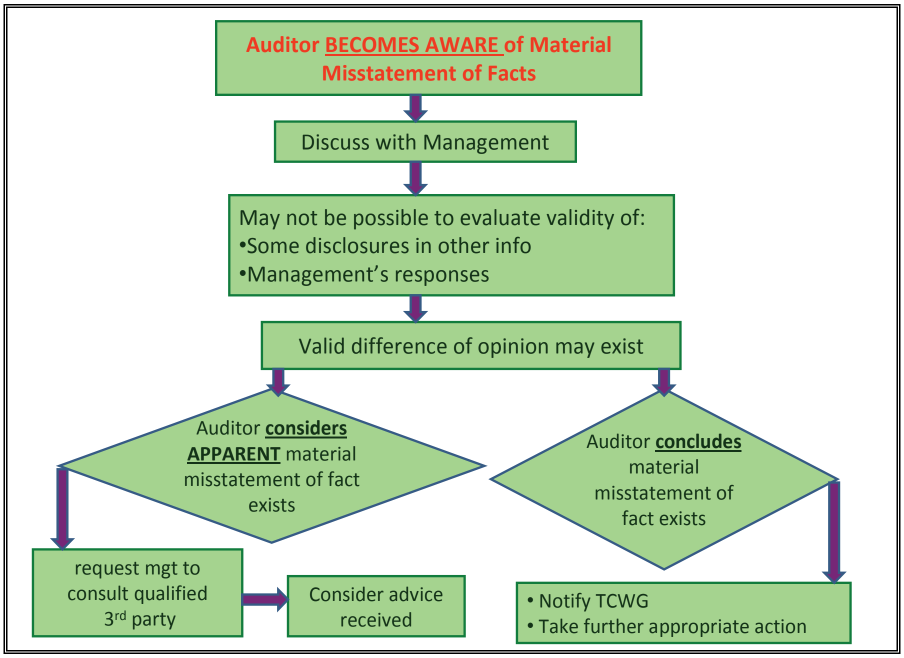
Misstatement of Fact

- OI that is:
  - Unrelated to audited FS and
  - Incorrectly stated/ presented.
- May undermine credibility of audited FS.

Reading Other Information

- Read OI to identify material inconsistencies *vis-a-vis* audited FS.
- Make appropriate arrangements with mgt/TCWG to get OI before date of Audit Report:
  - Helps timely resolution of possible material inconsistency/ misstatement of facts.
  - Agreement with management as to time of availability of OI.
  - If not possible before, then get OI, as soon as practicable.


Material Inconsistency Identified
Prior to Date of Audit Report ?
Y
N
Audited FS needs revision?
Other info needs revision
Audited FS needs revision?
N
Y
Y
Follow SA 560
Mgt refuses ?
Y
Mgt refuses?
Mgt refuses ?
N
Y
Issue modified opinion
Carry out necessary procedures
Y
• communicate to TCWG AND
• emphasis of matter para
OR
• withdraw if legally permitted
Can seek legal advice
• notify TCWG
• take any other action, including seeking legal advice


Auditor BECOMES AWARE of Material Misstatement of Facts
Discuss with Management
May not be possible to evaluate validity of:
•Some disclosures in other info
•Management's responses
Valid difference of opinion may exist
Auditor considers APPARENT material misstatement of fact exists
Auditor concludes material misstatement of fact exists
request mgt to consult qualified 3rd party
Consider advice received
• Notify TCWG
• Take further appropriate action

Chapter 1
Background

This implementation guide provides supplementary guidance to SA 720 and has to be read together with the SA. In absence of any separate requirement, the auditor's opinion does not cover 'Other Information' in documents containing audited financial statements and the auditor has no specific responsibility for determining whether or not other information is properly stated except where there exists a regulatory requirement to do so. However, in case there are material inconsistencies between the audited financial statements and the other information, the credibility of the financial statements would be undermined and thus, it may be considered necessary by the auditor to review the Other Information.

The SA deals with the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. It prescribes the procedure that the auditor needs to perform in respect of the other information and the responsibility of the auditor in case there are any material inconsistencies between the audited financial information and other information or in case there is a material misstatement of fact in the other information.

Table A: Auditors Responsibility under the Companies Act, 1956

Pursuant to the requirements of section 215 of the Companies Act, 1956 (the "Act") the balance sheet and the profit and loss account shall be approved by the Board of the directors before they are signed on behalf of the Board in accordance with provisions of this section and before submitted to the auditors for their report thereon.

Further, as stated in section 216 of the Act, the profit and loss account shall be annexed to the balance sheet and the auditors' report including the auditors' separate, special or supplementary report, if any shall be attached to.

In accordance with section 217 of the Act, the director's report is attached to the balance sheet laid before a company in general meeting and thus the auditors are not required to express any opinion on the appropriateness of the content included therein, while commenting on 'true and fair view' of the financial statement pursuant to the requirement of section 227 of the Act.

Under section 222 of the Act, which deals with construction of references to documents annexed to accounts, it is acknowledged that certain information which should have formed part of statement 'annexed' to the accounts, may be included in the director's report and the information so included in the directors report, would be construed as 'annexed' to the accounts and the auditor should consider the same while giving any opinion on the financial statement.

To illustrate , claim raised by Excise Department on a company if acknowledged by the directors in the directors report instead of being disclosed as 'contingent liability', would be considered as part of notes and the auditor should consider the same while giving any opinion on the financial statement.

The Implementation guide provides additional guidance to the members by way of 'Frequently Asked Questions', specifically in the following areas:

(a) Definition of Other Information

(b) Material Inconsistencies

(c) Material Misstatements of Fact

(d) Other relevant areas

Also, as an appendix, the implementation guide contains flow charts and case studies for the better understanding of the readers.

Frequently Asked Questions (FAQs)

Q1: What is the definition of Other Information?

A1: SA 720 defines other information as financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.

Paragraph A2 of the SA provides examples of other information in documents containing audited financial statements:

- A report by management or those charged with governance on operations, this would include the following:
  - Director's Report under section 227(2A) of the Act;
  - Report on compliance with the corporate governance norms as required by Clause 49 of the Listing Agreement;
  - Report on Corporate Social Responsibility in accordance with the Ministry of Corporate Affairs ('MCA') voluntary guidelines;
  - Management discussion and analysis;
  - Sustainability Report;
- Financial summaries or highlights;
- Group and related entity data;
- Planned capital expenditures;
- Contractual obligations;
- Financial ratios;
- Selected quarterly data;
- Market information.

In this regard it is also important to understand what should not be construed as other information. Paragraph A3 of SA list down the certain examples which would not be considered as other information:

- A press release or a transmittal memorandum, such as a covering letter, accompanying the document containing audited financial statements and the auditor's report thereon.
- Information contained in analyst briefings.
- Information contained on the entity's web site
- XBRL financial statements.

The above list of other documents should not be considered as an all inclusive list, rather the examples are guiding principles and whether or not a particular piece of information should be construed as other information would depend on each case. Accordingly, the members should exercise their judgment.

Q2: What are documents containing audited financial statements?

A2: In this SA "documents containing audited financial statements" refers to annual reports (or similar documents), that are issued to shareholders, containing audited financial statements and the auditor's report thereon. This SA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements, such as those used in securities offerings and part of a bid documents. (SA 200.2).

Consideration specific to smaller entities

Unless required by law or regulation, smaller entities are less likely to issue documents containing audited financial statements and other information. However, an example of such a document would be where a legal requirement exists for an accompanying report by those charged with governance. [SA 720.2; A4]

Q3: What is meant by Material inconsistency?

A3: Other information that contradicts audited financial statements would give rise to an inconsistency. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and possibly, about the basis for the auditor's opinion on the financial statements.

Accordingly, in considering the financial data in the other information, the auditor shall identify financial data where an inconsistency would have a **material effect** on the credibility of the audited financial statements.

Material inconsistencies

The effect of an inconsistency is considered to be material if, individually or in aggregate, it could reasonably be expected to influence the economic decisions of the intended user taken on the basis of the audited financial statements and the other information as a whole.

The above could be explained by way of examples:

i. Difference in amount reported as turnover in the Directors Report and as reported in the audited financial statements; and

ii. In accordance with the requirements of section 227 of the Act, in cases where the auditor has included an observation in his/her audit report, the directors are required to respond to those observations in director's report. However, if same is not included in the directors report same would lead to violation with the provisions of the Act and they would be classified as material inconsistency.

Q4: Is the auditor required to audit 'Other Information' for purpose of expressing an opinion on true and fair view of the financial information?

A4: No, the auditor is **only required to read** the other information to ensure that the credibility of the audited financial statement is not undermined by material inconsistencies between the audited financial statement and other information [SA720.6].

To be specific it is not the primary purpose of the auditor to identify and settle material inconsistencies or material misstatements of fact within other information. Nonetheless, the auditor can become aware that other information appears to include material inconsistencies or material misstatements of fact. Under these circumstances, the auditor should not knowingly allow audited financial statements, which are the subject of his/her report, to be included in a document that contains materially false or misleading other information or a material omission of fact.

If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. [SA 720.14]

Q5: What could be possible instances of material misstatement of facts, which the auditor may become aware of while reading other information?

A5: Certain instances of material misstatement of fact which the auditor may become aware of while reading other information, would include but not restricted to the following:

- In the Management Discussion and Analysis the competitive market share held by the Company is different from what has been placed on record for the auditors and which formed the basis of 'going concern assumption'.
- Director has been wrongly represented as Independent Director and consequently, this may result into non-compliance with clause 49 of the listing agreement.

Also refer to FAQ 3 above.

Q6: In addition to procedure identified in FAQ 4 above, how should the auditor determine the existence of material inconsistency between audited financial statements and other information?

A6: Existence of material inconsistency between audited financial statements and Other Information can be determined in the following manner:

- For financial data that are intended to be the same as those in the audited financial statements, compare the financial data to the audited financial statements; and
- For financial data that are directly reconcilable to the audited financial statements, obtain management's reconciliation of such data and compare the components of the reconciliation to the audited financial statements. Examples include commonly used non-GAAP measures such as, earnings before interest, taxes, depreciation, and amortization (EBITDA).

There may be other financial data that may include information derived from the entity's financial reporting system but which are not directly reconcilable to the audited financial statements because such data contains elements which are not derived from the entity's underlying accounting records or are based on complex models. Examples include actuarial figures. Because there is no direct relationship between such data and the audited financial statements, such data is not directly reconcilable to the audited financial statements. In these circumstances, it would be appropriate for the auditor to seek necessary assurance by relying on the work of experts.

Q7: Paragraph A1 of SA mentions that the auditor may have additional responsibilities, through statutory or other regulatory requirements, in relation to other information which are beyond the scope of this SA.

What are the circumstances where the auditor may have such additional responsibilities? What would be the auditor's responsibility in those circumstances?

A7: There could be circumstances such as those listed below, where there may be statutory and regulatory requirements for the auditor to apply specific procedures on other information, which are beyond the scope of this SA.

i. Report on pro forma financial information in accordance with the requirements of paragraph 23 of item (IX)(B) of Schedule VIII of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;

ii. Examination Report for proposed IPO, in accordance with the requirements of paragraph B (1) of Part II of Schedule II to the Act and item (IX) of Part A of Schedule VIII of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009; and

iii. Opinion on the reliability of performance indicators described in the other information.

When there are such obligations, the auditor's additional responsibilities are determined by the nature of the engagement and by law, regulation and professional standards. The auditor's responsibility in such circumstances would be to express an audit opinion and where such other information is omitted or contains deficiencies, the auditor may require by law or regulation to refer to the matter in the related report. These circumstances would not be covered within this SA.

Q8: The SA states that the auditor should obtain all the other information prior to the date of the auditor's report and if it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable. What is meant by as soon as practicable?

A8: The SA does not prescribe any time frame for reviewing other information; however one should construe the same to be information readily available within a reasonable timeframe. However, under all circumstances, it should preferably be received before that audit report.

Q9: Is the Management of the Company legally bound to give 'other information' prior to the date of the auditor's report?

A9: No, the auditor can only request the management or those charged with governance to provide the other information prior to the date of audit report.

However, as an exception to the above, reference should be made to Table A: Auditors Responsibility above.

Q10: Where the auditor does not receive 'other information' prior to the date of the auditor's report, whether same needs to be referred in the auditor's report?

A10: In this regard reference should be made to some of the specific reporting responsibility of the auditor under section 227(3) of the Act, which are -

i. whether he has obtained all the information and explanations, which to the best of his knowledge and belief, were necessary for the purposes of his audit;

ii. 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;

iii. whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns;

iv. whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211;

v. Other information are neither considered necessary for the purpose of the audit, nor would these be required to be commented as part of the proper books of accounts and thus, the auditor has no responsibility to audit the other information and consider them for the purpose of expressing opinion on true and fair view of the financial statements.

Thus, the fact that the other information has not been received would not lead to modification in the audit report. In this regard one should also consider whether non-receipt of other information could be considered for reporting as 'other matter' under SA 706.

As defined under paragraph 5(b) of SA 706, other matter paragraph are 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 judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Considering above, the auditor may report certain matter under other matter paragraph where in his/her opinion the matter under evaluation is of relevance to the users' understanding and same has not been presented or disclosed in the financial statements. Thus, the mere non-receipt of other information could not be considered for reporting under 'other matter' paragraph. However, in this regard reference should be made to FAQ 13.

Q11: The SA states that the auditor should make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. What could be such possible arrangements?

A11: Obtaining the other information prior to the date of the auditor's report enables the auditor to resolve possible material inconsistencies and apparent material misstatements of fact with management on a timely basis.

The possible appropriate arrangements with management or those charged with governance to ensure obtaining other information prior to the date of the auditor's report can be:

- Incorporating the requirement for review of the other information in the engagement letter;

- Making written request to the management to review other information during the engagement. For example, review of other information in the meeting of the Audit Committee/ Board of directors.

Q12: What could be the possible recourse for the auditors for the non-receipt of other information?

A12: The auditor should communicate with those charged with governance in writing. After making written request, the auditor is not duty bound to perform any other procedures and the communication thus made should be documented appropriately in the working files.

Q13: What are the auditor's responsibilities when material inconsistencies or material misstatement of facts are identified in Other Information?

A13: ***Auditor's Response to Material Inconsistencies***

Material inconsistencies can be identified by the auditor prior to the Date of the Auditor's Report and or subsequent to the Date of the Auditor's Report. Where material inconsistencies are identified, the auditor should assess whether there is any need to revise the financial statements or the other information. [SA 720.10]

When management agrees to revise the audited financial statement and/or financial information (as the case may be), the auditor should consider impact of those revisions on its audit procedures and audit opinion thereon. If considered necessary the auditor should modify its audit procedures to obtain reasonable assurance on the revised information and document the same in its working papers.

- When revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in accordance with SA 705[1].

The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

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

- When revision of the other information is considered necessary by the auditor and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance; and
    i. Include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with SA 706[2]; or
    ii. Where withdrawal is legally permitted, withdraw from the engagement.

[1] In view of the change in effective date of Revised SA 700; SA 705 and SA 706, reference should be made to existing SA 700.

[2] Refer footnote 1 above. Accordingly, under the existing SA 700, there would be no requirement to include a other matter paragraph and should consider modifying its audit report for refusal to make changes to the 'other information' [Refer section 222 of the Companies Act, 1956].

In case of certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions), withdrawal from the engagement may not be an option. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency. [SA 720.A7]

However, for the situations where material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report [SA 720.12-13] and the auditor considers that the revision of the audited financial statements is necessary, the auditor shall follow the relevant requirements in SA 560 (Revised), depending upon the following situations:

i. Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued.

ii. Facts Which Become Known to the Auditor After the Financial Statements have been Issued.

In accordance with the requirement of paragraph A8 the auditor should review the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor's report thereon, and the other information are informed of the revision. However, where the management refuses to make the revision of such other information that the auditor concludes is necessary, appropriate further actions by the auditor may include obtaining advice from the auditor's legal counsel.

Auditor's Response to Material Misstatement of Facts

If the auditor becomes aware of material misstatement of facts, the matter should be discussed with the management. However, if the auditor still believes that there still remains an apparent material misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's legal counsel, and the auditor shall consider the advice received. [SA 720.15]

When the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action. [SA 720.16; A11]

Q14: What are the material modifications *vis-à-vis* ISA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements"?

A 14: Below are some of the deletions made to the SA 720

1. Paragraph 10 of ISA 720 dealt with the circumstances where the revision of the financial statements is necessary and management refuses to make the revision. In these circumstances, the auditor shall communicate this matter to those charged with governance and include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA 706; or withhold the auditor's report; or where withdrawal is legally permitted, withdraw from the engagement. Since in India, the practice of withholding the auditor's report is not in vogue, an option of withholding the auditor's report by the auditor has been deleted. Similarly in paragraph A7 of the Application Section, an option of withholding the auditor's report by the auditor has been deleted.

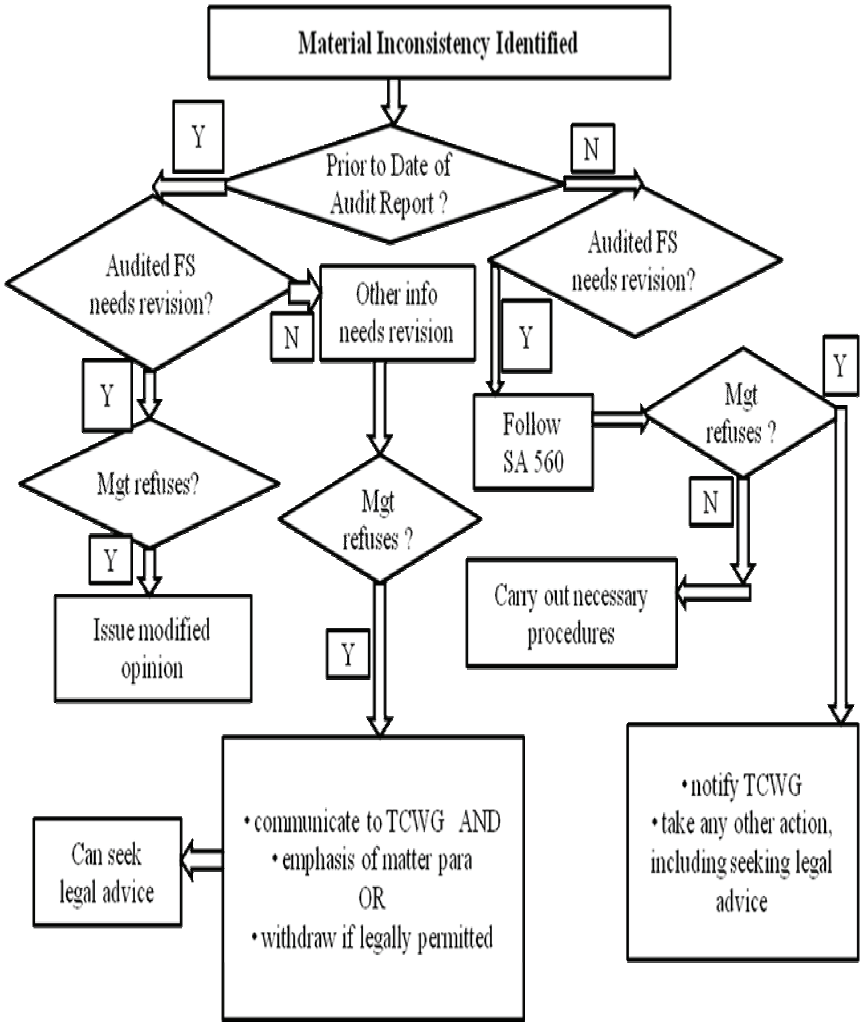
2. Paragraph A2 of ISA 720 provides the examples of the other information including 'employment data' and 'names of officers and directors'. Reference to these two specific examples has been deleted so that the auditor can focus on more relevant aspects of other information.

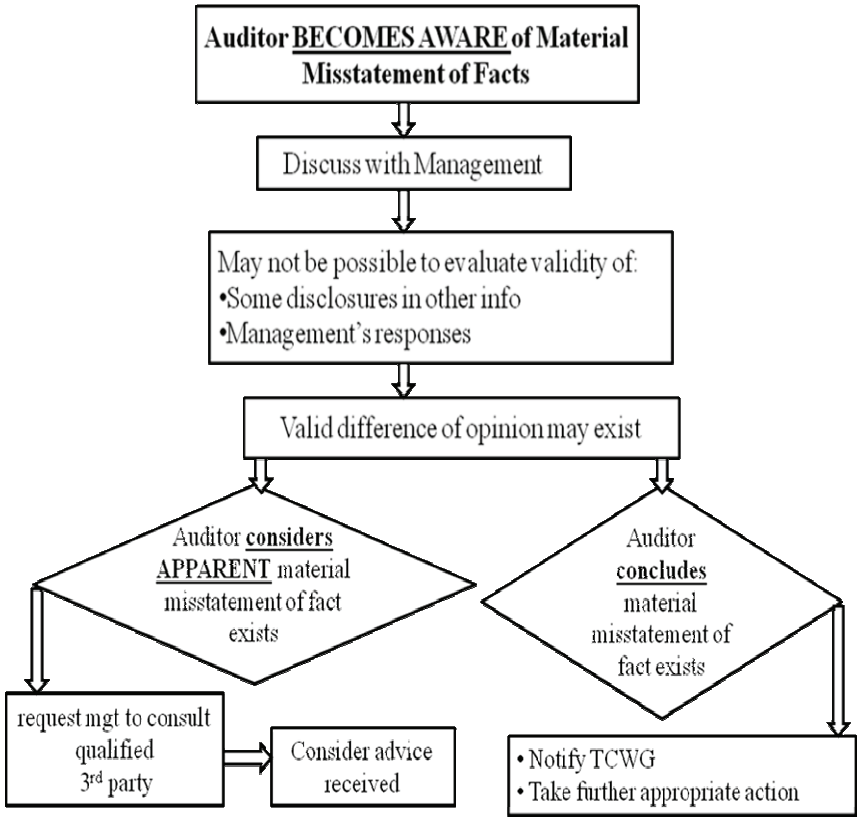
3. Paragraph A4 of ISA 720 provides an example of the other information that may be included in a document containing the audited financial statements of a smaller entity are a detailed income statement and a management report. Since, in India, the terminology of "detailed income statement" and a "management report" do not exist; these have been deleted completely from the SA.

4. Paragraph A7 of ISA 720 provides that in case of public sector entitles, withdrawal from the engagement or withholding the auditor's report may not be the options. In such cases the auditor may issue a report to the appropriate statutory body giving details of the inconsistency. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

5. Further, it is also possible that withdrawal from the engagement may not be an option even in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Paragraph A7 has, accordingly, been made more generic in its application.

Appendix A
Flow Charts




Auditor BECOMES AWARE of Material Misstatement of Facts
Discuss with Management
May not be possible to evaluate validity of:
•Some disclosures in other info
•Management's responses
Valid difference of opinion may exist
Auditor considers APPARENT material misstatement of fact exists
Auditor concludes material misstatement of fact exists
request mgt to consult qualified 3rd party
Consider advice received
• Notify TCWG
• Take further appropriate action

Appendix B

Case Studies

Background

The Draft Annual Report of the Company XYZ Limited for the year ended March 31, 2011 in the Management Discussion and Analysis states following in respect of the 'other income'

Management Discussion and Analysis

Other Income

Stand alone other Income at Rs. 300 crore was higher on account of better yields and higher treasury corpus, post the return of capital by one of the subsidiaries

Profit and Loss Account for the year ended March 31, 2011

	Schedule	For the year ended 31st March, 2011	For the year ended 31st March, 2010
Income			
Gross Sales and Operating Revenues	14	____	____
Less: Excise Duty		____	____
Net Sales and Operating Revenues	15	216	209

However, the same is not evident from the profit and loss account. In view of above, there exist material inconsistency between the facts furnished by the management under the Management Discussion and Analysis and the profit and loss account. Auditor becomes aware of the material inconsistency prior to the date of audit report after reading the draft management discussion and analysis as proposed to be included in the annual report.

Analysis and conclusion

The auditor should request for rectification of the material misstatement of fact in the Management Discussion and Analysis and the management should ensure the correction of the factual misstatement.

Background

The Draft Annual Report of the Company ABC Limited for the year ended March 31, 2010 in the Directors report under the responsibility statement states as under:

Quote

Pursuant to Section 217(2AA) of the Companies Act, 1956, the Directors, based on the representations received from the Operating Management, confirm:

a) That in the preparation of the annual accounts, the applicable accounting standards have been followed and that no material departures have been made from the same;

b) That they have, in selection of the accounting policies, consulted the statutory auditors and have applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit of the Company for that period;

c) That to the best of their knowledge and information, they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Companies Act, 1956 for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities; and

d) That they have prepared the annual accounts on a going concern basis.

Unquote

Notes to the financial statement states the following as its accounting policy

Significant Accounting Policy:

The financial statements have been prepared, on the assumption that the Company will not be a going concern (Refer Note 2 below), to comply in all material aspects with applicable accounting principles in India, the applicable Accounting Standards notified u/s 211 (3C) of the Companies Act, 1956 of India (the "Act") and the relevant provisions thereof.

Note 2:

The Company has terminated its operations effective March 31, 2012 and the necessary applications have been made to the respective regulatory authorities, in this regard. Accordingly, the financial statements for the year ended March 31, 2012 are not prepared on a going concern assumption and necessary adjustment has been made to write down its assets to net realisable value, wherever applicable.

Analysis and conclusion

There exists an apparent material inconsistency between the director's responsibility statement and the accounting policy set out in the notes to the financial statements.

The auditor after reading the director's responsibility statement should request the management to correct the same. Further, in the instant situations the directors are casted an additional responsibility under the provisions of section 217(2A) the Act to ratify the same.

Background

Director report states as under in respect of claims

The estimated amount of sales tax claim is Rs. 1,682 million (2010: Rs. 2,648 million).

Notes to the financial statements do not include any reference to the sales tax claim.

Analysis and Conclusion

Considering the requirement of Accounting Standard (AS) 29, Provisions, Contingent Liabilities and Contingent Assets, sales tax claim should have been disclosed as 'contingent liability', failure to which would tantamount to non-compliance with Section 211(3C) of the Act and thus auditors should consider the same while expressing an opinion on the financial statement.

In this regard reference should be made to Table A above.

Background

The auditor is about to sign the audit report and requested the management for draft copy of the annual report that would include the audited financial statements. The management inspite of regular reminders from the auditor did not provide other information.

Issue

What could be the possible recourse available to the auditor?

Response

The management of the company cannot be forced to share any information other than those considered necessary for the purpose of the audit of the financial statements. The power of the auditor to assess the books and records of the company is clearly specified in the section 227 of the Act.

To avoid any consequential implications, the auditor should ensure that the requirement for review of the other information is appropriately incorporated in the engagement letter. Apart from the citing the arrangement made in the engagement letter the auditor should make written request to the management to review other information during the engagement.

The written requests so made should be appropriately documented as part of the working papers of the engagement.