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Auditing and Assurance

Standards & Guidance Notes

Vol. 2

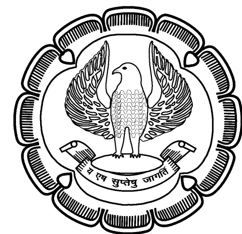
Board of Studies
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

PAPER 6

AUDITING AND ASSURANCE

Auditing and Assurance Standards
&
Guidance Notes

VOLUME : 2



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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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SYLLABUS

PAPER – 6 : AUDITING AND ASSURANCE

(One Paper- Three hours -100 Marks)

Level of knowledge: Working Knowledge

Objective:

To understand objective and concept of auditing and gain working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements.

Contents:

1. Auditing Concepts — Nature and limitations of Auditing, Basic Principles governing an audit, Ethical principles and concept of Auditor's Independence, Relationship of auditing with other disciplines.

2. **Auditing and Assurance Standards and Guidance Notes —** Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board, Auditing and Assurance Standards issued by the ICAI AAS 1 – AAS 30 and AAS 34; Guidance Note(s) on — Audit of Fixed Assets, Audit of Inventories, Audit of Investments, Audit of Debtors, Loans and Advances, Audit of Cash and Bank Balances, Audit of Miscellaneous Expenditure, Audit of Liabilities, Audit of Revenue, Audit of Expenses.

3. Auditing engagement — Audit planning, Audit programme, Control of quality of audit work — Delegation and supervision of audit work.

4. Documentation — Audit working papers, Audit files: Permanent and current audit files, Ownership and custody of working papers.

5. Audit evidence — Audit procedures for obtaining evidence, Sources of evidence, Reliability of audit evidence, Methods of obtaining audit evidence — Physical verification, Documentation, Direct confirmation, Re-computation, Analytical review techniques, Representation by management, Obtaining certificate.

6. Internal Control — Elements of internal control, Review and documentation, Evaluation of internal control system, Internal control questionnaire, Internal control check list, Tests of control, Application of concept of materiality and audit risk, Concept of internal audit.

7. Internal Control and Computerized Environment, Approaches to Auditing in Computerised Environment.

8. Auditing Sampling — Types of sampling, Test checking, Techniques of test checks.

9. Analytical review procedures.

10. Audit of payments — General considerations, Wages, Capital expenditure, Other payments and expenses, Petty cash payments, Bank payments, Bank reconciliation.

11. Audit of receipts — General considerations, Cash sales, Receipts from debtors, Other Receipts.

12. Audit of Purchases — Vouching cash and credit purchases, Forward purchases, Purchase returns, Allowance received from suppliers.

13. Audit of Sales — Vouching of cash and credit sales, Goods on consignment, Sale on approval basis, Sale under hire-purchase agreement, Returnable containers, Various types of allowances given to customers, Sale returns.

14. Audit of suppliers' ledger and the debtors' ledger — Self-balancing and the sectional balancing system, Total or control accounts, Confirmatory statements from credit customers and suppliers, Provision for bad and doubtful debts, Writing off of bad debts.

15. Audit of impersonal ledger — Capital expenditure, deferred revenue expenditure and revenue expenditure, Outstanding expenses and income, Repairs and renewals, Distinction between reserves and provisions, Implications of change in the basis of accounting.

16. Audit of assets and liabilities.

17. Company Audit — Audit of Shares, Qualifications and Disqualifications of Auditors, Appointment of auditors, Removal of auditors, Powers and duties of auditors, Branch audit , Joint audit , Special audit, Reporting requirements under the Companies Act, 1956.

18. Audit Report — Qualifications, Disclaimers, Adverse opinion, Disclosures, Reports and certificates.

19. Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies).

20. Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.

Note : Candidates are expected to have working knowledge of relevant Auditing and Assurance Standards issued by the ICAI with reference to above mentioned topics.

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PART I

AUDITING AND ASSURANCE STANDARDS

[NOW RENAMED AS STANDARDS ON AUDITING (SA)]

FRAMEWORK OF STATEMENTS ON STANDARD AUDITING PRACTICES[*] AND GUIDANCE NOTES ON RELATED SERVICES[**]

Introduction

1. The Auditing Practices Committee (APC)[***] of the Institute of Chartered Accountants of India develops Statements on Standard Auditing Practices (SAPs) and Guidance Notes on related services. SAPs and Guidance Notes[1] are issued under the authority of the Council of the Institute. The purpose of this document is to describe the framework within which SAPs and Guidance Notes on related services are issued in relation to the services which may be performed by auditors.

2. For ease of reference, except where indicated, the term "auditor" is used throughout the SAPs and Guidance Notes (except where a different term is considered appropriate) when describing both auditing and related services which may be performed. Such reference is not intended to imply that a person performing related services need be the auditor of the entity's financial statements.

Financial Reporting Framework

3. Financial statements are ordinarily prepared and presented annually and are directed toward the common information needs of a wide range of users. Many of those users rely on the financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of :

(a) relevant statutory requirements, e.g., the Companies Act, 1956, for companies;

(b) accounting standards issued by the Institute of Chartered Accountants of India; and

(c) other recognised accounting principles and practices, e.g., those recommended in the Guidance Notes issued by the Institute of Chartered Accountants of India.

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[*] Now known as the Auditing and Assurance Standards.

[**] Published in July, 2001 issue of 'The Chartered Accountant'.

[***] Now known as the Auditing and Assurance Standards Board (AASB).

[1] For the authoritative status of AASs and Guidance Notes, attention is invited to the "Clarification Regarding Authority Attached to the Documents Issued by the Institute" (first published in the December, 1985 issue of the Journal).

Framework for Auditing and Related Services

4. This Framework distinguishes audits from related services. Related services comprise reviews, agreed-upon procedures and compilations. As illustrated in the diagram below, audits and reviews are designed to enable the auditor to provide high and moderate levels of assurance respectively, such terms being used to indicate their comparative ranking. Engagements to undertake agreed-upon procedures and compilations are not intended to enable the auditor to express assurance.

	Auditing	Related Services		
Nature of service	Audit	Review	Agreed-upon Procedures	Compilation
Comparative level of assurance provided by the auditor	High, but not absolute assurance	Moderate assurance	No assurance	No assurance
Report provided	Positive assurance on assertion(s)	Negative assurance on assertion(s)	Factual findings of procedures	Identification of information compiled

5. The Framework does not apply to other services provided by auditors such as taxation, consultancy, and financial and accounting advice.

Levels of Assurance

6. Assurance in the context of this Framework refers to the auditor's satisfaction as to the reliability of an assertion being made by one party for use by another party. To provide such assurance, the auditor assesses the evidence collected as a result of procedures conducted and expresses a conclusion. The degree of satisfaction achieved and, therefore, the level of assurance which may be provided is determined by the procedures performed and their results.

7. In an audit engagement, the auditor provides a high, but not absolute, level of assurance that the information subject to audit is free of material misstatement. This is expressed positively in the audit report.

8. In a review engagement, the auditor provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of negative assurance.

9. For agreed-upon procedures, as the auditor simply provides a report of the factual findings, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

10. In a compilation engagement, although the users of the compiled information derive some benefit from the involvement of a member[1] of the Institute, no assurance is expressed in the report.

Audit

11. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrase used to express the auditor's opinion is "give a true and fair view". A similar objective applies to the audit of financial or other information prepared in accordance with appropriate criteria.

12. In forming the audit opinion, the auditor obtains sufficient appropriate audit evidence to be able to draw conclusions on which to base that opinion.

13. The auditor's opinion enhances the credibility of financial statements by providing a high, but not absolute, level of assurance. Absolute assurance in auditing is not attainable as a result of such factors as the need for judgement, the use of test checks, the inherent limitations of any accounting and internal control systems and the fact that most of the evidence available to the auditor is persuasive, rather than conclusive, in nature.

Related Services

Reviews

14. The objective of a review of financial statements is to enable an auditor[2] to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework. A similar objective applies to the review of financial or other information prepared in accordance with appropriate criteria.

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[1] To distinguish compilation engagements from audits and other related services, the term "member" (rather than "auditor") has been used to refer to a professional accountant in practice.

[2] As explained in paragraph 2, the term 'auditor' is used when describing both auditing and related services. Such reference is not intended to imply that a person performing related services need be the auditor of the entity's financial statements.

15. A review comprises inquiry and analytical procedures which are designed to review the reliability of an assertion that is the responsibility of one party for use by another party. While a review involves the application of audit skills and techniques and the gathering of evidence, it does not ordinarily, involve an assessment of accounting and internal control systems, tests of records and of responses to inquiries by obtaining corroborating evidence through inspection, observation, confirmation and computation, which are procedures ordinarily performed during an audit.

16. Although the auditor attempts to become aware of all significant matters, the procedures of a review make the achievement of this objective less likely than in an audit engagement, thus the level of assurance provided in a review report is correspondingly less than that given in an audit report.

Agreed-upon Procedures

17. In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

Compilations

18. In a compilation engagement, a member[1] of the Institute is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the member's involvement because the service has been performed with due professional skill and care.

Auditor's Association with Financial Information

19. An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection. If the auditor is not associated in this manner, third parties can assume

[1] To distinguish compilation engagements from audits and other related services, the term "member" (rather than "auditor") has been used to refer to a professional accountant in practice.

no responsibility of the auditor. If the auditor learns that an entity is inappropriately using the auditor's name in association with financial information, the auditor would require management to cease doing so and consider what further steps, if any, need to be taken, such as informing any regulatory authority and/or known third party users of the information of the inappropriate use of the auditor's name in connection with the information. The auditor may, if necessary, take other action, for example, seeking legal advice.

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

Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards

The Auditing and Assurance Standards Board, in 2007, adopted the *Revised Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.* In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz.,

(i) *Standards on Auditing (SAs)* - to be applied in the audit of historical financial information

(ii) *Standards on Review Engagements (SREs)* - to be applied in the review of historical financial information

(iii) *Standards on Assurance Engagements (SAEs)* - to be applied in assurance engagements, engagements dealing with subject matters other than historical financial information

(iv) *Standards on Related Services (SRSs)* - to be applied to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements

Further, there is also a mother standard on quality control. In addition, each of the above group of Standards has been allotted a numerical series as follows and the Standards pertaining to a particular group is allotted a number from that numerical series:

Type of Standard	Numerical Series
Standards on Quality Control	01-99
Standards on Auditing	100-999
Standards on Review Engagements	2000-2699
Standards on Assurance Engagements	3000-3699
Related Services	4000-4699

The Standards on Auditing have also been further divided into seven categories

based on the aspect of audit engagement addressed by them and each of these categories has a unique numerical series allotted. Therefore, a Standard pertaining to a particular aspect of audit would be al otted a number from that relevant numerical series. These categories and series are as follows:

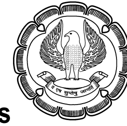
Aspect of Auditing Covered	Numerical Series
Introductory Matters	100 - 199
General Principles and Responsibilities	200 – 299
Risk Assessment and Response to Assessed	300 - 499
Risk	
Audit Evidence	
Using Work of Others	500 – 599
Audit Conclusions and Reporting	600 - 699
Specialised Areas	700 - 799
	800 - 899

Accordingly, the erstwhile Auditing and Assurance Standard (AAS) 30, *External*

Confirmations can be found under the category "Audit Evidence" as Standard on Auditing (SA) 505. Similarly, AAS 3, *Documentation* can be found under the category "General Principles and Responsibilities" as SA 230. The readers would therefore, find the Standards appearing in the order of the new number allotted to them and not the number which they carried as AAS. A complete table of old AAS numbers *vis a vis* corresponding SA number is given below.

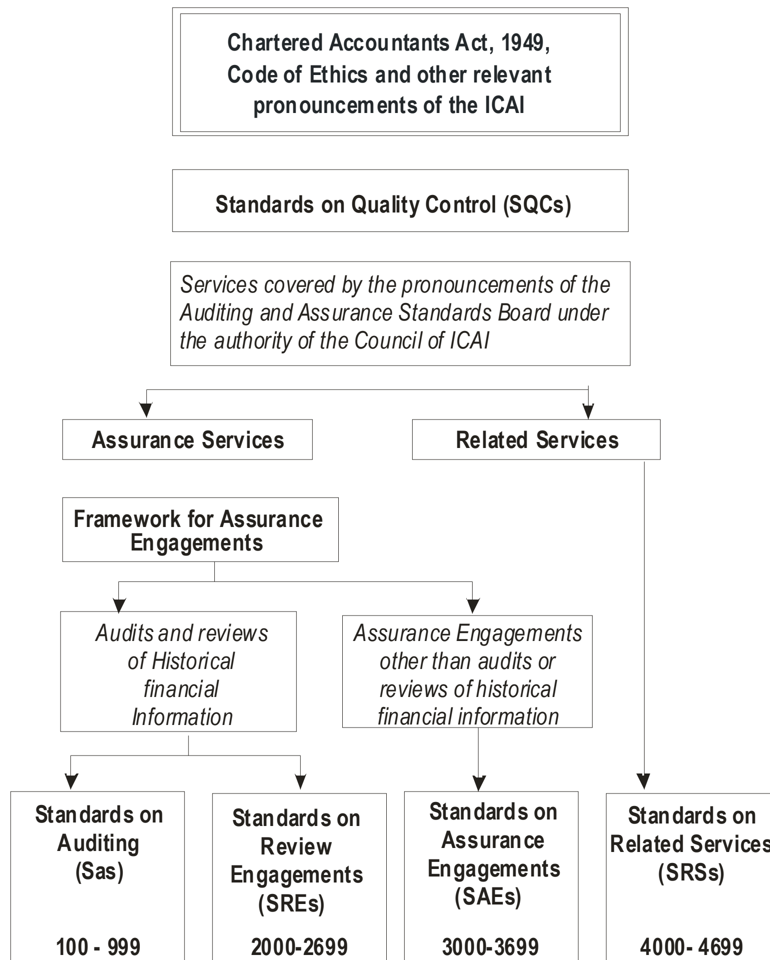
Existing AAS Number	Title of the Standard	New Number of the Standard
1	Basic Principles Governing an Audit	SA 200
2	Objectives and Scope of the Audit of Financial Statements	SA 200A
3	Documentation	SA 230
4	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements	SA 240
5	Audit Evidence	SA 500
6	Risk Assessments and Internal Control	SA 400
7	Relying Upon the Work of an Internal Auditor	SA610
8	Audit Planning	SA 300
9	Using the Work of an Expert	SA 620
10	Using the Work of Another Auditor	SA 600
11	Representations by Management	SA 580
12	Responsibility of Joint Auditors	SA 299
13	Audit Materiality	SA 320
14	Analytical Procedures	SA 520
15	Audit Sampling	SA 530
16	Going Concern	SA 570
17	Quality Control for Audit Work	SA 220
18	Auditing of Accounting Estimates	SA 540
19	Subsequent Events	SA 560
20	Knowledge of the Business	SA 310
21	Consideration of Laws and Regulations in an Audit of Financial Statements	SA 250

22	Initial Engagements – Opening Balances	SA 510
23	Related Parties	SA 550
24	Audit Considerations Relating to Entities Using Service Organisations	SA 402
25	Comparatives	SA 710
26	Terms of Audit Engagement	SA 210
27	Communication of Audit Matters with Those Charged with Governance	SA 260
28	The Auditor's Report on Financial Statements	SA 700
29	Audit in a Computer Information Systems Environment	SA 401
30	External Confirmations	SA 505
31	Engagements to Compile Financial Information	SRS 4410
32	Engagements to Perform Agreed- upon Procedures Regarding Financial Information	SRS 4400
33	Engagements to Review Financial Statements	SRE 2400
34	Audit Evidence - Additional Considerations for Specific Items	SA 501
35	The Examination of Prospective Financial Information	SAE 3400



A diagrammatic representation of the structure of Standards under the new Preface is given below:

Diagrammatic Representation of the Structure of Standards Under the New Preface



PREFACE TO STANDARDS ON QUALITY CONTROL, AUDITING, REVIEW, OTHER ASSURANCE AND RELATED SERVICES [1]

(Effective from April 1, 2008)

Introduction I.12

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Annexure - Structure of Standards issued by Auditing and Assurance Standards Board under the Authority of the Council of ICAI

Appendix – Auditing and Assurance Standards Board and its Due Process

[1] Issued in July, 2007.

Introduction

1. This Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services has been issued to facilitate understanding of the scope and authority of the pronouncements of the AASB issued under the authority of the Council of the Institute of Chartered Accountants of India (the ICAI).

2. The ICAI is committed to the goal of enabling the accountancy profession in India to provide services of high quality in the public interest and which are accepted worldwide. To further this goal, the ICAI develops and promulgates technical Standards and other professional literature. The ICAI being one of the founder members of the International Federation of Accountants (IFAC), the Standards developed and promulgated by the AASB under the authority of the Council of the ICAI are in conformity with the corresponding International Standards issued by the International Auditing and Assurance Standards Board

(IAASB), established by the IFAC. The "Due Process" of the AASB for formulation of Standards, Statements, Guidance Notes and its other pronouncements is given in the **Appendix** to this Preface.

Standards Issued by AASB Under the Authority of the Council of ICAI

3. The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

(a) Standards on Auditing (SAs), to be applied in the audit of historical financial information.

(b) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

(c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.

(d) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

4. Standards on Quality Control (SQCs), issued by the AASB under the authority of the Council, are to be applied for all services covered by the

Engagement Standards as described in paragraph 3 above.

A diagram containing the structure of the Standards issued by the Auditing and Assurance Standards Board under the authority of the Council is given as

Annexure to this Preface.

Standards on Auditing

5. The Standards on Auditing (SAs) referred to in Paragraph 3(a) above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

6. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. It is undertaken to enhance the degree of confidence of intended users in the financial statements. The Standards on Auditing, taken together, provide the standards for the auditor's work in fulfilling this objective.

7. In conducting an audit, the overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor's findings. However, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. In all cases, when this overall objective has not been or cannot be achieved, the SAs require the auditor to modify the auditor's opinion accordingly or withdraw from the engagement as may be appropriate, depending upon the facts and circumstances of each case.

8. The auditor applies each Standard on Auditing (SA) relevant to the audit. An SA is relevant when the SA is in effect and the circumstances addressed by the SA exist.

9. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific areas. An SA contains objectives and requirements together with related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context to a proper understanding of the SAs, and definitions. It is, therefore, necessary to consider the entire text of an SA to understand and apply its requirements.

Objectives

10. Each SA contains an objective or objectives, which provide the context in which the requirements of the Standards on Auditing are set. Any limitation of the applicability of a specific Standard is made clear in the Standard itself. An individual Standard should be read in the context of the objective stated in the Standard as well as this Preface. The auditor aims to achieve these objectives, having regard to the interrelationships amongst the SAs. For this

purpose, the auditor uses the objectives to judge whether, having complied with the requirements of the SAs, sufficient appropriate audit evidence has been obtained in the context of the overall objective of the auditor. Where an individual objective has not been or cannot be achieved, the auditor considers whether this prevents the auditor from achieving his overall objective.

Requirements[2]

11. The requirements of each SA are contained in a separate section and expressed using the word "shall". The auditor applies the requirements in the context of the other material included in the Standard.

12. The auditor complies with the requirements of an SA in all cases where they are relevant in the circumstances of the audit. In exceptional circumstances, however, the auditor may judge it necessary to depart from a relevant requirement by performing alternate audit procedures to achieve the aim of that requirement. The need for the auditor to depart from

[2] The International Auditing and Assurance Standards Board, pursuant to its Clarity Project, has adopted a new format for presentation of the International Standards on Auditing (ISAs) issued by it. As per the new format, an ISA is divided into two sections, one, the requirements section and second, the application and other explanatory material section. Accordingly, the practice of presenting the standard portion (i.e., the principles enunciated) in **bold** lettering and the application/ explanatory guidance in plain lettering has been done away with. The entire text of the Standard, whether the requirements section or the application and other explanatory material section are presented in plain lettering.

In so far as the Auditing and Assurance Standards (AASs) issued by the Institute are concerned, in the AASs issued prior to December 1997, the entire text of the Standard is presented in the plain lettering, whereas in case of the AASs issued subsequent to that date, the standard portion/ principles enunciated are given in **bold** lettering whereas the explanatory/ application guidance is given in plain lettering. The presentation of the Standards on Auditing, issued subsequent to the date this Preface comes into effect, would be in line with that adopted by the IAASB for its ISAs pursuant to the Clarity Project. In the due course, the existing Standards would also be brought in line with the abovementioned convention.

a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective.

13. When a situation envisaged in paragraph 12 above arises, the auditor is required to document how alternative procedures performed achieve the aim of the requirement, and, the reasons for the departure. Further, his report also should draw attention to such departures. However, a mere disclosure in his report does not absolve an auditor from complying with the applicable Standard(s).

14. A requirement is not relevant only in the cases where the SA is not relevant, or the circumstances envisioned do not apply because the requirement is conditional and the condition does not exist. The auditor is not required to comply with a requirement that is not relevant in the circumstances of the audit and this does not constitute a departure from the requirement. However, the auditor should document the steps undertaken by him to satisfy himself that the process adopted in the circumstances of the audit assisted him in achieving his overall objective.

Application and Other Explanatory Material

15. The application and other explanatory material contained in an SA is an integral part of the SA as it provides further explanation of, and guidance for carrying out, the requirements of an SA, along with the background information on the matters addressed in the SA. It may include examples of procedures, some of which the auditor may judge to be appropriate in the circumstances. Such guidance is, however, not intended to impose a requirement.

16. Appendices, which form part of the application and other explanatory material, are an integral part of an SA. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself.

Introductory Material and Definitions

17. Introductory material may include, as needed, such matters as explanation of the purpose and scope of the Standard, including how the SA relates to other SAs, the subject matter of the SA, specific expectations from the auditor and others, and the context in which the SA is set.

18. A Standard on Auditing may include, in a separate section under the heading 'Definitions', a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs.

Standards on Quality Control

19 SQCs are written to apply to firms[3] in respect of all their services falling under the Engagement Standards issued by the AASB of ICAI. The authority of SQCs is set out in the introduction to the SQCs.

Other Standards

20. The other Engagement Standards identified in paragraph 3 (b) to (d) as well as Standards on Quality Control referred to in paragraph 4 contain basic principles and essential procedures (identified in **bold type** lettering and by the word "should") together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures. Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself. An individual Standard should be read in the context of the objective stated in

the Standard as well as this Preface. Any limitation of the applicability of a specific Standard is made clear in the Standard itself.

Statements on Auditing

21. Statements on Auditing are issued with a view to securing compliance by professional accountants on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. Statements are, therefore, mandatory.

General Clarifications

22. General Clarifications are issued by the Board under the authority of the Council of the Institute with a view to clarify any issues arising from the Standards. General Clarifications are mandatory in nature.

[3] The term "firm" refers to a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

Professional Judgment

23. The nature of the Standards/Statements/General Clarifications requires the professional accountant[4] to exercise professional judgment in applying them.

Authority Attached to Other Standards, Statements on Auditing and General Clarifications

24. It is the duty of the professional accountants to ensure that the Standards/ Statements/General Clarifications are followed in the engagements undertaken by them[5]. The need for the professional accountants to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedure would be ineffective. If because of that reason, a professional accountant has not been able to perform an engagement procedure in accordance with any Standard/Statement/General Clarification, he is required to document how alternative procedures performed achieve the purpose of the procedure, and, unless otherwise clear, the reasons for the departure. Further, his report should draw attention to such departures. However, a mere disclosure in his report does not absolve a professional accountant from complying with the applicable Standards/Statements/General Clarifications [6].

[4] The term "professional accountant" refers to a member of the Institute of Chartered Accountants of India.

[5] Members' attention is invited to Clause 5 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, according to which a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity. Further Clause 7 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

[6] Attention of the members is also drawn to Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, whereby, a member is deemed to be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted procedures of audit applicable to the circumstances.

25. There may be a situation where a matter is covered both by a Standard as also by a Statement on Auditing. In such a situation, the Statement shall prevail till the time the Standard becomes mandatory. Once a Standard becomes mandatory, the concerned Statement or the relevant portion(s) thereof will automatically be withdrawn.

Guidance Notes

26. Guidance Notes are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council. Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard. Professional accountants should be aware of and consider Guidance Notes applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Guidance Note should be prepared to justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

27. The Board may also publish Technical Guides, Practice Manuals, Studies and other papers. Technical Guides are ordinarily aimed at imparting broad knowledge about a particular aspect or of an industry to the professional accountants. Practice Manuals are aimed at providing additional guidance to professional accountants in performing audit and other related assignments. Studies and other papers are aimed at promoting discussion or debate or creating awareness on issues relating to quality control, auditing, assurance and related service, affecting the profession. Such publications of the Board do not establish any basic principles or essential procedures to be followed in audit, review, other assurance or related services engagements, and accordingly, have no authority of the Council attached to them.

Material Modifications to the Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Additions

1. This Preface, by virtue of the requirement of the Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, requires a member to draw attention to any material departures from the requirements of the applicable Standards, Statements and

General clarifications in his report. However, there is no such requirement in the Preface issued by the IAASB.

2. This Preface deals, apart from the Standards, with the Statements on Auditing and the General Clarifications as the mandatory documents for use by the professional accountants in performing engagements by them, whereas, the Preface issued by the IAASB does not deal with such aspects. Further, the nomenclature of International Auditing Practice Statements (IAPSs) referred in the Preface issued by the IAASB has been changed to Guidance Notes in this Preface.

3. The Preface issued by the IAASB requires documentation of the reasons for the departure from the requirements of the other International Standards only, i.e., International Standards other than International Standards on Auditing andInternational Standard on Quality control, whereas this Preface requires such documentation in the cases of departure from the requirements of any Engagement Standard, Statement and/or General Clarification.

4. The Preface issued by the AASB refers to inherent limitations of an audit in paragraph 7 for better understanding of audit function.

Deletion

1. The Preface issued by the IAASB provides to include, in appropriate cases, additional considerations specific to public sector entities within the body of the Standard. 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 Preface does not deal separately with the public sector perspective

AAS 1

[New Number of the Standard SA 200]

BASIC PRINCIPLES GOVERNING AN AUDIT

The following is the text of the Auditing and Assurance Standard (AAS) 1[*]***(SA 200),*** *"Basic Principles Governing an Audit", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*[5]*.*

Introduction

1. This Standard describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out.

2. An audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.[6] In this Standard, the term "financial information" encompasses financial statements.

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[*] Issued in April, 1985.

[5] With the formation of the Auditing Practices Committee {now known as the Auditing and Assurance Standards Board} in 1982, the Council of the Institute has been issuing a series of Statements on Standard Auditing Practices (SAPs). SAPs have been renamed as Auditing and Assurance Standards (AASs). The Auditing and Assurance Standards (hitherto known as SAPs) lay down the principles governing an audit.These principles apply whenever an independent audit is carried out. Auditing and Assurance Standards become mandatory on the dates specified in the respective AAS.Their mandatory status implies that, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the AASs are followed in the audit of financial information covered by their audit reports. If,for any reason, a member has not been able to perform an audit in accordance with the AASs, his report should draw attention to the material departures therefrom. The Auditing and Assurance Standards have the same authority as that attached to the Statements on Standard Auditing Practices.

[6] See para. 3.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Council of the Institute of Chartered Accountants of India.

3. Other Auditing and Assurance Standards to be issued by the Institute will elaborate on the principles set out herein to give guidance on auditing procedures and reporting practices.

4. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances.

Integrity, Objectivity and Independence

5. The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and 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.

Confidentiality

6. The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

Skills and Competence

7. The audit should be performed and the report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing.

8. The auditor requires specialised skills and competence which are acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

Work Performed by Others

9. When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that

he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956, the auditor's report should expressly state the fact of such reliance.

10. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

Documentation

11. The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

Planning

12. The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.

13. Plans should be made to cover, among other things:

(a) acquiring knowledge of the client's accounting system, policies and internal control procedures;

(b) establishing the expected degree of reliance to be placed on internal control;

(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) coordinating the work to be performed.

14. Plans should be further developed and revised as necessary during the course of the audit.

Audit Evidence

15. The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions there from on which to base his opinion on the financial information.

16. Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.

17. Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

They are of two types:

(i) tests of details of transactions and balances;

(ii) analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

Accounting System and Internal Control

18. Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

19. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

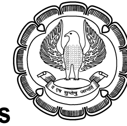
20. Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

Audit Conclusions and Reporting

21. The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether:

(a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

(b) the financial information complies with relevant regulations and statutory requirements;



(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

22. The audit report should contain a clear written expression of opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters dealt with in paragraph 21 or as may be laid down or prescribed under the relevant agreement or statute or regulation, as the case may be.

23. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefor.

Effective Date

24. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1985.

AAS 2

[New Number of the Standard SA 200A]

OBJECTIVE AND SCOPE OF THE AUDIT OF FINANCIAL STATEMENTS

The following is the text of the Auditing and Assurance Standard (AAS) 2[*]***(SA 200A),*** *"Objective and Scope of the Audit of Financial Statements", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. This Standard describes the overall objective and scope of the audit of general purpose financial statements of an enterprise by an independent auditor. According to para 3.3 of the 'Preface to the Statements of Accounting Standards' issued by the Institute of Chartered Accountants of India, "the term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for the use of shareholders/members, creditors, employees and public at large." References to financial statements in this Standard should be construed to refer to general purpose financial statements.

Objective of an Audit

2. The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

3. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

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[*]Issued in April, 1985.

Responsibility for the Financial Statements

4. While the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the management of the enterprise. Management's responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise. The audit of the financial statements does not relieve management of its responsibilities.

Scope of an Audit

5. The scope of an audit of financial statements will be determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

6. The audit should be organised to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements subject to statutory requirements, where applicable.

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

(a) making a study and evaluation of accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; and

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

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

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

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

9. The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements. Furthermore, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. Because of these factors, absolute certainty in auditing is rarely attainable.

10. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions.

11. The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements[7]. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgement.

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

[7] Accounting Standard (AS) 1, on "Disclosure of Accounting Policies" issued by the Council of the Institute of Chartered Accountants of India.

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

Effective Date

14. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1985.

AAS 3

[New Number of the Standard SA 230]

DOCUMENTATION

The following is the text of the Auditing and Assurance Standard (AAS) 3[*] ***(SA 230),*** *"Documentation", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. Auditing and Assurance Standard (AAS)1**(SA 200),** *"Basic Principles Governing an Audit"* (Paragraph 11), states, "The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles." The purpose of this Standard is to amplify the basic principle outlined above.

2. Documentation, for purposes of this Standard, refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

3. 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.

Form and Content

4. Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

5. The form and content of working papers are affected by matters such as:

- The nature of the engagement.

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[*] Issued in July, 1985.

- The form of the auditor's report.
- The nature and complexity of the client's business.
- The nature and condition of the client's records and degree of reliance on internal controls.
- The needs in particular circumstances for direction, supervision and review of work performed by assistants.

6. Working papers should be designed and properly organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardisation of working papers (for example, checklists, specimen letters, standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality.

7. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

8. All significant matters which require the exercise of judgement, together with the auditor's conclusion thereon, should be included in the working papers.

9. To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor should satisfy himself that these working papers have been properly prepared. Examples of such working papers are detailed analyses of important revenue accounts, receivables, etc.

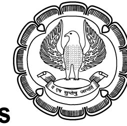
10. In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits, as distinct from current audit files, which contain information relating primarily to the audit of a single period.

11. A permanent audit file normally includes:

    - Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
    - Extracts or copies of important legal documents, agreements and minutes relevant to the audit.

- A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

12. The current file normally includes:
    - Correspondence relating to acceptance of annual reappointment.
    - Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.
    - Evidence of the planning process of the audit and audit programme.
    - Analysis of transactions and balances.
    - A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
    - Evidence that the work performed by assistants was supervised and reviewed.
    - Copies of communications with other auditors, experts and other third parties.
    - Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
    - Letters of representation or confirmation received from the client.
    - Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
    - Copies of the financial information being reported on and the related audit reports.



Ownership and Custody of Working Papers

13. Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client.

14. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

Effective Date

15. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after July 1, 1985.

AAS 4

[New Number of the Standard SA 240]

THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF FINANCIAL STATEMENTS

*The following is the text of the Auditing and Assurance Standard (AAS) 4 (Revised[*]**(SA 240)**, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in* the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibility to consider fraud and error in an audit of financial statements. While this SA focuses on the auditor's responsibilities with respect to fraud and error, the primary responsibility for the prevention and detection of fraud and error rests with both those charged with governance and the management of an entity. In this Standard, the term 'financial information' encompasses 'financial statements'. In some circumstances, specific legislations and regulations may require the auditor to undertake procedures additional to those set out in this SA.

2. **When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error.**

Fraud and Error and Their Characteristics

3. Misstatements in the financial statements can arise from fraud or error. The term "error" refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, such as:

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[*] Issued in January, 2003. This Standard was originally issued in June 1987 and was titled, "Fraud and Error".

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

4. 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. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. 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 with third parties outside the entity.

5. Two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

6. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

7. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

8. Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example, because the individuals

are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

9. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.

Responsibility of Those Charged With Governance and of Management

10. The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary from entity to entity. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity.

11. It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, the integrity of an entity's accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the laws and regulations.

12. It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes implementing and ensuring the continued operation of accounting and internal control systems, which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements, whether caused by fraud or error. Accordingly, management assumes responsibility for any remaining risk.

Responsibilities of the Auditor

13. As described in AAS 2**(SA 200A),** "Objective and Scope of the Audit of Financial Statements", the objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. An audit conducted in accordance with the auditing standards generally accepted in India[8] is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

Inherent Limitations of an Audit

14. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the auditing standards generally accepted in India. An audit does not guarantee that all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only a reasonable assurance that material misstatements in the financial statements will be detected.

15. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud, generally, involves sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the

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[8] Paragraph 15 of AAS 28, "*The Auditor's Report on Financial Statements*" describes auditing standards generally accepted in India.

degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

16. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees, for example, by directing subordinates to record transactions incorrectly or to conceal them. Given its position of authority within an entity, management has the ability to either direct employees to do something or solicit their help to assist management in carrying out a fraud, with or without the employees' knowledge.

17. The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

(a) failure to obtain reasonable assurance,

(b) inadequate planning, performance or judgment,

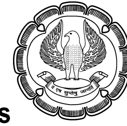
(c) absence of professional competence and due care, or,

(d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

Professional Skepticism

18. The auditor plans and performs an audit with an attitude of professional skepticism. Such an attitude is necessary for the auditor to identify and properly evaluate, for example:



- Matters that increase the risk of a material misstatement in the financial statements resulting from fraud or error (for instance, management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability).
- Circumstances that make the auditor suspect that the financial statements are materially misstated.
- Evidence obtained (including the auditor's knowledge from previous audits) that brings into question the reliability of management representations.

19. However, unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents as genuine. Accordingly, an audit performed in accordance with auditing standards generally accepted in India rarely contemplate authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication.

Planning Discussions

20. **In planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.**

21. Such discussions would involve considering, for example, in the context of the particular entity, where errors may be more likely to occur or how fraud might be perpetrated. Based on these discussions, members of the audit team may gain a better understanding of the potential for material misstatements in the financial statements resulting from fraud or error in the specific areas of the audit assigned to them, and how the results of the audit procedures that they perform may affect other aspects of the audit. Decisions may also be made as to which members of the audit team will conduct certain inquiries or audit procedures, and how the results of those inquiries and procedures will be shared.

Inquiries of Management

22. When planning the audit, the auditor should make inquiries of management:

(a) to obtain an understanding of:

(i) management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(ii) the accounting and internal control systems management has put in place to address such risk;

(b) to obtain knowledge of management's understanding regarding the accounting and internal control systems in place to prevent and detect error;

(c) to determine whether management is aware of any known fraud that has affected the entity or suspected fraud that the entity is investigating; and

(d) to determine whether management has discovered any material errors.

23. The auditor supplements his own knowledge of the entity's business by making inquiries of management regarding management's own assessment of the risk of fraud and the systems in place to prevent and detect it. In addition, the auditor makes inquiries of management regarding the accounting and internal control systems in place to prevent and detect error. Since management is responsible for the entity's accounting and internal control systems and for the preparation of the financial statements, it is appropriate for the auditor to inquire of management how it is discharging these responsibilities. Matters that might be discussed as part of these inquiries include:

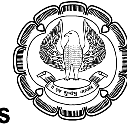
(a) whether there are particular subsidiary locations, business segments, types of transactions, account balances or financial statement categories where the possibility of error may be high, or where fraud risk factors may exist, and how they are being addressed by management;

(b) the work of the entity's internal audit function and whether internal audit has identified fraud or any serious weaknesses in the system of internal control; and

(c) how management communicates to employees its view on responsible business practices and ethical behaviour, such as through ethics policies or codes of conduct.

24. The nature, extent and frequency of management's assessment of such systems and risk vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less formal and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may be indicative of the lack of importance that management places on internal control.

25. It is also important that the auditor obtains an understanding of the design of the accounting and internal control systems within the entity. In designing such systems, management makes informed judgments on the nature and extent of the control procedures it chooses to implement and the nature and extent of the risks it chooses to assume. As a result of making these inquiries of management, the auditor may learn, for example, that management has consciously chosen to accept the risk associated with a lack of segregation of duties. Information from these inquiries may also be useful in identifying fraud risk factors



that may affect the auditor's assessment of the risk that the financial statements may contain material misstatements caused by fraud.

26. It is also important for the auditor to inquire about management's knowledge of frauds that have affected the entity, suspected frauds that are being investigated, and material errors that have been discovered. Such inquiries might indicate possible weaknesses in control procedures if, for example, a number of errors have been found in certain areas. Alternatively, such inquiries might indicate that control procedures are operating effectively because anomalies are being identified and investigated promptly.

27. Although the auditor's inquiries of management may provide useful information concerning the risk of material misstatements in the financial statements resulting from employee fraud, such inquiries are unlikely to provide useful information regarding the risk of material misstatements in the financial statements resulting from management fraud. Accordingly, the auditor's follow-up of fraud risk factors, as discussed in paragraph 39, is of particular relevance in relation to management fraud.

Discussions with Those Charged with Governance

28. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In case of clients whose corporate governance practices are well developed and those charged with governance play an active role in oversight of how management has discharged its responsibilities, auditors are encouraged to seek the views of those charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect fraud and error, the risk of fraud and error, and the competence and integrity of management. Such inquiries may, for example, provide insights regarding the susceptibility of the entity to management fraud. The auditor may have an opportunity to seek the views of those charged with governance during, for example, a meeting with the audit committee to discuss the general approach and overall scope of the audit and eliciting views of independent directors. This discussion may also provide those charged with governance with the opportunity to bring matters of concern to the auditor's attention.

29. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands the nature of these responsibilities within an entity to ensure that the inquiries and communications described above are directed to the appropriate individuals[9].

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[9] AAS 27, *"Communications of Audit Matters with Those Charged with Governance"*, paragraph 8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

30. In addition, following the inquiries of management described in paragraphs 22-27, the auditor considers whether there are any matters of governance interest to be discussed with those charged with governance of the entity[10]. Such matters may include for example:

- Concerns about the nature, extent and frequency of management's assessments of the accounting and control systems in place to prevent and detect fraud and error, and of the risk that the financial statements may be misstated.
- A failure by management to address appropriately material weaknesses in internal control identified during the prior period's audit.
- The auditor's evaluation of the entity's control environment, including questions regarding management's competence and integrity.
- The effect of any matters, such as those above, on the general approach and overall scope of the audit, including additional procedures that the auditor may need to perform.

Audit Risk

31. AAS 6 (Revised **(SA 400)**, "Risk Assessments and Internal Control," paragraph 3, states that "audit risk" is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Such misstatements can result from either fraud or error. AAS 6 (Revised) **(SA 400)** identifies the three components of audit risk i.e., inherent risk, control risk and detection risk, and also provides guidance on how to assess these risks.

Inherent Risk and Control Risk

32. **When assessing inherent risk and control risk in accordance with AAS 6 (Revised), (SA 400) "Risk Assessments and Internal Control", the auditor should consider how the financial statements might be materially misstated as a result of fraud or error. In considering the risk of material misstatement resulting from fraud, the auditor should consider whether fraud risk factors are present that indicate the possibility of either fraudulent financial reporting or misappropriation of assets.**

33. AAS 6 (Revised) **(SA 400)**, "Risk Assessments and Internal Control", describes the auditor's assessment of inherent risk and control risk, and how those assessments affect the nature, timing and extent of the audit procedures. In making those assessments, the auditor considers how the financial statements might be materially misstated as a result of fraud or error.

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[10] For a discussion of these matters, see AAS 27, "*Communications of Audit Matters with Those Charged with Governance*," paragraphs 11-14.

34. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, using the auditor's knowledge of the business, the auditor may identify events or conditions that provide an opportunity, a motive or a means to commit fraud, or indicate that fraud may already have occurred. Such events or conditions are referred to as "fraud risk factors". For example, a document may be missing, a general ledger may be out of balance, or an analytical procedure may not make sense. However, these conditions may be the result of circumstances other than fraud. Therefore, fraud risk factors do not necessarily indicate the existence of fraud, however, they often have been present in circumstances where frauds have occurred. The presence of fraud risk factors may affect the auditor's assessment of inherent risk or control risk. Examples of fraud risk factors are set out in Appendix 1 to this SA.

35. Fraud risk factors cannot easily be ranked in order of importance or combined into effective predictive models. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present a risk of material misstatement. Accordingly, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk.

36. Although the fraud risk factors described in Appendix 1 cover a broad range of situations typically faced by auditors, they are only examples. Moreover, not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, with different ownership characteristics, in different industries, or because of other differing characteristics or circumstances. Accordingly, the auditor uses professional judgment when assessing the significance and relevance of fraud risk factors and determining the appropriate audit response.

37. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of those charged with governance, and the internal audit function. The auditor also considers what steps have been taken to enforce a formal code of conduct, and the effectiveness of the budgeting system. In the case of a small entity, some or all of these considerations may be inapplicable or less important. For example, a smaller entity might not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behaviour through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by

management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Furthermore, fraud risk factors considered at a business segment operating level may provide different insights than the consideration thereof at an entity-wide level.

38. The presence of fraud risk factors may indicate that the auditor will be unable to assess control risk at less than high for certain financial statement assertions. On the other hand, the auditor may be able to identify internal controls designed to mitigate those fraud risk factors that the auditor can test to support a control risk assessment below high.

Detection Risk

39. **Based on the auditor's assessment of inherent and control risks (including the results of any tests of controls), the auditor should design substantive procedures to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial statements taken as a whole will not be detected. In designing the substantive procedures, the auditor should address the fraud risk factors that the auditor has identified as being present.**

40. AAS 6 (Revised)**(SA 400)** “Risk Assessments and Internal Control”, explains that the auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk to an acceptably low level. In designing substantive procedures, the auditor addresses fraud risk factors that the auditor has identified as being present. The auditor's response to those factors is influenced by their nature and significance. In some cases, even though fraud risk factors have been identified as being present, the auditor's judgment may be that the audit procedures, including both tests of control, and substantive procedures, already planned, are sufficient to respond to the fraud risk factors.

41. In other circumstances, the auditor may conclude that there is a need to modify the nature, timing and extent of substantive procedures to address fraud risk factors present. In these circumstances, the auditor considers whether the assessment of the risk of material misstatement calls for an overall response, a response that is specific to a particular account balance, class of transactions or assertion, or both types of response. The auditor considers whether changing the nature of audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors. Examples of response procedures are set out in Appendix 2 to this SA, including examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

Procedures when Circumstances Indicate a Possible Misstatement

42. **When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.**

43. During the course of the audit, the auditor may encounter circumstances that indicate that the financial statements may contain a material misstatement resulting from fraud or error. Examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists are set out in Appendix 3 to this SA.

44. When the auditor encounters such circumstances, the nature, timing and extent of the procedures to be performed depends on the auditor's judgment as to the type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial statements. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial statements are materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor's report, as discussed in paragraph 48.

45. The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, the auditor considers whether the assessment of the components of audit risk made during the planning of the audit may need to be revised and whether the nature, timing and extent of the auditor's other procedures may need to be reconsidered. {See AAS 6 (Revised) **(SA 400)**, "Risk Assessments and Internal Control," paragraphs 40 and 47} For example, the auditor would consider:

- The nature, timing and extent of substantive procedures.
- The assessment of the effectiveness of internal controls if control risk was assessed below high.
- The assignment of audit team members that may be appropriate in the circumstances.

Considering Whether an Identified Misstatement may be Indicative of Fraud

46. **When the auditor identifies a misstatement, the auditor should consider whether such a misstatement may be indicative of fraud and if there is such an indication, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.**

47. If the auditor has determined that a misstatement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organizational position of the person or persons involved. For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material misstatement due to fraud. This is because both the manner of operating the fund and its size tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem. In such circumstances, the auditor reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence. If management, particularly at the highest level, is involved in fraud, the auditor may not be able to obtain the evidence necessary to complete the audit and report on the financial statements.

Evaluation and Disposition of Misstatements, and the Effect on the Auditor's Report

48. **When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud or error, the auditor should consider the implications for the audit.** AAS 13**(SA 320)**, "Audit Materiality," paragraphs 12-16, and AAS 28**(SA 700)**, “The Auditor’s Report on Financial Statements”, paragraphs 37-47, provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's report. Where a significant fraud has occurred or the fraud is committed by those charged with governance, the auditor should consider the necessity for a disclosure of the fraud in the financial statements. If adequate disclosure is not made the auditor should consider the necessity for a suitable disclosure in his report.

Documentation

49. **The auditor should document fraud risk factors identified as being present during the auditor's assessment process (see paragraph 32) and document the auditor's response to any such factors (see paragraph 39). If during the performance of the audit, fraud risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor should document the presence of such risk factors and the auditor's response to them.**

50. The auditor must document matters which are important in providing evidence to support the audit opinion, and the working papers must include the auditor's reasoning on all significant matters which require the auditor's judgment, together with the auditor's conclusion thereon. Because of the importance of fraud risk factors in the assessment of the inherent or control risk of material misstatement, the auditor documents fraud risk factors identified and the response considered appropriate by the auditor. (Reference may also be had to AAS 3**(SA 230)**, “Documentation”).

Management Representations

51. The auditor should obtain written representations from management that:

(a) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(b) it 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. A summary of such items should be included in or attached to the written representation;

(c) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(d) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

52. AAS 11**(SA 580)**, “Representations by Management” provides guidance on obtaining appropriate representations from management in the audit. In addition to acknowledging its responsibility for the financial statements, it is important that management acknowledges its responsibility for the accounting and internal control systems designed to prevent and detect fraud and error.

53. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from either fraud or error are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items …… and ……. constitute misstatements because [description of reasons]."

54. The auditor may designate an amount below which misstatements need not be

accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. In so doing, the auditor considers the fact that the determination of materiality involves qualitative as well as quantitative considerations and that misstatements of a relatively small amount could nevertheless have a material effect on the financial statements. The summary of uncorrected misstatements included in or attached to the written representation need not include such misstatements.

55. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtains a written representation from management confirming that it has disclosed to the auditor all facts relating to any frauds or suspected frauds that it is aware of that may have affected the entity, and that management has disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud.

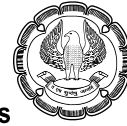
Communication

56. **When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor's responsibility to communicate that information to management, those charged with governance and, in some circumstances, when so required by the laws and regulations, to regulatory and enforcement authorities also.**

57. Communication of a misstatement resulting from fraud, or a suspected fraud, or error to the appropriate level of management on a timely basis is important because it enables management to take necessary action. The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the nature, magnitude and frequency of the misstatement or suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the misstatement or suspected fraud.

58. The determination of which matters are to be communicated by the auditor to those charged with governance is a matter of professional judgment and is also affected by any understanding between the parties as to which matters are to be communicated. Ordinarily, such matters include:

- Questions regarding management competence and integrity.
- Fraud involving management.



- Other frauds which result in a material misstatement of the financial statements.
- Material misstatements resulting from error.
- Misstatements that indicate material weaknesses in internal control, including the design or operation of the entity's financial reporting process.
- Misstatements that may cause future financial statements to be materially misstated.

Communication of Misstatements Resulting From Error to Management and to Those Charged With Governance

59. **If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatement to the appropriate level of management on a timely basis, and consider the need to report it to those charged with governance.**

60. **The auditor should inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.**

61. As noted in paragraph 54, the uncorrected misstatements communicated to those charged with governance need not include the misstatements below a designated amount.

Communication of Misstatements Resulting From Fraud to Management and to Those Charged with Governance

62. **If the auditor has:**

(a) identified a fraud, whether or not it results in a material misstatement in the financial statements; or

(b) obtained evidence that indicates that fraud may exist (even if the potential effect on the financial statements would not be material);

the auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance.

63. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter is brought to the attention of an appropriate level of management. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is also affected in these circumstances by the likelihood of collusion or the involvement of a member of management.

64. If the auditor has determined that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor:

(a) discusses the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved, and with management at the highest level; and

(b) if appropriate, suggests that management consult legal counsel.

Communication of Material Weaknesses in Internal Control

65. The auditor should communicate to management any material weaknesses in internal control related to the prevention or detection of fraud and error, which have come to the auditor's attention as a result of the performance of the audit. The auditor should also be satisfied that those charged with governance have been informed of any material weaknesses in internal control related to the prevention and detection of fraud that either have been brought to the auditor's attention by management or have been identified by the auditor during the audit.

66. When the auditor has identified any material weaknesses in internal control related to the prevention or detection of fraud or error, the auditor communicates these material weaknesses in internal control to management. Because of the serious implications of material weaknesses in internal control related to the prevention and detection of fraud, it is also important that such deficiencies be brought to the attention of those charged with governance.

67. If the integrity or honesty of management or those charged with governance are doubted, the auditor ordinarily considers seeking legal advice to assist in the determination of the appropriate course of action.

Communication to Regulatory and Enforcement Authorities

68. The auditor's professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the client entity. However, the auditor's legal responsibilities may vary and in certain circumstances, statute, the law or courts of law may override the duty of confidentiality. For example, under the regulatory framework for Non-Banking Financial Companies, an obligation is cast upon the auditor to report to the Reserve Bank of India any adverse or unfavourable remarks in his report. In such circumstances, the auditor may consider seeking legal advice.

Auditor Unable to Complete the Engagement

69. **If the auditor concludes that it is not possible to continue performing the audit as a result of a misstatement resulting from fraud or suspected fraud, the auditor should:**

(a) consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) consider the possibility of withdrawing from the engagement; and

(c) if the auditor withdraws:

  (i) discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

  (ii) consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

70. The auditor may encounter exceptional circumstances that bring into question the auditor's ability to continue performing the audit, for example, in circumstances where:

(a) the entity does not take the remedial action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

(b) the auditor's consideration of the risk of material misstatement resulting from fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) the auditor has significant concern about the competence or integrity of management or those charged with governance.

71. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of continuing association with the entity.

72. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary in different circumstances. For example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor considers seeking

legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action.

Communication with an Incoming Auditor

73. **Clause 8 of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down that a Chartered Accountant in practice would be guilty of professional misconduct if he accepts a position as an auditor, previously held by another chartered accountant without first communicating to him in writing. On receipt of an inquiry from a incoming auditor, the existing auditor should advise whether there are any professional reasons why the incoming auditor should not accept the appointment. If the client denies the existing auditor permission to discuss its affairs with the incoming auditor or limits what the existing auditor may say, that fact should be disclosed to the incoming auditor.**

74. The auditor may be contacted by an incoming auditor inquiring whether there are any professional reasons why the incoming auditor should not accept the appointment. The responsibilities of existing and incoming auditor are set out in the Code of Ethics, issued by the Institute of Chartered Accountants of India.

75. The extent to which an existing auditor can discuss the affairs of a client with an incoming auditor will depend on whether the existing auditor has obtained the client's permission to do so, and on the professional and legal responsibilities relating to such disclosure. Subject to any constraints arising from these responsibilities, the existing auditor advises the incoming auditor whether there are any professional reasons not to accept the appointment, providing details of the information and discussing freely with the incoming auditor all matters relevant to the appointment. If fraud or suspected fraud was a factor in the existing auditor's withdrawal from the engagement, it is important that the existing auditor take care to state only the facts (not his or her conclusions) relating to these matters.

Effective Date

76. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods commencing on or after 1st April 2003.

Compatibility with International Standard on Auditing (ISA) 240

The auditing standards established in this Auditing and Assurance Standard are generally consistent in all material respects with those set out in International Standard on Auditing (ISA) 240 on The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements.

APPENDIX 1

Examples of Risk Factors Relating to Misstatements Resulting from Fraud

The fraud risk factors identified in this Appendix are examples of such factors typically faced by auditors in a broad range of situations. However, the fraud risk factors listed below are only examples; not all of these factors are likely to be present in all audits, nor is the list necessarily complete. Furthermore, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk. Fraud risk factors are discussed in paragraphs 34-38.

Fraud Risk Factors Relating to Misstatements Resulting from Fraudulent Financial Reporting

Fraud risk factors that relate to misstatements resulting from fraudulent financial reporting may be grouped in the following three categories:

1. Management's Characteristics and Influence over the Control Environment.
2. Industry Conditions.
3. Operating Characteristics and Financial Stability.

For each of these three categories, examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting are set out below:

1. Fraud Risk Factors Relating to Management's Characteristics and Influence over the Control Environment

A. These fraud risk factors pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

♦ There is motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:

✓ A significant portion of management's compensation is represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.

✓ There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive

accounting practices.

- ✓ Management commits to analysts, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.
- ✓ Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.

B. There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:

- ♦ Management does not effectively communicate and support the entity's values or ethics, or management communicates inappropriate values or ethics.
- ♦ Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.
- ♦ Management does not monitor significant controls 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.
- ♦ Management continues to employ ineffective accounting, information technology or internal auditing staff.
- ♦ Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.
- ♦ There is a high turnover of management, counsel or board members.
- ♦ There is a strained relationship between management and the current or predecessor auditor. Specific indicators might include the following:
  - ✓ Frequent disputes with the current or a predecessor auditor 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.

- ✓ Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.

- ♦ There is a history of securities law violations, or claims against the entity or its management alleging fraud or violations of securities laws.
- ♦ The corporate governance structure is weak or ineffective, which may be evidenced by, for example:
  - ✓ A lack of members who are independent of management.
  - ✓ Little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.

2. Fraud Risk Factors Relating to Industry Conditions

These fraud risk factors involve the economic and regulatory environment in which the entity operates.

- ♦ New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
- ♦ A high degree of competition or market saturation, accompanied by declining margins.
- ♦ A declining industry with increasing business failures and significant declines in customer demand.
- ♦ Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

3. Fraud Risk Factors Relating to Operating Characteristics and Financial Stability

These fraud risk factors pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

- ♦ Inability to generate cash flows from operations while reporting earnings and earnings growth.
- ♦ 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).
- ♦ Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the

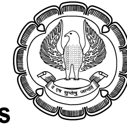
entity (for example, the ultimate collectibility of receivables, the timing of revenue recognition, the realisability of financial instruments based on highly-subjective valuation of collateral or difficult-to-assess repayment sources, or a significant deferral of costs).

- Significant related party transactions which are not in the ordinary course of business.
- Significant related party transactions which are not audited or are audited by another firm.
- Significant, unusual or highly complex transactions (especially those close to year-end) that pose difficult questions concerning substance over form.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or person (or persons) controlling the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability 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.
- A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Fraud Risk Factors Relating to Misstatements Resulting from Misappropriation of Assets

Fraud risk factors that relate to misstatements resulting from misappropriation of assets may be grouped in the following two categories:

1.Susceptibility of Assets to Misappropriation.



2.Controls.

For each of these two categories, examples of fraud risk factors relating to misstatements resulting from misappropriation of assets are set out below. The extent of the auditor's consideration of the fraud risk factors in category 2 is influenced by the degree to which fraud risk factors in category 1 are present.

1.Fraud Risk Factors Relating to Susceptibility of Assets to Misappropriation

These fraud risk factors pertain to the nature of an entity's assets and the degree to which they are subject 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.
- Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.

2.Fraud Risk Factors Relating to Controls

These fraud risk factors involve the lack of controls designed to prevent or detect misappropriation of assets.

- 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).
- Lack of mandatory vacations for employees performing key control functions.

APPENDIX 2

Examples of Modifications of Procedures in Response to the Assessment of Fraud Risk Factors in Accordance with Paragraphs 39-41

The following are examples of possible responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets. The auditor exercises judgment to select the most appropriate procedures in the circumstances. The procedures identified may neither be the most appropriate nor necessary in each circumstance. The auditor's response to fraud risk factors is discussed in paragraphs 40-41.

Overall Considerations

Judgments about the risk of material misstatements resulting from fraud may affect the audit in the following ways:

i. *Professional skepticism*: The application of professional skepticism may include: (i) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (ii) increased recognition of the need to corroborate management explanations or representations concerning material matters.

ii. *Assignment of members of the audit team*: The knowledge, skill and ability of members of the audit team assigned significant audit responsibilities need to be commensurate with the auditor's assessment of the level of risk for the engagement. In addition, the extent of supervision needs to recognize the risk of material misstatement resulting from fraud and the qualifications of members of the audit team performing the work.

iii. *Accounting principles and policies*: The auditor may decide to consider further management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset valuation or capitalizing versus expensing.

iv. *Controls:* The auditor's ability to assess control risk below high may be reduced. However, this does not eliminate the need for the auditor to obtain an understanding of the components of the entity's internal control sufficient to plan the audit. In fact, such an understanding may be of particular importance in further understanding and considering any controls (or lack thereof) the entity has in place to address the fraud risk factors identified. However, this consideration also needs to include an added sensitivity to management's ability to override such controls.

The nature, timing and extent of procedures may need to be modified in the following ways:

- The nature of audit procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more audit evidence may be needed from independent sources outside the entity.
- The timing of substantive procedures may need to be altered to be closer to, or at, year-end. For example, if there are unusual incentives for management to engage in fraudulent financial reporting, the auditor might conclude that substantive procedures should be performed near or at year-end because it would not be possible to control the incremental audit risk associated with that fraud risk factor.
- The extent of the procedures applied will need to reflect the assessment of the risk of material misstatement resulting from fraud. For example, increased sample sizes or more extensive analytical procedures may be appropriate.

The auditor considers whether changing the nature of the audit procedures, rather than the extent of them, may be more effective in responding to identified fraud risk factors.

Considerations at the Account Balance, Class of Transactions and Assertion Level

Specific responses to the auditor's assessment of the risk of material misstatement resulting from fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the account balances, classes of transactions and assertions they may affect. If these factors or conditions indicate a particular risk applicable to specific account balances or types of transactions, audit procedures addressing these specific areas will need to be considered that will, in the auditor's judgment, limit audit risk to an appropriate level in light of the fraud risk factors or conditions identified.

The following are specific examples of responses:

- Visit locations or perform certain tests on a surprise or unannounced basis. For example, observe inventory at locations where auditor attendance has not been previously announced or count cash at a particular date on a surprise basis.
- Request that inventories be counted at a date closer to the year-end.
- Alter the audit approach in the current year. For example, contact major customers and suppliers orally in addition to sending written confirmation, send confirmation requests to a specific party within an organization, or seek more and different information.

- Perform a detailed review of the entity's quarter-end or year-end adjusting entries and investigate any entries that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigate the possibility of related parties and the sources of financial resources supporting the transactions.
- Perform substantive analytical procedures at a detailed level. For example, compare sales and cost of sales by location and line of business to expectations developed by the auditor.
- Conduct interviews of personnel involved in areas for which there is a concern about the risk of material misstatement resulting from fraud, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, consider discussing with them the extent of work necessary to be performed to ensure that the risk of material misstatement resulting from fraud resulting from transactions and activities among these components is adequately addressed.
- If the work of an expert becomes particularly significant with respect a financial statement item for which the risk of misstatement due to fraud is high, perform additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engage another expert for that purpose.
- Perform audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Perform procedures on account or other reconciliation(s) prepared by the entity, including consideration of reconciliation(s) performed at interim periods.
- Perform computer-assisted techniques, such as data mining to test for anomalies in a population.
- Test the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses-Misstatements Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risk of material misstatements resulting from fraudulent financial reporting are as follows:

- *Revenue recognition:* If there is a risk of material misstatement resulting from fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side agreements, inasmuch as the appropriate accounting is often influenced by such terms or agreements.
- *Inventory quantities*: If there is a risk of material misstatement resulting from fraud relating to inventory quantities, reviewing the entity's inventory records may help to identify locations, areas or items for specific attention during or after the physical inventory count. Such a review may lead, for example, to a decision to observe inventory counts at certain locations on an unannounced basis, or to ask management to ensure that counts at all locations subject to count are performed on the same date.
- *Non-standard journal entries*: If there is a risk of material misstatements resulting from fraudulent financial reporting, performing tests of non-standard journal entries to confirm that they are adequately supported and reflect underlying events and transactions may help in identifying fictitious entries of aggressive recognition practices. While there is not generally accepted definition of non-standard journal entries, in general, they are financial statement changes or entries made in the books and records (including computer records) of an entity that usually are initiated by management-level personnel and are not routine or associated with the normal processing of transactions.

Specific Responses - Misstatements Resulting from Misappropriations of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to a risk of material misstatement resulting from fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions.

Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified. For example, where a particular asset is highly susceptible to misappropriation that is potentially material to the financial statements, it may be useful for the auditor to obtain an understanding of the control procedures related to the prevention and detection of such misappropriation and to test the operating effectiveness of such controls.

APPENDIX 3

Examples of Circumstances that Indicate the Possibility of Fraud or Error

The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; neither all of these circumstances are likely to be present in all audits nor is the list necessarily complete. Circumstances that indicate a possible misstatement are discussed in paragraphs 43-44.

- Unrealistic time deadlines for audit completion imposed by management.
- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
- Limitation in audit scope imposed by management.
- Identification of important matters not previously disclosed by management.
- Significant difficult-to-audit figures in the accounts.
- Aggressive application of accounting principles.
- Conflicting or unsatisfactory evidence provided by management or employees.
- Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
- Information provided unwillingly or after unreasonable delay.
- Seriously incomplete or inadequate accounting records.
- Unsupported transactions.
- Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year-end.
- Transactions not recorded in accordance with management's general or specific authorization.
- Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.

- Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
- Significant differences from expectations disclosed by analytical procedures.
- Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
- Evidence of an unduly lavish lifestyle by officers or employees.
- Unreconciled suspense accounts.
- Long outstanding account receivable balances.

AAS 5

[New Number of the Standard SA 500]

AUDIT EVIDENCE

The following is the text of the Auditing and Assurance Standard (AAS) 5[*]***(SA 500)**, *"Audit Evidence", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

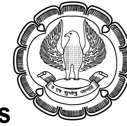
Introduction

1. Auditing and Assurance Standard (AAS) 1**(SA 200),** *"Basic Principles Governing an Audit"*, states (paragraphs 15-17):

> "The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.
>
> Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect.
>
> Substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
>
> They are of two types:
>
> (i) tests of details of transactions and balances;
>
> (ii) analysis of significant ratios and trends, including the resulting enquiry of unusual fluctuations and items."

The purpose of this Standard is to amplify the basic principle outlined above. In this Standard, the term "financial information" encompasses financial statements.

[*] Issued in May, 1988.



Sufficient Appropriate Audit Evidence

2. Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained; appropriateness relates to its relevance and reliability. Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. He may often seek evidence from different sources or of different nature to support the same assertion (see paragraphs 5 and 6).

3. The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he draws his conclusions therefrom. The audit evidence should, in total, enable the auditor to form an opinion on the financial information. In forming such an opinion, the auditor may obtain audit evidence on a selective basis by way of judgmental or statistical sampling procedures. For example, the auditor may select only certain accounts receivable for confirmation purposes, or make a selection of personnel records for the purpose of testing that changes in payroll rates have been properly authorised.

4. The auditor's judgement as to what is sufficient appropriate audit evidence is influenced by such factors as:

(a) The degree of risk of misstatement which may be affected by factors such as:

  (i) the nature of the item;

  (ii) the adequacy of internal control;

  (iii) the nature or size of the business carried on by the entity;

  (iv) situations which may exert an unusual influence on management;

  (v) the financial position of the entity.

(b) The materiality of the item.

(c) The experience gained during previous audits.

(d) The results of auditing procedures, including fraud or error which may have been found.

(e) The type of information available.

(f) The trend indicated by accounting ratios and analysis.

5. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the following assertions:

Existence	–	that the internal control exists.
Effectiveness	–	that the internal control is operating effectively.
Continuity	–	that the internal control has so operated throughout the period of intended reliance.

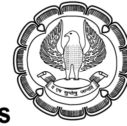
6. Obtaining audit evidence from substantive procedures is intended to reasonably assure the auditor in respect of the following assertions:

Existence	–	that an asset or a liability exists at a given date.
Rights and Obligations	–	that an asset is a right of the entity and a liability is an obligation of the entity at a given date.
Occurrence	–	that a transaction or event took place which pertains to the entity during the relevant period.
Completeness	–	that there are no unrecorded assets, liabilities or transactions.
Valuation	–	that an asset or liability is recorded at an appropriate carrying value.
Measurement	–	that a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period.
Presentation and Disclosure	–	an item is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

The extent and nature of substantive procedures to be performed will vary with respect to each of the above assertions.

Obtaining evidence relevant to one of the above assertions will not compensate for failure to do so with respect to another matter concerning the same item, e.g., existence of inventory and its valuation.

7. The reliability of audit evidence depends on its source - internal or external, and on its nature - visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:



- External evidence (e.g. confirmation received from a third party) is usually more reliable than internal evidence.
- Internal evidence is more reliable when related internal control is satisfactory.
- Evidence in the form of documents and written representations is usually more reliable than oral representations.
- Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

8. The auditor may gain increased assurance when audit evidence obtained from different sources or of different nature is consistent. In these circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, further procedures may have to be performed to resolve the inconsistency.

9. The auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation.

10. When the auditor is in reasonable doubt as to any assertion of material significance, he would attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence he should not express an unqualified opinion.

Obtaining Audit Evidence

11. The auditor obtains evidence in performing compliance and substantive procedures by one or more of the following methods:

- Inspection
- Observation
- Inquiry and confirmation
- Computation
- Analytical review

The timing of such procedures will be dependent, in part, upon the periods of time during which the audit evidence sought is available.

Inspection

12. Inspection consists of examining records, documents, or tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability, depending on their nature and source and the effectiveness of internal controls over their processing. Four major categories of documentary evidence, which provide different degrees of reliability to the auditor, are:

- documentary evidence originating from and held by third parties;
- documentary evidence originating from third parties and held by the entity;
- documentary evidence originating from the entity and held by third parties; and
- documentary evidence originating from and held by the entity.

Inspection of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

Observation

13. Observation consists of witnessing a process or procedure being performed by others. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trail.

Inquiry and Confirmation

14. Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

15. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors.

Computation

16. Computation consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.

Analytical Review

17. Analytical review consists of studying significant ratios and trends and investigating unusual fluctuations and items.

Effective Date

18. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after January 1, 1989.

AAS 6

[New Number of the Standard SA 400]

RISK ASSESSMENTS AND INTERNAL CONTROL

The following is the text of the Auditing and Assurance Standard (AAS) 6[*]***(SA 400)****, "Risk Assessments and Internal Control", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. The principles laid down in the other SAs, issued by the Institute of Chartered Accountants of India, would be applicable, to the extent practicable, to this SA also. In this Standard, the term 'financial information' encompasses 'financial statements'. In some circumstances, specific legislations and regulations may require the auditor to undertake procedures additional to those set out in this SA.

2. **The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.**

3. "Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

4. "Inherent risk" is the susceptibility of an account balance or class of transactions to

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[*] Issued in June, 2002. The Standard was originally issued in May, 1988 and was titled "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit".

misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

5. "Control risk" is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

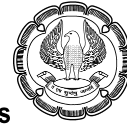
6. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.

7. "Accounting System" means the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions and other events.

8. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

9. The system of internal control must be under continuing supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in conditions. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:

(a) "the control environment" which means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures and provides the background against which other controls are operated. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong control environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:



- ♦ The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory functions).
- ♦ The function of the board of directors and its committees in the case of a company or the corresponding governing body in case of any other entity.
- ♦ Management's philosophy and operating style.
- ♦ Management's control system including the internal audit function, personnel policies and procedures.

(b) "control procedures" which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:

- ♦ Reporting and reviewing reconciliations.
- ♦ Checking the arithmetical accuracy of the records.
- ♦ Controlling applications and environment of computer information systems, for example, by establishing controls over:
  - changes to computer programs
  - access to data files.
- ♦ Maintaining and reviewing control accounts and related subsidiary ledgers.
- ♦ Approving and controlling of documents.
- ♦ Comparing internal data with external sources of information.
- ♦ Comparing the results of physical verification of cash, fixed assets, investments and inventory with corresponding accounting records.
- ♦ Restricting direct access to assets, records and information.
- ♦ Comparing and analysing the financial results with corresponding budgeted figures.

10. In the audit of financial statements, the auditor is concerned only with those policies and procedures within the accounting and internal control systems that are relevant to the assertions made in the financial statements. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

(a) assess the adequacy of the accounting system as a basis for preparing the financial statements;

(b) identify the types of potential material misstatements that could occur in the financial statements;

(c) consider factors that affect the risk of material misstatements; and

(d) develop an appropriate audit plan and determine the nature, timing and extent of his audit procedures.

11. When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the appropriate detection risk that may be accepted by the auditor for the assertions made in the financial statements and to determine the nature, timing and extent of substantive procedures for such assertions.

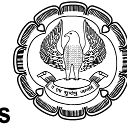
Inherent Risk

12. In developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions at the level of assertions made in the financial statements, or assume that inherent risk is high for the assertion, taking into account factors relevant both to the financial statements as a whole and to the specific assertions. When the auditor makes an assessment that the inherent risk is not high, he should document the reasons for such assessment.

13. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Examples of such factors are:

At the Level of Financial Statements

- The integrity of the management.
- Management's experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.



Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.

- The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the Level of Account Balance and Class of Transactions

- Quality of the accounting system.
- Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
- The complexity of underlying transactions and other events which might require using the work of an expert.
- The degree of judgement involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- The completion of unusual and complex transactions, particularly, at or near period end.
- Transactions not subjected to ordinary processing.

Accounting and Internal Control Systems

14. Internal controls relating to the accounting system are concerned with achieving the following objectives:

- Transactions are executed in accordance with management's general or specific authorisation.
- All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other

recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets. .

- Assets and records are safeguarded from unauthorised access, use or disposition.
- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Inherent Limitations of Internal Controls

15. Accounting and internal control systems can provide only reasonable, but not absolute, assurance that the objectives stated above are achieved. This is because the internal control systems are subject to some inherent limitations, such as:

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature.
- The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and the misunderstanding of instructions.
- The possibility of circumvention of internal controls through the collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

Understanding the Accounting and Internal Control Systems

16. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains a knowledge of the design of the accounting and internal control systems, and their operation. For example, an auditor may perform a "walk-through" test, that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk-through tests performed by the

auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

17. The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:

- The size and complexity of the entity and of its information system.
- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity's documentation of specific internal controls.
- The auditor's assessment of inherent risk.

18. Ordinarily, the auditor's understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:

(a) inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions, systems descriptions and flow charts;

(b) inspection of documents and records produced by the accounting and internal control systems; and

(c) observation of the entity's activities and operations, including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing.

Accounting System

19. The auditor should obtain an understanding of the accounting system sufficient to identify and understand:

(a) major classes of transactions in the entity's operations;

(b) how such transactions are initiated;

(c) significant accounting records, supporting documents and specific accounts in the financial statements; and

(d) the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.

Control Environment

20. **The auditor should obtain an understanding of the control environment sufficient to assess management's attitudes, awareness and actions regarding internal controls and their importance in the entity.** Such an understanding would also help the auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

21. **The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan.** In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled regularly. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

Control Risk

22. **After obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.**

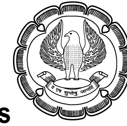
Preliminary Assessment of Control Risk

23. The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. The preliminary assessment of control risk is based on the assumption that the controls operate generally as described and that they operate effectively throughout the period of intended reliance. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

24. The auditor ordinarily assesses control risk at a high level for some or all assertions when:

(a) the entity's accounting and internal control systems are not effective; or

(b) evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.



In the above circumstances, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements.

25. **The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:**

(a) is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and

(b) plans to perform tests of control to support the assessment.

Documentation of Understanding and Assessment of Control Risk

26. **The auditor should document in the audit working papers:**

(a) the understanding obtained of the entity's accounting and internal control systems; and

(b) the assessment of control risk.

When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.

27. Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgement. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control systems. Generally, the more complex the entity's accounting and internal control systems and the more extensive the auditor's procedures, the more extensive the auditor's documentation will need to be.

Tests of Control

28. Tests of control are performed to obtain audit evidence about the effectiveness of the:

(a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

(b) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

29. Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

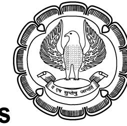
30. When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

31. Tests of control may include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

32. The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively.

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



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

34. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system.

35. Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

36. Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

37. In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. **Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance.** The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The

longer the time elapsed since the performance of such procedures the less assurance that may result.

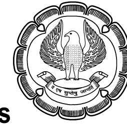
38. **The auditor should consider whether the internal controls were in use throughout the period.** If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions and other events of that period.

39. The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period. Factors to be considered include:

- The results of the interim tests.
- The length of the remaining period.
- Whether any changes have occurred in the accounting and internal control systems during the remaining period.
- The nature and amount of the transactions and other events and the balances involved.
- The control environment, especially supervisory controls.
- The nature, timing and extent of substantive procedures which the auditor plans to carry out.

Final Assessment of Control Risk

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



Relationship Between the Assessments of Inherent and Control Risks

41. Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

Detection Risk

42. The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

43. **The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level.** In this regard the auditor would consider:

(a) the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;

(b) the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and

(c) the extent of substantive procedures, for example, using a larger sample size.

44. There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

45. While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other.

Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

46. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. **Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.**

47. The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

48. **The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures.** When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. **When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.**

Audit Risk in the Small Business

49. The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities. However, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.

Communication of Weaknesses

50. As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. **The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention.** The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

Effective Date

51. This Auditing and Assurance Standard becomes operative for all audits related to accounting periods beginning on or after 1st April, 2002.

APPENDIX

Illustration of the Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks.

		Auditor's assessment of control risk		
		High	Medium	Low
Auditor's assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

AAS 7

[New Number of the Standard SA 610]

RELYING UPON THE WORK OF AN INTERNAL AUDITOR

The following is the text of the Auditing and Assurance Standard (AAS) 7[*]***(SA 610),*** *"Relying upon the Work of an Internal Auditor", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs. This Auditing and Assurance Standard supersedes the Guidance Note on Co-ordination between the Internal Auditor and Statutory Auditors, issued by the Institute in 1979.*

Introduction

1. Auditing and Assurance Standard (AAS) 6[**] **(SA 400)**, "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit", states (paragraph 8):

> "Internal Control System means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated."

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[*] Issued in January, 1989.

[**] Paragraph 6 of AAS 6 (Revised), "Risk Assessments and Internal Controls" is the paragraph corresponding to paragraph 8 of the erstwhile (the original AAS 6, which was issued in May, 1988) AAS 6, "Study and Evaluation of the Accounting System and Related Internal Controls in connection with an Audit. A reference may be made to paragraph 6 of AAS 6 (revised), "Risk Assessments and Internal Control".

2. The purpose of this Standard is to provide guidance as to the procedures which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work.

3. With the introduction of the Manufacturing and Other Companies (Auditor's Report) Order, 1988[***], internal audit function has acquired special significance as the statutory auditor is required to state, in relation to a company having a paid-up capital exceeding Rs. 25 lakhs or having an average annual turnover exceeding Rs. 2 crore for a period of three consecutive financial years immediately preceding the financial year concerned to which the Order applies, whether the internal audit system is commensurate with the size and nature of its business.[11]

4. In this Standard, "financial information" encompasses financial statements.

5. While the external auditor has sole responsibility for his report and for the determination of the nature, timing and extent of the auditing procedures, much of the work of the internal audit function may be useful to him in his examination of the financial information.

Scope and Objectives of the Internal Audit Function

6. The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its management.

Normally, however, internal audit operates in one or more of the following areas:

(a) ***Review of accounting system and related internal controls:*** The establishment of an adequate accounting system and the related controls is the responsibility of management which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.

[***] The Order has been replaced by the Companies (Auditor's) Report Order, 2003, issued by the Department of Company Affairs in June, 2003 under section 227(4A) of the Companies Act, 1956.

[11] Readers' attention is also drawn to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India, for a study of various factors to be considered by the auditor in evaluating the adequacy of the internal audit system for the purposes of reporting under the Order.

(b) ***Examination for management of financial and operating information:*** This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

(c) ***Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation:*** Generally, the external auditor is interested in the results of such audit work only when it has an important bearing on the reliability of the financial records.

(d) ***Physical examination and verification:*** This would generally include examination and verification of physical existence and condition of the tangible assets of the entity.

Relationship between Internal and External Auditors

7. The role of the internal audit function within an entity is determined by management and its prime objective differs from that of the external auditor who is appointed to report independently on financial information. Nevertheless, some of the means of achieving their respective objectives are often similar and, thus, much of the work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of his procedures.

8. The external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would otherwise be required.

9. By its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. The report of the external auditor is his sole responsibility, and that responsibility is not by any means reduced because of the reliance he places on the internal auditor's work.

General Evaluation of Internal Audit Function

10. The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

(a) ***Organisational Status:*** Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, he reports to the highest level of management and is

free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

(b) ***Scope of Function:*** The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

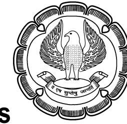
(c) ***Technical Competence:*** The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

(d) ***Due Professional Care:*** The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes, and working papers.

Coordination

11. Having decided in principle that he intends to rely upon the work of the internal auditor, it is desirable that the external auditor ascertains the internal auditor's tentative plan for the year and discusses it with him at as early a stage as possible to determine areas where he considers that he could rely upon the internal auditor's work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed, and review and reporting procedures.

12. Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work.



Evaluating Specific Internal Audit Work

13. Where, following the general evaluation described in paragraph 10, the external auditor intends to rely upon specific internal audit work as a basis for modifying the nature, timing and extent of his procedures, he should review the internal auditor's work, taking into account the following factors:

(a) The scope of work and related audit programmes are adequate for the external auditor's purpose.

(b) The work was properly planned and the work of assistants was properly supervised, reviewed, and documented.

(c) Sufficient appropriate evidence was obtained to afford a reasonable basis for the conclusions reached.

(d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.

(e) Any exceptions or unusual matters disclosed by the internal auditor's procedures have been properly resolved.

The external auditor should document his conclusions in respect of the specific work which he has reviewed.

14. The external auditor should also test the work of the internal auditor on which he intends to rely. The nature, timing and extent of the external auditor's tests will depend upon his judgement as to the materiality of the area concerned to the financial statements taken as a whole and the results of his evaluation of the internal audit function and of the specific internal audit work. His tests may include examination of items already examined by the internal auditor, examination of other similar items, and observation of the internal auditor's procedures.

Effective Date

15. This Auditing and Assurance Standard, becomes operative for all audits relating to accounting periods beginning on or after April 1, 1989.

AAS 8

[New Number of the Standard SA 300]

AUDIT PLANNING

*The following is the text of the Auditing and Assurance Standard (AAS) 8[*] **(SA 300)**, "Audit Planning", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. Auditing and Assurance Standard (AAS) 1**(SA 200)**, *"Basic Principles Governing an Audit"*, states (paragraphs 12-14):

> "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.
>
> Plans should be made to cover, among other things:
>
> (a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
>
> (b) establishing the expected degree of reliance to be placed on internal control;
>
> (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and
>
> (d) coordinating the work to be performed.
>
> Plans should be further developed and revised as necessary during the course of the audit."

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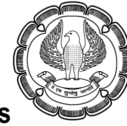
[*] Issued in April, 1989.



The purpose of this Standard is to amplify the basic principle outlined above.

2. This Standard applies to the planning process of the audit of both financial statements and other financial information. The Statement is framed in the context of recurring audits. In a first audit, the auditor may need to extend his planning process beyond the matters discussed herein.

3. Planning should be continuous throughout the engagement and involves:

- developing an overall plan for the expected scope and conduct of the audit; and
- developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan and of the audit programme. The reasons for significant changes may be documented.

4. Adequate audit planning helps to:

- ensure that appropriate attention is devoted to important areas of the audit;
- ensure that potential problems are promptly identified;
- ensure that the work is completed expeditiously;
- utilise the assistants properly; and
- co-ordinate the work done by other auditors and experts.

5. In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates, his previous experience with the client and knowledge of the client's business.

6. The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

Knowledge of the Client's Business

7. The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgement, may have a significant effect on the financial information. Among other things, the auditor can obtain such knowledge from:

- The client's annual reports to shareholders.

- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets, if any.
- The previous year's audit working papers, and other relevant files.
- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- Discussions with client.
- The client's policy and procedures manual.
- Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
- Consideration of the state of the economy and its effect on the client's business.
- Visits to the client's premises and plant facilities.

8. With respect to the previous year's audit working papers and other relevant files, the auditor should pay particular attention to matters that required special consideration and decide whether they might affect the work to be done in the current year.

9. Discussions with the client might include such subjects as:

- Changes in management, organisational structure, and activities of the client.
- Current Government legislation, rules, regulations and directives affecting the client.
- Current business developments affecting the client.
- Current or impending financial difficulties or accounting problems.
- Existence of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- New or closed premises and plant facilities.
- Recent or impending changes in technology, type of products or services and production or distribution methods.
- Significant matters arising from previous year's financial statements, audit report and management letters, if any.

- Changes in the accounting practices and procedures and in the system of internal control.
- Scope and timing of the examination.
- Assistance of client personnel in data preparation.
- Relevance of any work to be carried out by the client's internal auditors.

10. In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgements regarding the appropriateness of accounting policies and disclosures.

Development of an Overall Plan

11. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.

- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

12. The auditor should document his overall plan. The form and extent of the documentation will vary depending on the size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be an effective planning tool.

Developing the Audit Programme

13. The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

14. In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

15. The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

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

Effective Date

17. This Auditing and Assurance Standard becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1989.

AAS 9

[New Number of the Standard SA 620]

USING THE WORK OF AN EXPERT

The following is the text of the Auditing and Assurance Standard (AAS) 9[*] ***(SA 620),*** *"Using the Work of an Expert", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. Auditing and Assurance Standard (AAS) 1 **(SA 200)**, *Basic Principles Governing an Audit*, states (paragraphs 9-10):

> "When the auditor delegates work to assistants, or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956, the auditor's report should expressly state the fact of such reliance."
>
> "The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose."

This Standard discusses the auditor's responsibility in relation to, and the procedures the auditor should consider in, using the work of an expert as audit evidence. In this Standard, the term 'financial information' encompasses financial statements.

[*] Issued in December, 1991.

2. The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation, such as an actuary or engineer.

3. An expert (or a specialist), for the purpose of this Statement, is a person, firm or other association of persons possessing special skill, knowledge and experience in a particular field other than accounting and auditing. An 'expert' may be:

- engaged by the client,
- engaged by the auditor,
- employed by the client, or
- employed by the auditor.

4. When the auditor uses the work of an expert employed by him, he is using that work in the employee's capacity as an expert rather than delegating the work to an assistant on the audit. Accordingly, in such circumstances, he should apply relevant procedures described in this Statement in satisfying himself as to his employee's work and findings.

Determining the Need to Use the Work of an Expert

5. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. Examples are:

- Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
- Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, mineral and petroleum reserves, and the remaining useful life of plant and machinery.
- Determination of amounts using specialised techniques or methods, for example, an actuarial valuation.
- The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.

- Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

6. When determining whether to use the work of an expert or not, the auditor should consider:

- the materiality of the item being examined in relation to the financial information as a whole,
- the nature and complexity of the item including the risk of error therein, and
- the other audit evidence available with respect to the item.

Skills and Competence of the Expert

7. When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:

- professional qualifications, licence or membership in an appropriate professional body, and
- experience and reputation in the field in which the evidence is sought.

However, when the auditor uses the work of an expert employed by him, he will not need to inquire into his skills and competence.

Objectivity of the Expert

8. The auditor should also consider the objectivity of the expert. The risk that an expert's objectivity will be impaired increases when the expert is:

- employed by the client, or
- related in some other manner to the client.

Accordingly, in these circumstances, the auditor should (after taking into account the factors in paragraphs 6 and 7) consider performing more extensive procedures than would otherwise have been planned, or he might consider engaging another expert.

Evaluating the Work of an Expert

9. When the auditor intends to use the work of an expert, he should examine evidence to gain knowledge regarding the terms of the expert's engagement and such other matters as :

- the objectives and scope of the expert's work,

- a general outline as to the specific items in the expert's report,
- confidentiality of the expert's work, including the possibility of its communication to third parties,
- the expert's relationship with the client, if any,
- confidentiality of the client's information used by the expert.

10. The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:-

- the source data used,
- the assumptions and methods used and, if appropriate, their consistency with the prior period, and
- the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial information.

11. The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:

- making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable, and
- conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

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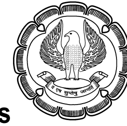
13. Normally, completion of the above procedures will provide the auditor with reasonable assurance that he has obtained appropriate audit evidence in support of the financial information. In exceptional cases where the work of an expert does not support the related representations in the financial information, the auditor should attempt to resolve the inconsistency by discussions with the client and the expert. Applying additional procedures, including possibly engaging another expert, may also assist the auditor in resolving the inconsistency.

14. If, after performing these procedures, the auditor concludes that:



- the work of the expert is inconsistent with the information in the financial statements, or that
- the work of the expert does not constitute sufficient appropriate audit evidence (e.g., where the work of the expert involves highly technical matters or where, on grounds of confidentiality, the expert refuses to make available to the auditor the source data used by him),

he should express a qualified opinion, a disclaimer of opinion or an adverse opinion, as may be appropriate.

Reference to an Expert in the Auditor's Report

15. When expressing an unqualified opinion, the auditor should not refer to the work of an expert in his report. If, as a result of the work of an expert, the auditor decides to express other than an unqualified opinion, it may in some circumstances benefit the reader of his report if the auditor, in explaining the nature of his reservation, refers to or describes the work of the expert. Where, in doing so, the auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure if such consent has not already been obtained.

Effective Date

16. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1991.

AAS 10

[New Number of the Standard SA 600]

USING THE WORK OF ANOTHER AUDITOR

The following is the text of the Auditing and Assurance Standard (AAS) 10[*] ***(SA 600),*** *"Using the Work of Another Auditor ", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The Auditing and Assurance Standard (AAS) 1 **(SA 200)*,*** *Basic Principles Governing an Audit,* states (paragraph 9):

> "When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance."

2. The purpose of this Auditing and Assurance Standard (SA) is to establish standards to be applied in situations where an auditor (referred to herein as the 'principal auditor'), reporting on the financial information of an entity, uses the work of another auditor (referred to herein as the 'other auditor') with respect to the financial information of one or more components included in the financial information of the entity. This Statement also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Statement, the term 'financial information' encompasses 'financial statements'.

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[*] Issued in April, 1995. Revised in September, 2002.

3. This Standard does not deal with those instances where two or more auditors are appointed as joint auditors[12] nor does it deal with the auditor's relationship with a predecessor auditor.

4. When the principal auditor concludes that the financial information of a component is immaterial, the procedures outlined in this Statement do not apply. When several components, immaterial in themselves, are together material in relation to the financial information of the entity as a whole, the procedures outlined in this Statement should be considered.

5. **When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.**

6. "Principal auditor" means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.

7. "Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.

8. "Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

Acceptance as Principal Auditor

9. **The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.** For this purpose the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

(d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

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[12] Auditing and Assurance Standard (AAS) 12, "*Responsibility of Joint Auditors*", deals with the audit procedures to be employed where two or more auditors are appointed as joint auditors.

The Principal Auditor's Procedures

10. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

11. **When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.**

12. **The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.** When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and

(b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

13. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

14. The principal auditor may conclude that it is not necessary to apply procedures such as those described in paragraph 13 because sufficient appropriate audit evidence previously

obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

15. **The principal auditor should consider the significant findings of the other auditor.**

16. The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

17. In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor. This may happen, for instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component. In such circumstances, the procedures outlined in paragraphs 10 to 16 assume added importance.

18. The principal auditor should document in his working papers the components whose financial information was audited by other auditors; their significance to the financial information of the entity as a whole; the names of the other auditors; and any conclusions reached that individual components are not material. The principal auditor should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures. However, the principal auditor need not document the reasons for limiting the procedures in the circumstances described at 14 above, provided those reasons are summarised elsewhere in the documentation maintained by the principal auditor. Where the other auditor's report is other than unmodified[13],the principal auditor should

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[13] Auditing and Assurance Standard (AAS) 28, "Auditor's Report on Financial Statements", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:

Matters that do not affect the auditor 's opinion

(a) emphasis of matter

Matters that do affect the auditor 's opinion

(a) qualified opinion,

(b) disclaimer of opinion, or

(c) adverse opinion.

also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

Co-ordination Between Auditors

19. **There should be sufficient liaison between the principal auditor and the other auditor.** For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

20. **The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.** For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

21. When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

Reporting Considerations

22. **When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.**

23. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting, that it requires a modification of the principal auditor's report.

Division of Responsibility

24. The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the

reliability of the work performed by the other auditors.

25. **When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.**

Effective Date

26. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 2002.

Compatibility with International Standard on Auditing (ISA) 600

The auditing standards established in this Auditing and Assurance Standard (SA) are generally consistent, in all material respects, with those set out in ISA 600 "Using the Work of Another Auditor".

AAS 11

[New Number of the Standard SA 580]

REPRESENTATIONS BY MANAGEMENT

The following is the text of the Auditing and Assurance Standard (AAS) 11[*] ***(SA 580),*** *"Representations by Management", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Standard is to establish standards on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations, and the action to be taken if management refuses to provide appropriate representations.

2. The auditor should obtain representations from management, where considered appropriate.

Acknowledgement by Management of its Responsibility for the Financial Information

3. The auditor should obtain evidence that management acknowledges its responsibility for the appropriate preparation and presentation of financial information and that management has approved the financial information.

Representations by Management as Audit Evidence

4. The auditor should exercise his professional judgement in determining the matters on which he wishes to obtain representations from management. Similarly, the matters on which the auditor wishes to obtain such representations in writing should also be determined by the auditor using his professional judgement. However, representations should be obtained from management invariably in writing on matters material to financial information, either individually or collectively, when other sufficient appropriate audit evidence cannot reasonably

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[*] Issued in February, 1996.

be expected to exist. Matters which might be included in a representation letter from management in an audit of financial statements are contained in the example of a management representation letter in the Appendix.

5. During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to specific enquiries. When such representations relate to matters which are material to the financial information, the auditor should:

(a) seek corroborative audit evidence from sources inside or outside the entity;

(b) evaluate whether the representations made by management appear reasonable and consistent with other audit evidence obtained, including other representations; and

(c) consider whether the individuals making the representations can be expected to be well-informed on the matter.

6. Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the quantity, existence and cost of inventories is no substitute for adopting normal audit procedures regarding verification and valuation of inventories. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.

7. In certain instances such as where knowledge of the facts is confined to management or where the matter is principally one of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available; for example, intention of management to hold a specific investment for long-term appreciation.

8. If a representation by management is contradicted by other evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by management.

Documentation of Representations by Management

9. The auditor should document in his working papers evidence of management's representations.

10. A written representation is better audit evidence than an oral representation and can take the form of:

(a) a representation letter from management;

(b) a letter from the auditor outlining the auditor's understanding of management's

representations, duly acknowledged and confirmed by management;

(c) a duly authenticated copy of relevant minutes of meetings of the board of directors or similar body.

Basic Elements of a Management Representation Letter

11. A management representation letter should be addressed to the auditor, containing the relevant information and be appropriately dated and signed.

12. A management representation letter would normally be dated the same date as the auditor's report on the financial information or a date prior thereto. However, in certain circumstances, in respect to specific transactions or events, separate representation letters may also be obtained during the course of audit.

13. A management representation letter should ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects, e.g., managing director, finance director.

14. If management refuses to provide representations on any matter that the auditor considers necessary, this will constitute a limitation on the scope of his examination. In such circumstances, the auditor should evaluate any reliance he has placed on other representations made by management during the course of his examination and consider if the refusal may have any additional effect on his report.

15. In case management is not willing to give in writing the representations made by it during the course of audit, the auditor should himself prepare a letter in writing setting out his understanding of management's representations that have been made to him during the course of audit and send it to management with a request to acknowledge and confirm that his understanding of the representations is correct. If the management refuses to acknowledge or confirm the letter sent by the auditor, this will constitute a limitation on the scope of his examination. In such circumstances, the auditor should evaluate any reliance on those representations and consider if the refusal may have any additional effect on his report.

Effective Date

16. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1995.

APPENDIX

Example of a Management Representation Letter in an Audit of Financial Statements

(Ref. Paragraph 4)

The following letter is for use as a general guide in conjunction with the considerations set forth in this Statement. Representations by management will vary from one entity to another, and from one year to the next. Therefore, this letter is not intended to be a standard letter and should be adapted in the light of individual requirements and circumstances.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of .... for the year ended ...... for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of the financial position of .... as of ...... and of the results of operations for the year then ended. We acknowledge our responsibility for preparation of financial statements in accordance with the requirements of the Companies Act, 1956[14] and recognised accounting policies and practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India.

We confirm, to the best of our knowledge and belief, the following representations:

Accounting Policies

1. The accounting policies which are material or critical in determining the results of operations for the year or financial position are set out in the financial statements and are consistent with those adopted in the financial statements for the previous year. The financial statements are prepared on accrual basis.

Assets

2. The company has a satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in Note X to the financial

[14] or other relevant statute.

statements.

Fixed Assets

3. The net book values at which fixed assets are stated in the Balance Sheet are arrived at:

(a) after taking into account all capital expenditure on additions thereto, but no expenditure properly chargeable to revenue;

(b) after eliminating the cost and accumulated depreciation relating to items sold, discarded, demolished or destroyed;

(c) after providing adequate depreciation on fixed assets during the period.

Capital Commitments

4. At the balance sheet date, there were no outstanding commitments for capital expenditure excepting those disclosed in Note X to the financial statements.

Investments

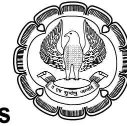
5. The current investments as appearing in the Balance Sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the Balance Sheet as 'long-term investments'.

6. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.

7. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renunciated, or allowed to lapse. In no case have they been renunciated in favour of third parties without consideration which has been properly accounted for in the books of account.

8. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.

9. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity and there are no charges against the investments of the entity except those appearing in the records of the entity.



Inventories

10. Inventories at the year-end consisted of the following:

Raw Materials (including components)	Rs ....
Work-in-Process	Rs ....
Finished Goods (including by-products)	Rs ....
Maintenance supplies and Stores and Spare Parts	Rs ....
Loose Tools	Rs ....
Others (specify each major head separately)	Rs ....
Total	Rs ....

11. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on .... (date/dates of physical verification), except as follows:[15]

....

....

12. All goods included in the inventory are the property of the entity, none of the goods are held as consignee for others or as bailee, and, except as set out below, none of the goods are subject to any charge.

....

....

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[15] Where physical verification of inventories is carried out at a date other than the closing date, this paragraph may be modified as below:

> Inventories recorded in the books as at ....(date of balance sheet) aggregating to Rs. .... are based upon the physical inventories taken as at .... (date of physical verification) by actual count, weight or measurement. The material discrepancies noticed on physical verification of stocks as compared to book records have been properly dealt with in the books of account and subsequent transactions recorded in the accounts fairly reflect the changes in the inventories up to .... (balance sheet date).

13. All inventories owned by the entity, wherever located, have been recorded, including goods sent on consignment.

14. Inventories do not include goods sold to customers for which delivery is yet to be made.

15. Inventories have been valued on the following basis/bases:

    Raw Materials (including components)

    Work-in-Process

    Finished Goods (including by-products)

    Maintenance supplies and Stores and Spare Parts

    Loose Tools

    Others (specify each major head separately)

    (In describing the basis/bases of valuation, the method of ascertaining the cost (e.g. FIFO, Average Cost or LIFO) should also be stated. Similarly, the extent to which overheads have been included in the cost should also be stated.)

16. The following provisions have been made in respect of excess, slow-moving, damaged, or obsolete inventories and these, in our view, are adequate.

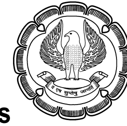
....

....

17. No item of inventories has a net realisable value in the ordinary course of business which is less than the amount at which it is included in inventories.

18. The basis/bases of valuation is/are the same as that/those used in the previous year, except as set out below:

Class of inventory	*Basis of Valuation*		*Effect of change in Basis of Valuation*
	This Year	Last Year	
.....	....	....	....
.....	....	....	....



Debtors, Loans and Advances

19. The following items appearing in the books as at ....(date of the Balance Sheet) are considered good and fully recoverable with the exception of those specifically shown as "doubtful" in the Balance Sheet.

Sundry Debtors	Rs.
Loans and Advances	Rs.

Other Current Assets

20. In the opinion of the Board of Directors, other current assets have a value on realisation in the ordinary course of the company's business which is atleast equal to the amount at which they are stated in the Balance Sheet, except as stated in Note X to the financial statements.

Liabilities

21. We have recorded all known liabilities in the financial statements.

22. We have disclosed in notes to the financial statements all guarantees that we have given to third parties and all other contingent liabilities.

23. Contingent liabilities disclosed in the notes to the financial statements do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.

Provisions for Claims and Losses

24. Provision has been made in the accounts for all known losses and claims of material amounts.

25. There have been no events subsequent to the balance sheet date which require adjustment of, or disclosure in, the financial statements or notes thereto.

Profit and Loss Account

26. Except as disclosed in the financial statements, the results for the year were not materially affected by:

(a) transactions of a nature not usually undertaken by the company;

(b) circumstances of an exceptional or non-recurring nature;

(c) charges or credits relating to prior years;

(d) changes in accounting policies.

General

27. The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements:

(a) Losses arising from sale and purchase commitments.

(b) Agreements and options to buy back assets previously sold.

(c) Assets pledged as collateral.

28. There have been no irregularities involving management or employees who have a significant role in the system of internal control that could have a material effect on the financial statements.

29. The financial statements are free of material misstatements, including omissions.

30. The company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.

31. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities reflected in the financial statements.

AAS 12

[New Number of the Standard SA 299]

RESPONSIBILITY OF JOINT AUDITORS

The following is the text of the Auditing and Assurance Standard (AAS) 12[*] ***(SA 299),*** *"Responsibility of Joint Auditors", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

The Statement on the Responsibility of Joint Auditors issued by the Institute earlier shall stand completely withdrawn in respect of all audits relating to accounting periods beginning on or after April 1, 1996[16]

Introduction

1. The practice of appointing more than one auditor to conduct the audit of large entities is in vogue these days. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The Standard does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more divisions or branches included in the financial statements of the entity, e.g., the relationship between a company auditor appointed under section 224 of the Companies Act, 1956 and a branch auditor appointed under section 228 of the said Act[17]

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[*] Issued in November, 1996.

[16] Paragraphs 17-29 of the *Statement on the Responsibility of Joint Auditors* already stand withdrawn in respect of all audits relating to accounting periods beginning on or after April 1, 1995, pursuant to the issuance of AAS 10, *Using the Work of Another Auditor* in 1995.

[17] These aspects have been dealt with in Auditing and Assurance Standard (AAS) 10 (revised 2002), *Using the Work of Another Auditor*. It may also be mentioned that presently, there is no legal

Division of Work

2. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

3. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Coordination

4. Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This should be done by the submission of a report or note prior to the finalisation of the audit.

Relationship Among Joint Auditors

5. In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing

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requirement under the Companies Act, 1956 to prepare consolidated accounts or group accounts. Section 212 of the Companies Act, 1956 requires that the accounts of a holding company shall have attached thereto the Balance Sheet, Profit and Loss Account, Directors' Report and Auditors' Report of each subsidiary company. Certain additional information is also required. In view of the fact that a subsidiary is a separate legal entity, the Council of the Institute is of the opinion that no responsibility is cast upon the auditors of a holding company in respect of the work performed by the auditors of the subsidiary. However, Auditing and Assurance Standard (AAS) 10 (revised 2002), '*Using the Work of Another Auditor*' lays down the responsibility of the auditors of the holding company when they are required to issue an audit opinion on consolidated financial statements.

or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

6. If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7. Subject to paragraph 5(b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

8. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

9. A significant part of the audit work involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where

specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

10. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures.[18] It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

11. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

Reporting Responsibilities

12. Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Effective Date

13. This Auditing and Assurance Standard becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

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[18] Reference may be made in this regard to the Auditing and Assurance Standards and other mandatory Statements relating to auditing matters issued by the Council of the Institute from time to time.

AAS 13

[New Number of the Standard SA 320]

AUDIT MATERIALITY

*The following is the text of the Auditing and Assurance Standard (AAS) 13[*] **(SA 320),** "Audit Materiality", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Standard is to establish standards on the concept of materiality and its relationship with audit risk.

2. The auditor should consider materiality and its relationship with audit risk when conducting an audit.

Materiality

3. 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, judged in the particular circumstances of its misstatement. Thus, 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.

4 The objective of an audit of financial information prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable the auditor to express an opinion on such financial information. The assessment of what is material is a matter of professional judgement.

5. 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

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[*] Issued in January, 1997

materiality at both the overall financial information level and in relation to individual account balances and classes of transactions. Materiality may also be influenced by other considerations, such as the legal and regulatory requirements, non-compliance with which may have a significant bearing on the financial information, and considerations relating to individual account balances and relationships. This process may result in different levels of materiality depending on the matter being audited.

6. Although the auditor ordinarily establishes an acceptable materiality level to detect quantitatively material misstatements, both the amount (quantity) and nature (quality) of misstatements need to be considered. An example of a qualitative misstatement would be the inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.

7. The auditor needs to consider the possibility of misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial information. For example, an error in a month-end (or other periodic) procedure could be an indication of a potential material misstatement if that error is repeated each month or each period, as the case may be.

8. Materiality should be considered by the auditor when –

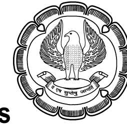
(a) determining the nature, timing and extent of audit procedures;

(b) evaluating the effect of misstatements.

The Relationship between Materiality and Audit Risk

9. When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor's preliminary assessment of materiality, related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk.

10. There is an inverse relationship between materiality and the degree of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:



(a) reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or

(b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Materiality and Audit Risk in Evaluating Audit Evidence

11. The auditor's assessment of materiality and audit risk may be different at the time of initially planning the engagement from that at the time of evaluating the results of his audit procedures. This could be because of a change in circumstances or a change in the auditor's knowledge as a result of the audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally, the auditor may, in planning the audit work, intentionally set the acceptable cut off level for verifying individual transactions at a lower level than is intended to be used to evaluate the results of the audit. This may be done to cover a larger number of items and thereby reduce the likelihood of undiscovered misstatements and to provide the auditor with the margin of safety when evaluating the effect of misstatements discovered during the audit.

12. In forming his opinion on the financial information, the auditor should consider whether the effect of aggregate uncorrected misstatements on the financial information is material. Qualitative considerations also influence an auditor in reaching a conclusion as to whether the misstatements are material.

13. The aggregate of uncorrected misstatements comprises:

(a) specific misstatements identified by the auditor, including the net effect of uncorrected misstatements identified during the audit of previous periods; and

(b) the auditor's best estimate of other misstatements which cannot be specifically identified (that is, projected errors).

14. When the auditor tests an account balance or class of transactions by an analytical procedure, he ordinarily would not specifically identify misstatements but would only obtain an indication of whether misstatements might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that misstatements might exist, but not its approximate amount, the auditor ordinarily would have to employ other procedures to enable him to estimate the aggregate misstatement in the balance or class.

15. When an auditor uses audit sampling to test an account balance or class of transactions, he projects the amount of known misstatements identified by him in his sample to the items in the balance or class from which his sample was selected. That projected misstatement, along with the results of other substantive tests, contributes to the auditor's assessment of aggregate misstatement in the balance or class.

16. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, or if auditor determines that the aggregate of uncorrected misstatements causes the financial information to be materially misstated, he should consider requesting the management to adjust the financial information or extending his audit procedures. In any event, the management may want to adjust the financial information for known misstatements. The adjustment of financial information may involve, for example, application of appropriate accounting principles, other adjustments in amounts, or the addition of appropriate disclosure of inadequately disclosed matters. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate.

Effective Date

17. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1996.

AAS 14

[New Number of the Standard SA 520]

ANALYTICAL PROCEDURES

The following is the text of Auditing and Assurance Standard (AAS) 14[*]***(SA 520),*** *"Analytical Procedures", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs..*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the application of analytical procedures during an audit.

2. **The auditor should apply analytical procedures at the planning and overall review stages of the audit.** Analytical procedures may also be applied at other stages.

3. "Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

Nature and Purpose of Analytical Procedures

4. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- ♦ Comparable information for prior periods.
- ♦ Anticipated results of the entity, such as budgets or forecasts.
- ♦ Predictive estimates prepared by the auditor, such as an estimation of depreciation charge for the year.
- ♦ Similar industry information, such as a comparison of the entity's ratio of sales to trade debtors with industry averages, or with other entities of comparable size in the

[*] Issued in December, 1997.

same industry.

5. Analytical procedures also include consideration of relationships:

   - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
   - Between financial information and relevant non-financial information, such as payroll costs to number of employees.

6. Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.

7. Analytical procedures are used for the following purposes:

   (a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

   (b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

   (c) as an overall review of the financial statements in the final review stage of the audit.

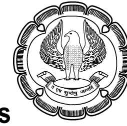
Analytical Procedures in Planning the Audit

8. **The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk.** Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.

9. Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical Procedures as Substantive Procedures

10. The auditor's reliance on substantive procedures to reduce detection risk relating to specific financial statement assertions may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to



achieve a particular audit objective is based on the auditor's judgement about the expected effectiveness and efficiency of the available procedures in reducing detection risk for specific financial statement assertions.

11. The auditor will ordinarily inquire of management as to the availability and reliability of information needed to apply analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.

12. When intending to perform analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the:

- Objectives of the analytical procedures and the extent to which their results can be relied upon (paragraphs 14-16).
- Nature of the entity and the degree to which information can be disaggregated, for example, analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- Availability of information, both financial, such as budgets or forecasts, and non-financial, such as the number of units produced or sold.
- Reliability of the information available, for example, whether budgets are prepared with sufficient care.
- Relevance of the information available, for example, whether budgets have been established as results to be expected rather than as goals to be achieved.
- Source of the information available, for example, sources independent of the entity are ordinarily more reliable than internal sources.
- Comparability of the information available, for example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products.
- Knowledge gained during previous audits, together with the auditor's understanding of the effectiveness of the accounting and internal control systems and the types of problems that in prior periods have given rise to accounting adjustments.

Analytical Procedures in the Overall Review at the End of the Audit

13. **The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business.** The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

Extent of Reliance on Analytical Procedures

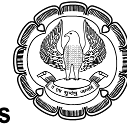
14. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

15. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(a) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(b) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

(c) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and



(d) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

16. The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Investigating Unusual Items

17. **When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.**

18. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

(a) corroboration of management's responses, for example, by comparing them with the auditor's knowledge of the business and other evidence obtained during the course of the audit; and

(b) consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

Effective Date

19. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1997.

AAS 15

[New Number of the Standard SA 530]

AUDIT SAMPLING

The following is the text of Auditing and Assurance Standard (AAS) 15 * ***(SA 530),*** *"Audit Sampling", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the design and selection of an audit sample and the evaluation of the sample results. This SA applies equally to both statistical and non-statistical sampling methods. Either method, when properly applied, can provide sufficient appropriate audit evidence.

2. **When using either statistical or non-statistical sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.**

3. "Audit sampling" means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.

4. It is important to recognise that certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Likewise, applying audit procedures to all items within a population which have a particular characteristic (for example, all items over a certain amount) does not qualify as audit sampling with respect to the portion of the population examined, nor with regard to the population as a whole, since the items were not selected from the total population on a

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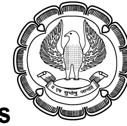
* Issued in April, 1998.



basis that was expected to be representative. Such items might imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

Design of the Sample

5. **When designing an audit sample, the auditor should consider the specific audit objectives, the population from which the auditor wishes to sample, and the sample size.**

Audit Objectives

6. The auditor would first consider the specific audit objectives to be achieved and the audit procedures which are likely to best achieve those objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing tests of control over an entity's purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

Population

7. The population is the entire set of data from which the auditor wishes to sample in order to reach a conclusion. The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. For example, if the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

8. The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. For example, if the auditor's objective were to test the validity of accounts receivables, the sampling unit could be defined as customer balances or individual customer invoices. The auditor defines the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

Stratification

9. To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value). The strata need to be explicitly defined so that each sampling unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification therefore, enables the auditor to direct audit efforts towards the items which, for example, contain the greatest potential monetary error. For example, the auditor may direct attention to larger value items for accounts receivable to detect overstated material misstatements. In addition, stratification may result in a smaller sample size.

Sample Size

10. **When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error**. Examples of some factors affecting sample size are contained in Appendix 1 and Appendix 2.

Sampling Risk

11. Sampling risk[19] arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

12. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

(a) Tests of Control:

(i) *Risk of Under Reliance*: The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.

(ii) *Risk of Over Reliance*: The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment.

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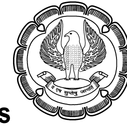
[19] Sampling risk can be contrasted with non-sampling risk which arises when the auditor uses any audit procedures. Non-sampling risk arises because, for example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures or might misinterpret evidence and, thus, fail to recognise an error. The auditor attempts to reduce non-sampling risk to a negligible degree by appropriate planning, direction, supervision and review.



(b) Substantive Procedures:

(i) *Risk of Incorrect Rejection*: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.

(ii) *Risk of Incorrect Acceptance*: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially misstated, in fact it is materially misstated.

13. The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

14. Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Tolerable Error

15. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable error, the greater the sample size will need to be.

16. In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected Error

17. If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified

when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity's procedures, and evidence available from other procedures.

Selection of the Sample

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

19. While there are a number of selection methods, three methods commonly used are:

- *Random selection*, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.
- *Systematic selection*, which involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that the auditor would have selected all, or none, of the sales of that particular branch.
- *Haphazard selection*, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

Evaluation of Sample Results

20. **Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:**

(a) analyse any errors detected in the sample;

(b) project the errors found in the sample to the population; and

(c) reassess the sampling risk.

Analysis of Errors in the Sample

21. In analysing the errors detected in the sample, the auditor will first need to determine that an item in question is in fact an error. In designing the sample, the auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be inappropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

22. When the expected audit evidence regarding a specific sample item cannot be obtained, the auditor may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive account receivable confirmation has been requested and no reply was received, the auditor may be able to obtain sufficient appropriate audit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the auditor does not, or is unable to, perform satisfactory alternative procedures, or if the procedures performed do not enable the auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

23. The auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

24. In analysing the errors discovered, 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 which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The auditor would then perform a separate analysis based on the items examined for each sub-population.

Projection of Errors

25. The auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into sub-population, the projection of errors is done separately for each sub-population and the results are combined.

Reassessing Sampling Risk

26. The auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative audit procedures.

Effective Date

27. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1998.

APPENDIX 1

Examples of Factors Influencing Sample Size for Tests of Control

	Conditions leading to	
Factor	**Smaller Sample Size**	**Larger Sample Size**
Assessment of control risk	Higher preliminary assessment of control risk	Lower preliminary assessment of control risk
Tolerable error	Higher acceptable rate of deviation	Lower acceptable rate of deviation
Allowable risk of over reliance	Higher risk of over reliance	Lower risk of over reliance
Expected error	Lower expected rate of deviation in population	Higher expected rate of deviation in population*
Number of items in population	Virtually no effect on sample size unless population is small	

*High expected deviation rates ordinarily warrant little, if any, reduction of control risk and, therefore, tests of controls might be omitted.

APPENDIX 2

Examples of Factors Influencing Sample Size for Substantive Procedures

	Conditions Leading to	
Factor	**Smaller Sample Size**	***Larger Sample Size***
Assessment of control risk	Lower control risk	Higher Control risk
Reduction in detection risk because of other substantive tests related to the same financial statement assertions	Greater use of other substantive tests	Reduced use of other substantive tests
Tolerable error	Large measure of tolerable error	Smaller measure of tolerable error
Expected error	Smaller errors or lower frequency	Larger errors or higher frequency
Population value	Smaller monetary significance to the financial statements	Larger monetary significance to the financial statements
Number of items in population	Virtually no effect on sample size unless population is small	
Acceptable level of detection risk	Higher acceptable level of detection risk	Lower acceptable level of detection risk
Stratification	Stratification of the population, if appropriate	No stratification of the population

AAS 16

[New Number of the Standard SA 570]

GOING CONCERN

The following is the text of Auditing and Assurance Standard (AAS) 16[*] ***(SA 570),*** *"Going Concern", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

2. **When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.**

3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.

4. An entity's continuance as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of 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 entity may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statements may need to be adjusted.

Appropriateness of the Going Concern Assumption

5. **The auditor should consider the risk that the going concern assumption may no longer be appropriate.**

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[*] Issued in October, 1998.

6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

Financial Indications

- Negative net worth or negative working capital.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Adverse key financial ratios.
- Substantial operating losses.
- Substantial negative cash flows from operations.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Difficulty in complying 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.
- Entering into a scheme of arrangement with creditors for reduction of liability.

Operating Indications

- Loss of key management without replacement.
- Loss of a major market, franchise, licence, or principal supplier.
- Labour difficulties or shortages of important supplies.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met.
- Changes in legislation or government policy.
- Sickness of the entity under any statutory definition.

7. The significance of such indications can often be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, obtaining additional capital or having funding arrangements backed by government. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Audit Evidence

8. **When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future.**

9. During the course of the audit, the auditor carries out audit procedures designed to obtain audit evidence as the basis for the expression of an opinion on the financial statements. When a question arises regarding the going concern assumption, certain of these procedures may take on additional significance or it may be necessary to perform additional procedures or to update information obtained earlier. Procedures that are relevant in this connection may include:

- Analyse and discuss cash flow, profit and other relevant forecasts with management.
- Review events after the balance sheet date for items affecting the entity's ability to continue as a going concern.
- Analyse and discuss the entity's latest available interim financial statements.
- Review the terms of debentures and loan agreements and determine whether any have been breached.
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- Review the status of matters under litigation and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Consider the entity's position concerning unfilled customer orders.

10. When analysing cash flow, profit and other relevant forecasts, the auditor would consider the reliability of the entity's system for generating such information. The auditor would also consider whether the assumptions underlying the forecast appear appropriate in the circumstances. In addition, the auditor would compare the prospective data for recent prior periods with historical results, and would compare the prospective data for the current period with results achieved to date.

11. The auditor would also consider and discuss with management its plans for future action, such as plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditure, or increase capital. The relevance of such plans to an auditor generally decreases as the time period for planned actions and anticipated events increases. Particular emphasis is ordinarily placed on plans that might have a significant effect on the entity's solvency within the foreseeable future. The auditor would obtain sufficient appropriate audit evidence that these plans are feasible, are likely to be implemented and that the outcome of these plans will improve the situation. The auditor would ordinarily seek written representations from management regarding these plans.

Audit Conclusions and Reporting

12. After the procedures considered necessary have been carried out, all the information required has been obtained, and the effect of any plans of management and other mitigating factors have been considered, the auditor would decide whether the question raised regarding the going concern assumption has been satisfactorily resolved.

Going Concern Assumption Considered Appropriate

13. If, in the auditor's judgement, sufficient appropriate audit evidence has been obtained to support the going concern assumption, the auditor would not qualify his report on this account.

14. If, in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular management's plans for future action, the auditor should consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed, but have not been adequately disclosed, the auditor should express a qualified or adverse opinion, as appropriate.

Going Concern Question not Resolved

15. If, in the auditor's judgement, the going concern question is not satisfactorily resolved, the auditor would consider whether the financial statements:

(a) adequately describe the principal conditions that raise substantial doubt about the entity's ability to continue in operation for the foreseeable future;

(b) state that there is significant uncertainty that the entity will be able to continue as a going concern and, therefore, may be unable to realise its assets and discharge its liabilities in the normal course of business; and

(c) 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 if the entity is unable to continue as a going concern.

Provided the disclosure is considered adequate, the auditor would not express a qualified or adverse opinion.

16. **If adequate disclosure is made in the financial statements, the auditor should ordinarily express an unqualified opinion. However, he should, in his report, add a paragraph that highlights the going concern problem by drawing attention to the note in the financial statements that discloses the matters set out in paragraph 15.** The following is an example of such a paragraph:

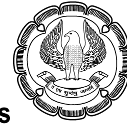
"We draw attention to Note X in the financial statements. The Company incurred a net loss of Rs. XXX during the year ended March 31, 19X1 and, as of that date, the Company's current liabilities exceeded its current assets by Rs. XXX and its total liabilities exceeded its total assets by Rs. XXX. These factors, along with other matters as set forth in Note X, raise substantial doubt that the Company will be able to continue as a going concern."

The auditor is not precluded from expressing a disclaimer of opinion for a going concern uncertainty.

17. **If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate.** The following is an example of the explanation and opinion paragraphs when a qualified opinion is to be expressed:

"The Company has been unable to renegotiate its borrowings from its bankers. Without such financial support there is substantial doubt that it will be able to continue as a going concern. Consequently, adjustments may be required to the recorded asset amounts and classification of liabilities. The financial statements (and notes thereto) do not disclose this fact.

In our opinion, subject to the omission of the information dealt with in the preceding paragraph, the financial statements give a true and fair view of the financial position of the Company at March 31, 19X1 and the results of its operations for the year then ended."



Going Concern Assumption Considered Inappropriate

18. If, on the basis of the additional procedures carried out and the information obtained, including the effect of mitigating circumstances, the auditor's judgment is that the entity will not be able to continue in operation for the foreseeable future, the auditor would conclude that the going concern assumption used in the preparation of the financial statements is inappropriate. **If the result of the inappropriate assumption used in the preparation of the financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.**

Effective Date

19. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1999.

AAS 17

[New Number of the Standard SA 220]

QUALITY CONTROL FOR AUDIT WORK

The following is the text of Auditing and Assurance Standard (AAS) 17[*] ***(SA 220),*** *"Quality Control for Audit Work", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs. From the date this Auditing and Assurance Standard becomes effective, the Guidance Note on Control of the Quality of Audit Work issued by the Institute shall stand withdrawn.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the quality control:

   (a) policies and procedures of an audit firm regarding audit work generally; and

   (b) procedures regarding the work delegated to assistants on an individual audit.

2. **Quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits.**

3. In this SA, the following terms have the meaning attributed below:

   (a) "the auditor" means the person with final responsibility for the audit;

   (b) "audit firm" means either the partners of a firm providing audit services or a sole practitioner providing audit services, as appropriate;

   (c) "personnel" means all partners and professional staff engaged in the audit practice of the firm; and

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[*] Issued in July, 1999.

(d) "assistants" means personnel involved in an individual audit other than the auditor.

Audit Firm

4. **The audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with Auditing and Assurance Standards (SAs).**

5. Compliance with Auditing and Assurance Standards (SAs) is essential whenever an audit is carried out and requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. An audit firm needs to implement appropriate quality control policies and procedures to ensure that all audits are carried out in accordance with Auditing and Assurance Standards (SAs).

6. The objectives of the quality control policies to be adopted by an audit firm will ordinarily incorporate the following:

(a) ***Professional Requirements:*** Personnel in the firm are to adhere to the principles of Independence, Integrity, Objectivity, Confidentiality and Professional Behavior.

(b) ***Skills and Competence[20]:*** The firm is to be staffed by personnel who have attained and maintain the Technical Standards and Professional Competence required to enable them to fulfil their responsibilities with Due Care.

(c) ***Assignment:*** Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

(d) ***Delegation:*** There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

(e) ***Consultation:*** Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.

(f) ***Acceptance and Retention of Clients:*** An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.

(g) ***Monitoring:*** The continued adequacy and operational effectiveness of quality

[20]Refer to AAS 1, `Basic Principles Governing an Audit'.

control policies and procedures is to be monitored.

7. **The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.**

Individual Audits

8. **The auditor should implement those quality control procedures which are, in the context of the policies and procedures of the firm, appropriate to the individual audit.**

9. The auditor, and assistants with supervisory responsibilities, will consider the professional competence of assistants performing work delegated to them when deciding the extent of direction, supervision and review appropriate for each assistant.

10. Any delegation of work to assistants would be in a manner that provides reasonable assurance that such work will be performed with due care by persons having the degree of professional competence required in the circumstances.

Direction

11. Assistants to whom work is delegated need appropriate direction. Direction involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. It also involves informing them of matters, such as the nature of the entity's business and possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved.

12. The audit programme is an important tool for the communication of audit directions. Time budgets and the overall audit plan are also helpful in communicating audit directions.

Supervision

13. Supervision is closely related to both direction and review and may involve elements of both.

14. Personnel carrying out supervisory responsibilities perform the following functions during the audit:

(a) monitor the progress of the audit to consider whether:

   (i) assistants have the necessary skills and competence to carry out their assigned tasks;

   (ii) assistants understand the audit directions; and

   (iii) the work is being carried out in accordance with the overall audit plan and the audit programme;

(b) become informed of and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit plan and the audit programme as appropriate; and

(c) resolve any differences of professional judgement between personnel and consider the level of consultation that is appropriate.

Review

15. The work performed by each assistant needs to be reviewed by personnel of at least equal competence to consider whether:

(a) the work has been performed in accordance with the audit programme;

(b) the work performed and the results obtained have been adequately documented;

(c) all significant audit matters have been resolved or are reflected in audit conclusions;

(d) the objectives of the audit procedures have been achieved; and

(e) the conclusions expressed are consistent with the results of the work performed and support the audit opinion.

16. The following need to be reviewed on a timely basis:

(a) overall audit plan and the audit programme;

(b) assessments of inherent and control risks, including the results of tests of control and the modifications, if any, made to the overall audit plan and the audit programme as a result of tests of control;

(c) documentation of the audit evidence obtained from substantive procedures and the conclusions drawn therefrom, including the results of consultations; and

(d) financial statements, proposed adjustments in financial statements arising out of the auditor's examination, and the auditor's proposed observations/report.

17. The process of reviewing an audit may include, particularly in the case of large complex audits, requesting personnel not otherwise involved in the audit to perform certain additional procedures before issuing the auditor's report.

Effective Date

18. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1999.

AAS 18

[New Number of the Standard SA 540]

AUDIT OF ACCOUNTING ESTIMATES

*The following is the text of Auditing and Assurance Standard (AAS) 18[*] **(SA 540)**, "Audit of Accounting Estimates", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the audit of accounting estimates contained in financial statements. This SA is not intended to be applicable to the examination of prospective financial information[21]

2. The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.

3. "Accounting estimate" means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:

- Allowances to reduce inventory and accounts receivable to their estimated realisable value.
- Provisions to allocate the cost of fixed assets over their estimated useful lives.
- Accrued revenue.
- Provision for taxation.
- Provision for a loss from a lawsuit.

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[*] Issued in April, 2000.

[21] In this regard, it may be noted that the Institute of Chartered Accountants of India has issued an Auditing and Assuance Standard (AAS) 35, "The Examination of Prospective Financial Information.

- Insurer's liability for outstanding claims.
- Losses on construction contracts in progress.
- Amortisation of certain items like goodwill and deferred revenue expenditure.
- Provision to meet warranty claims.
- Provision for retirement benefits in the financial statements of employers.

4. Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgement. As a result, the risk of material misstatement is greater when accounting estimates are involved.

Nature of Accounting Estimates

5. The determination of an accounting estimate may be simple or complex, depending upon the nature of the item. For example, accruing a charge for rent may be a simple calculation, whereas estimating a provision for slow-moving or surplus inventory may involve considerable analysis of current data and a forecast of future sales. In complex estimates, a high degree of special knowledge and judgment may be required.

6. Accounting estimates may be determined as part of the routine accounting system operating on a continuing basis, or may be non-routine, operating only at the end of the period. In many cases, accounting estimates are made by using a formula based on experience, such as the use of standard rates for depreciating each category of fixed assets or a standard percentage of sales revenue for computing a warranty provision. In such cases, the formula needs to be reviewed regularly by management, for example, by reassessing the remaining useful lives of assets or by comparing actual results with the estimate and adjusting the formula when necessary.

7. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case, the auditor needs to consider the same while expressing his opinion on the financial statements.

Audit Procedures

8. The auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and, when required, is appropriately disclosed in the financial statements. The evidence available to support an

accounting estimate will often be more difficult to obtain and less conclusive than evidence available to support other items in the financial statements.

9. An understanding of the procedures and methods, including the accounting and internal control systems, used by management in making the accounting estimates is often important for the auditor to plan the nature, timing and extent of the audit procedures.

10. The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:

(a) review and test the process used by management to develop the estimate;

(b) use an independent estimate for comparison with that prepared by management; or

(c) review subsequent events which confirm the estimate made.

Reviewing and Testing the Process Used by Management

11. The steps ordinarily involved in reviewing and testing of the process used by management are:

(a) evaluation of the data and consideration of assumptions on which the estimate is based;

(b) testing of the calculations involved in the estimate;

(c) comparison, when possible, of estimates made for prior periods with actual results of those periods; and

(d) consideration of management's approval procedures.

Evaluation of Data and Consideration of Assumptions

12. The auditor would evaluate whether the data on which the estimate is based is accurate, complete and relevant. When accounting data is used, it will need to be consistent with the data processed through the accounting system. For example, in substantiating a warranty provision, the auditor would obtain audit evidence that the data relating to products still within the warranty period, at period end, agree with the sales information within the accounting system.

13. External evidence is, usually, more reliable for the purpose of an audit than internal evidence. Accordingly, obtaining external evidence may be warranted in certain circumstances. For example, where there may be uncertainties with regard to the anticipated

future sales of products requiring provision for obsolescence of inventories, the auditor, in addition to examining internal data such as past levels of sales, orders on hand etc., may seek external evidence to corroborate the requirement for inventory obsolescence provision. Similarly, in respect of claims against the entity arising out of litigation, internal evidence may be required to be corroborated by making a reference to entity's lawyers, if so required. Internal evidence relating to provision for gratuity, pension or other terminal benefits for the staff, where funded by external agencies, may sought to be corroborated by external evidence.

14. The auditor would evaluate whether the data collected is appropriately analysed to form a reasonable basis for determining the accounting estimate. For example, the analysis of the age of accounts receivable to estimate the provision for doubtful debts and advances.

15. The assumptions used in the accounting estimate will be specific to the entity and would be based on internally generated data, while in other cases, the assumptions may be based on industry or government statistics. The auditor would evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate.

16. In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:

- ♦ Reasonable in light of actual results in prior periods.
- ♦ Consistent with those used for other accounting estimates.
- ♦ Consistent with management's plans which appear appropriate.

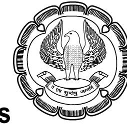
The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

17. In the case of complex estimating processes involving specialised techniques, it may be necessary for the auditor to use the work of an expert, for example, engineers for estimating quantities in stock piles of mineral ores. Requirements as to how to use the work of an expert are prescribed in SAP 9, "Using the Work of an Expert."

18. The auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates. For this purpose, the auditor's knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor would be useful.

Testing of Calculations

19. The auditor would test the calculation procedures used by management. The nature, timing and extent of the auditor's testing will depend on such factors as the complexity



involved in calculating the accounting estimate, the auditor's evaluation of the procedures and methods used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

Comparison of Previous Estimates with Actual Results

20. When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:

(a) obtaining evidence about the general reliability of the entity's estimating procedures;

(b) considering whether adjustments to estimating formulae may be required; and

(c) evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

Consideration of Management's Approval Procedures

21. Material accounting estimates are ordinarily reviewed and approved by management. The auditor would consider whether such review and approval is performed by the appropriate level of management and that it is evidenced in the documentation supporting the determination of the accounting estimate.

Use of an Independent Estimate

22. The auditor may make or obtain an independent estimate and compare it with the accounting estimate, prepared by management. When using an independent estimate, the auditor would ordinarily evaluate the data, consider the assumptions and test the calculation procedures used in its development. It may also be appropriate to compare accounting estimates so made for prior periods with actual results of those periods.

Review of Subsequent Events

23. Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and test the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

Evaluation of Results of Audit Procedures

24. The auditor should make a final assessment of the reasonableness of the estimate based on the auditor's knowledge of the business and whether the estimate is consistent with other audit evidence obtained during the audit.

25. The auditor would consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimate.

26. Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the auditor's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the auditor would determine whether such a difference requires adjustment. If the difference is reasonable, for example, because the amount in the financial statements falls within a range of acceptable results, it may not require adjustment. However, if the auditor believes the difference is unreasonable, management would be requested to revise the estimate. If management refuses to revise the estimate, the difference would be considered a misstatement and would be considered with all other misstatements in assessing whether the effect on the financial statements is material. However, the auditor would also consider whether individual differences which have been accepted as reasonable are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the auditor would evaluate the accounting estimates taken as a whole.

Effective Date

27. This Auditing and Assurance Standard becomes operative for all audits commencing on or after 1st April, 2000.

AAS 19

[New Number of the Standard SA 560]

SUBSEQUENT EVENTS

*The following is the text of Auditing and Assurance Standard (AAS) 19[*] **(SA 560)**, "Subsequent Events", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs..*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibility regarding subsequent events. In this SA, the term "subsequent events" is used to refer to significant events occurring between the balance sheet date and the date of the auditor's report. In the context of audit of a component, such as a branch or division, of an entity "subsequent events" would refer to significant events upto the date of the report of the auditor of that component of the entity.

2. The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

3. Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date", issued by the Institute of Chartered Accountants of India, deals with the treatment in financial statements of events, both favourable and unfavourable, occurring between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity. AS 4 identifies two types of events:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

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[*] Issued in April, 2000.

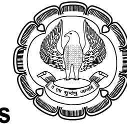
(b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Audit Procedures

4. **The auditor should perform procedures designed 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.** These procedures are in addition to routine procedures which may be applied to specified transactions occurring after the balance sheet date to obtain audit evidence as to account balances as at the balance sheet date, for example, the testing of inventory cut-off and payments to creditors. The auditor is not, however, expected to conduct a continuing review of all matters to which previously applied procedures have provided satisfactory conclusions.

5. The procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:

- Reviewing procedures that the management has established to ensure that subsequent events are identified.
- Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.
- Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
- Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.
- Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements. Examples of inquiries of management on specific matters are:
  - The current status of items that were accounted for on the basis of preliminary or inconclusive data.



- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

6. When a component, such as a division or a branch, of an entity, has already been audited by another auditor, the principal auditor would make similar enquiries as set out in para 5 in respect of events, occurring between the date of signing of the report of the auditor of the component of the entity and signing of his report.

7. When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events that the auditor believes should be accounted for, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Effective Date

8. This Auditing and Assurance Standard becomes operative for all audits commencing on or after 1st April, 2000.

AAS 20

[New Number of the Standard SA 310]

KNOWLEDGE OF THE BUSINESS

*The following is the text of the Auditing and Assurance Standard (AAS) 20[*] **(SA 310)**, "Knowledge of the Business", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Standard is to establish standards on what is knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge.

2. In performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report. Such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.

3. The auditor's level of knowledge for an engagement would include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates. The level of knowledge required by the auditor would, however, ordinarily be less than that possessed by management. A list of matters to be considered in a specific engagement is set out in the Appendix.

Obtaining the Knowledge

4. Prior to accepting an engagement, the auditor would obtain a preliminary knowledge of the industry and of the nature of ownership, management and operations of the entity to be

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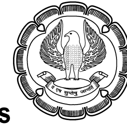
[*] Issued in April, 2000.



audited, and would consider whether a level of knowledge of the business adequate to perform the audit can be obtained.

5. Following acceptance of the engagement, further and more detailed information would be obtained. To the extent practicable, the auditor would obtain the required knowledge at the start of the engagement. As the audit progresses, that information would be assessed and updated and more information would be obtained.

6. Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit. For example, although information is gathered at the planning stage, it is ordinarily refined and added to in later stages of the audit as the auditor and the members of his audit staff learn more about the business.

7. For continuing engagements, the auditor would update and re-evaluate information gathered previously, including information in the prior year's working papers. The auditor would also perform procedures designed to identify significant changes that have taken place since the last audit.

8. The auditor can obtain knowledge of the industry and the entity from a number of sources. For example:

- ♦ Previous experience with the entity and its industry.
- ♦ Discussion with people with the entity (for example, directors and senior operating personnel).
- ♦ Discussion with internal audit personnel and review of internal audit reports.
- ♦ Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
- ♦ Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers and suppliers).
- ♦ Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers).
- ♦ Legislation and regulations that significantly affect the entity.
- ♦ Visits to the entity premises and plant facilities.

Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual, manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).

Using the Knowledge

9. Knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:

- Assessing risks and identifying problems.
- Planning and performing the audit effectively and efficiently.
- Evaluating audit evidence.
- Providing better service to the client.

10. The auditor makes judgments about many matters throughout the course of the audit where knowledge of the business is important. For example:

- Assessing inherent risk and control risk.
- Considering business risks and management's response thereto.
- Developing the overall audit plan and the audit programme.
- Determining a materiality level and assessing whether the materiality level chosen remains appropriate.
- Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions.
- Evaluating accounting estimates and management representations.
- Identifying areas where special audit consideration and skills may be necessary.
- Identifying related parties and related party transactions.
- Recognising conflicting information (for example, contradictory representations).
- Recognising unusual circumstances (for example, fraud and non-compliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results).
- Making informed inquiries and assessing the reasonableness of answers.
- Considering the appropriateness of accounting policies and financial statement disclosures.

11. The auditor should ensure that the audit staff assigned to an audit engagement obtain sufficient knowledge of the business to enable them to carry out the audit work delegated to them. The auditor would also ensure that the audit staff understand the need to be alert for additional information and the need to share that information with the auditor and other audit staff.

12. To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

Effective Date

13. This Auditing and Assurance Standard becomes operative for all audits commencing on or after 1st April, 2000.

APPENDIX

Knowledge of the Business - Matters to Consider

This list covers a broad range of matters applicable to many engagements; however, not all matters will be relevant to every engagement and the listing is only illustrative.

A. General Economic Factors

General level of economic activity (for example, recession, growth)

- Interest rates and availability of finance
- Inflation, currency revaluation
- Government policies :-
  - monetary
  - fiscal
  - taxation-corporate and other
  - financial incentives (for example, government grants and subsidies)
  - tariffs, trade restrictions
- Foreign currency rates and controls

B. The Industry - Important Conditions Affecting the Client's Business

- The market and competition
- Cyclical or seasonal activity
- Changes in product technology
- Business risk (for example, high technology, high fashion, ease of entry for competition)
- Declining or expanding operations
- Adverse conditions (for example, declining demand, excess capacity, serious price competition)
- Key ratios and operating statistics
- Specific accounting practices and problems
- Environmental requirements and problems
- Legislation and Regulatory framework
- Energy supply and cost
- Specific or unique practices (for example, relating to labour contracts, financing methods, accounting methods)

C. The Entity

1. Management and ownership - important characteristics

- Structure of entity (corporate and non-corporate) - private, public, government (including any recent or planned changes)
- Beneficial owners and related parties (local, foreign, business reputation and experience)
- Capital structure (including any recent or planned changes)
- Organizational structure
- Management objectives, philosophy, strategic plans
- Business restructuring - Acquisitions, mergers or disposals of business activities (planned or recently executed)
- Sources and methods of financing (current, historical)
- Board of directors - Corporate form

- composition
- business reputation and experience of individuals
- independence from and control over operating management
- frequency of meetings
- existence of audit committee and scope of its activities
- existence of policy on corporate conduct

♦ Members of the Managing Committee (by whatever name called) - non-corporate entities

- composition and election of members
- business reputation and experience of individuals
- independence from and control over operating management
- frequency of meetings
- existence of policy on conduct of business by the enterprise

♦ Operating Management

- experience and reputation
- turnover
- key financial personnel and their status in the organization
- staffing of accounting department
- incentive or bonus plans as part of remuneration (for example, based on profit)
- use of forecasts and budgets
- pressures on management (for example, over-extended dominance by one individual, unreasonable deadlines for announcing results)
- management information systems

♦ Internal audit function (existence, quality)

♦ Attitude to internal control environment

2. The entity's business - products, markets, suppliers, expenses, operations.

- Nature of business(es) (for example, manufacturer, wholesaler, financial services, import/export)
- Location of production facilities, warehouses, offices
- Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation)
- Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
- Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time")
- Inventories (for example, locations, quantities)
- Franchises, licenses, patents
- Important expense categories
- Research and development
- Foreign currency assets, liabilities and transactions - by currency hedging
- Legislation and regulation that significantly affect the entity
- Information systems - current, plans to change

3. Financial performance - factors concerning the entity's financial condition and profitability

- Key ratios and operating statistics
- Trends
- Debt structure, including covenants and restrictions

4. Reporting environment - external influences which affect management in the preparation of the financial statements

5. Legislation

- Regulatory environment and requirements
- Taxation, both direct and indirect
- Measurement and disclosure issues peculiar to the business
- Audit reporting requirements

Users of the financial statements

AAS 21

[New Number of the Standard SA 250]

CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

The following is the text of the Auditing and Assurance Standard (AAS) 21[*] ***(SA 250),*** *"Consideration of Laws and Regulations in an Audit of Financial Statements", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibility regarding consideration of laws and regulations in an audit of financial statements.

2. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that non-compliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations. Detection of non-compliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

3. The term "non-compliance" as used in this SA refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. For the purpose of this SA,

[*] Issued in July, 2001.

non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by the entity's management or employees.

4. Whether an act constitutes non-compliance is a legal determination that is ordinarily beyond the auditor's professional competence. The auditor's training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor's attention may constitute non-compliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute non-compliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.

5. Laws and regulations vary considerably in their relation to the financial statements. Some laws or regulations determine the form or content of an entity's financial statements or the amounts to be recorded or disclosures to be made in financial statements. Other laws or regulations are to be complied with by management or prescribe the provisions under which the entity is allowed to conduct its business. Some entities operate in heavily regulated industries (such as banks, sugar and pharmaceuticals industries). Others are only subject to the many laws and regulations that generally relate to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations could result in financial consequences for the entity such as fines, litigation, etc. Generally, the further removed non-compliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of it or to recognize its possible non-compliance.

6. This SA applies to audits of financial statements and does not apply to other engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

7. The auditor's responsibility to consider fraud and errors in an audit of financial statements is provided in AAS 4 **(SA 240),** "Fraud and Error"[22].

Responsibility of Management for the Compliance with Laws and Regulations

8. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of non-compliance rests with management.

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[22] The original AAS 4, "Fraud and Error" which was issued in June, 1987 has been revised in January, 2003. The revised AAS 4 is titled "The Auditor's Responsibility to consider Fraud and Error in an Audit of Financial Statements".

9. The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a Code of Conduct[23].
- Ensuring employees are properly trained and understand the Code of Conduct.
- Monitoring compliance with the Code of Conduct and acting appropriately to discipline employees who fail to comply with it.
- Establishing a legal department and/or engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws with which the entity has to comply within its particular industry and a record of complaints in respect of non-compliance.
- In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to:
    - An internal audit function
    - An audit committee

The Auditor's Consideration of Compliance with Laws and Regulations

10. The auditor is not, and cannot be held responsible for preventing non-compliance. The fact that an audit is carried out may, however, act as a deterrent.

11. An audit is subject to the unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with SAs and other generally accepted audit procedures. This risk is higher with regard to material misstatements resulting from non-compliance with laws and regulations due to factors such as:

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[23] Code of Conduct in this context means a document containing standard instructions to be following by employees for ensuring compliance with laws and regulations.

- Existence of laws and regulations, relating to the operating aspects of the entity, that do not have a material effect on the financial statements and are not captured by the accounting and internal control systems.
- The inherent limitations of the accounting and internal control systems and the testing procedures.
- Persuasive rather than conclusive nature of audit evidence, in general.
    - Deliberate designs, such as collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentations being made to the auditor, to conceal non-compliance.

12. The auditor should plan and perform the audit recognizing that the audit may reveal conditions or events that would lead to questioning whether an entity is complying with laws and regulations.

13. In accordance with specific statutory requirements, the auditor may be specifically required to report as part of the audit of the financial statements whether the entity complies with certain provisions of laws or regulations. In these circumstances, the auditor would plan to test for compliance with these provisions of the laws and regulations.

14. In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

15. In obtaining this general understanding, the auditor would particularly recognize that non-compliance of some laws and regulations may have a fundamental effect on the operations of the entity and may even cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, a Non-Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard.

16. To obtain the general understanding of laws and regulations, the auditor would ordinarily:

- Use the existing knowledge of the entity's industry and business.
- Inquire of management as to the laws or regulations that may be expected to have a fundamental effect on the operations of the entity.
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations.

- Discuss with management the policies or procedures adopted for identifying, evaluating and accounting for litigation claims and assessments.

17. After obtaining the general understanding, the auditor should perform procedures to identify instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements, specifically:

- **Inquiring of management as to whether the entity is in compliance with such laws and regulations.**
- **Inspecting correspondence with the relevant licensing or regulatory authorities.**

18. Further, the auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognised by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

19. Such laws and regulations would be well established and known to the entity and within the industry; they would be considered on a recurring basis each time financial statements are issued. These laws and regulations may relate, for example, to the form and content of financial statements, including industry specific requirements or the accrual or recognition of expenses for retirement benefits, etc.

20. Other than as described in paragraphs 17, 18 and 19, the auditor need not test or perform other procedures on the entity's compliance with laws and regulations since this would be outside the scope of an audit of financial statements.

21. The auditor should be conscious that procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible non-compliance with laws and regulations to the auditor's attention. For example, such procedures include reading minutes; inquiring of the entity's management and legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of transactions or balances.

22. The auditor should obtain written representations that management has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects should be considered when preparing financial statements.

23. In the absence of evidence to the contrary, the auditor is entitled to assume the entity is in compliance with these laws and regulations.

Procedures when Non-compliance is Discovered

24. The Appendix to this SA sets out examples of the type of information that might come to the auditor's attention that may indicate non-compliance.

25. When the auditor becomes aware of information concerning a possible instance of non-compliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.

26. When evaluating the possible effect on the financial statements, the auditor considers:

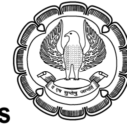
- The potential financial consequences, such as fines, penalties, damages, litigation, threat of expropriation of assets and enforced discontinuation of operations, including violation of the going concern assumption.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the true and fair view given by the financial statements.

27. When the auditor believes there may be non-compliance, the auditor should document the findings and discuss them with management. Documentation of findings would include copies of records and documents and making minutes of conversations, if appropriate.

28. If management does not provide satisfactory information that it is in fact in compliance, the auditor would consult with the entity's lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's lawyer or when the auditor is not satisfied with the opinion, the auditor would consider consulting some other lawyer as to whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, the auditor would take.

29. When adequate information about the suspected non-compliance cannot be obtained, the auditor should consider the effect of the lack of audit evidence on the auditor's report.

30. The auditor should consider the implications of non-compliance in relation to other aspects of the audit, particularly the reliability of management representations. In this regard, the auditor reconsiders the risk assessment and the validity of management representations, in case of non-compliance not detected by internal controls or not included in



management representations. The implications of particular instances of non-compliance discovered by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control procedures and the level of management or employees involved.

Communication/Reporting of Non-compliance

To Management

31. The auditor should, as soon as practicable, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding non-compliance that comes to the auditor's attention. However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.

32. If in the auditor's judgement, the non-compliance is believed to be intentional and/or material, the auditor should communicate the finding without delay.

33. If the auditor suspects that members of senior management, including members of the board of directors, are involved in non-compliance, the auditor should communicate the matter to the next higher level of authority at the entity, such as an audit committee or board of directors. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor may consider seeking legal advice.

To the Users of the Auditor's Report on the Financial Statements

34. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.

35. If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.

36. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.

To Regulatory and Enforcement Authorities

37. The auditor's duty of confidentiality would ordinarily preclude reporting non-compliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by

statute, law or by courts of law (for example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India).

Withdrawal from the Engagement

38. The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements. Factors that would affect the auditor's conclusion include the implications of the involvement of the highest authority within the entity which may affect the reliability of management representations, and the effects on the auditor of continuing association with the entity. In appropriate circumstances, the auditor may consider seeking legal advice.

39. An outgoing auditor, on receiving communication from the incoming auditor, should send a reply to him as soon as possible, setting out in detail the reasons, which according to him had given rise to the attendant circumstances but without disclosing any information as regards the affairs of the client which he is not competent to do. However, with the permission of the client he may disclose information regarding affairs of the client to the incoming auditor.

Effective Date

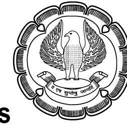
40. This Auditing and Assurance Standard becomes operative for all audits commencing on or after 1st July, 2001.

APPENDIX

Indications That Non-compliance May Have Occurred

Examples of the type of information that may come to the auditor's attention that may indicate that non-compliance with laws or regulations has occurred are listed below:

- Investigation by government departments or payment of fines, additional taxes or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commission or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.



- Purchases at prices significantly above or below market price.
- Unusual payments in cash and other unusual transactions.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Media comment.

AAS 22

[New Number of the Standard SA 510]

INITIAL ENGAGEMENTS - OPENING BALANCES

*The following is the text of the Auditing and Assurance Standard (AAS) 22[*] **(SA 510),** "Initial Engagements - Opening Balances", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. This Statement would also be considered by the auditor so that he may become aware of contingencies and commitments existing at the beginning of the current period.

2. "Opening balances" means those account balances which exist at the beginning of the period. Opening balances are the closing balances of the preceding period brought forward to the current period and reflect the effect of:

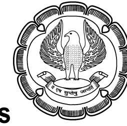
(a) transactions and other events of the preceding periods; and

(b) accounting policies applied in the preceding period.

3. For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) the closing balances of the preceding period have been correctly brought forward to the current period;

[*] Issued in July, 2001.



(b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(c) appropriate accounting policies are consistently applied.

4. In an initial audit engagement, the auditor will not have previously obtained audit evidence supporting the opening balances.

Audit Procedures

5. For the purpose of this Statement, the sufficiency and appropriateness of the audit evidence, the auditor will need to obtain regarding opening balances, would depend on the following matters:

- The accounting policies followed by the entity.
- Whether the auditor's report contained an unqualified opinion, a qualified opinion, adverse opinion or disclaimer of opinion where the financial statements for the preceding period were audited.
- The nature of the opening balances, including the risk of their misstatement in the financial statements for the current period.
- The materiality of the opening balances relative to the financial statements for the current period.

6. The auditor will need to consider whether the accounting policies followed in the preceding period, as per which the opening balances have been arrived at, were appropriate and that those policies are consistently applied in the financial statements for the current period and where such accounting policies are inappropriate, the same have been changed in the current period and adequately disclosed.

7. When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

8. When the financial statements of the preceding period were not audited or the auditor is not satisfied by using the procedures described in paragraph 7, the auditor will need to perform other procedures such as those discussed in paragraphs 9 and 10.

9. For current assets and liabilities, some audit evidence can ordinarily be obtained as part of the audit procedures performed during the current period. For example, the collection/payment of opening accounts receivable/ accounts payable during the current period will provide some audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

10. For other assets and liabilities, such as fixed assets, investments and long-term debt, the auditor will ordinarily examine the records underlying the opening balances. In certain cases, the auditor may be able to obtain confirmation of opening balances from third parties, for example, for long-term debt and investments.

Audit Conclusions and Reporting

11. If, after performing procedures including those set out above, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor should, as appropriate, express:

(a) a qualified opinion, or

(b) a disclaimer of opinion.

The auditor may also express an opinion which is qualified or disclaimed regarding the profit or loss and unqualified regarding state of affairs, as appropriate.

12. If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Effective Date

13. This Auditing and Assurance Standard becomes operative for all audits commencing on or after 1st July, 2001.

AAS 23

[New Number of the Standard SA 550]

RELATED PARTIES

*The following is the text of the Auditing and Assurance Standard (AAS) 23[*] **(SA 550),** "Related Parties" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties.

2. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements.** However, an audit cannot be expected to detect all related party transactions.

3.In certain circumstances there are limitations that may affect the persuasiveness of evidence available to the auditor to draw conclusions on particular financial statement assertions. Because of the degree of uncertainty associated with the financial statement assertions regarding the completeness of information of related parties, the procedures identified in this SA will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:

(a) increases the risk of misstatement beyond that which would ordinarily be expected; or

(b) indicates that a material misstatement regarding related parties has occurred.

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[*] Issued in September, 2001.

Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional procedures as are appropriate in the circumstances.

4. Definitions regarding related parties are given in Accounting Standard (AS) 18, "Related Party Disclosures" and are adopted for the purposes of this SA.[24]

5. Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility requires management to implement adequate accounting and internal control systems to ensure that transactions with related parties are appropriately identified in the accounting records and disclosed in the financial statements.

6. The auditor needs to have a level of knowledge of the entity's business and industry that will enable identification of the events, transactions and practices that may have a material effect on the financial statements. While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:

(a) the financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as those required by AS 18;

(b) the existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws which require special consideration when related parties exist;

(c) the source of audit evidence affects the auditor's assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from unrelated third parties; and

(d) a related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

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[24] Definitions of *"Related Party"* and *"Related Party Transactions"* from Accounting Standard (AS) 18 "Related Party Disclosures" are:

Related Party – parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Related Party Transactions – a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Existence and Disclosure of Related Parties

7. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

(a) review his working papers for the prior years for names of known related parties;

(b) review the entity's procedures for identification of related parties;

(c) inquire as to the affiliation of directors and key management personnel[25], officers with other entities;

(d) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;

(e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interests;

(f) inquire of other auditors[26] of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;

(g) review the entity's income tax returns and other information supplied to regulatory agencies; and

(h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgement, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as appropriate.

8. Where the financial reporting framework requires disclosure of related party relationships, the auditor should satisfy himself that the disclosure is adequate.

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[25] Definition of *"Key Management Personnel"* from AS 18 is:

Key Management Personnel - those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprises.

[26] The term "Other Auditors" includes internal auditor, special auditors appointed under any statute, cost auditors, and concurrent auditors.

Transactions with Related Parties

9. The auditor should review information provided by directors and key management personnel of the entity identifying related party transactions and should be alert for other material related party transactions.

10. **When obtaining an understanding of the accounting and internal control systems and making a preliminary assessment of control risk, the auditor should consider the adequacy of control procedures over the authorisation and recording of related party transactions.**

11. During the course of the audit, the auditor needs to be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include:

- Transactions which have abnormal terms of trade, such as, unusual prices, interest rates, guarantees, and repayment terms.
- Transactions which lack an apparent logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High volume or significant transactions with certain customers or suppliers as compared with others.
- Rendition of services without receipt or provision of management services at no charge.

12. During the course of the audit, the auditor carries out procedures which may identify the existence of transactions with related parties. Examples include:

- Performing detailed tests of transactions and balances.
- Reviewing minutes of meetings of shareholders and directors.
- Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognised at or near the end of the reporting period.
- Reviewing the entity's income tax returns and other information supplied to regulatory agencies.
- Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.

- Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

Examining Identified Related Party Transactions

13. In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.

14. Given the nature of related party relationships, evidence of a related party transactions may be limited, for example, regarding the existence of inventory held by a related party on consignment or an instruction from a parent company to a subsidiary to record a royalty expense. Because of the limited availability of appropriate evidence about such transactions, the auditor would consider performing procedures such as:

- Confirming the terms and amount of the transaction with the related party.
- Obtaining confirmation from persons associated with the transaction, such as, banks, lawyers, guarantors and agents.

Management Representations

15. The auditor should obtain a written representation from management concerning:

(a) the completeness of information provided regarding the identification of related parties; and

(b) the adequacy of related party disclosures in the financial statements.

16. An example of a written representation to be obtained from management is given as an Appendix to this Statement.

Audit Conclusions and Reporting

17. If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

Effective Date

18. This Auditing and Assurance Standard becomes operative for all audits related to accounting periods beginning on or after 1st April, 2001.

APPENDIX

Example of a Management Representation Letter Regarding Related Parties

(Refer Paragraph 16)

The following letter is for use as a general guide in conjunction with the considerations set forth in this Statement. Representations by management will vary from one entity to another, and from one year to the next. Therefore, this letter is not intended to be a standard letter and should be adapted in the light of individual requirements and circumstances.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of ____________ for the year ended _______. We acknowledge our responsibility for preparation of financial statements in accordance with the requirements of the Companies Act, 1956 and recognised accounting policies and practices, including the Accounting Standards issued by the Institute of Chartered Accountants of India.

We confirm the following representation in respect of related parties:

1. We have identified all the related parties and transactions with all such parties. The information provided to you is complete in all respects.
2. The disclosures made in the financial statements are adequate having regard to the framework under which the financial statements have been drawn.
3. The financial statements are free from material misstatements, including omissions with regard to related parties and transactions with related parties.

{Signature of the Authorised Person(s) of the Entity}

AAS 24

[New Number of the Standard SA 402]

AUDIT CONSIDERATIONS RELATING TO ENTITIES USING SERVICE ORGANISATIONS

The following is the text of the Auditing and Assurance Standard (AAS) 24[*] ***(SA 402)*** *on "Audit Considerations Relating to Entities Using Service Organisations" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards for an auditor whose client uses a service organisation. This SA also describes the reports of the auditors of the service organisation which may be obtained by the auditor of the client.

2. The auditor should consider how a service organisation affects the client's accounting and internal control systems so as to plan the audit and develop an effective audit approach.

3. Service organisations undertake a wide range of activities, for example, information processing, maintenance of accounting records, facilities management, maintenance of safe custody of assets such as investments, and initiation or execution of transactions on behalf of the other enterprise. Not all the activities undertaken by the service organisations are likely, by themselves, to have a significant effect on a user enterprise's financial statements. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

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[*] Issued in August, 2002.

Considerations for the Auditor of the Client

4. A service organisation may establish and execute policies and procedures that affect a client organisation's accounting and internal control systems. These policies and procedures are physically and operationally separate from the client's organisation. When the services provided by the service organisation are limited to recording and processing transactions of the client and the client retains authorisation and maintenance of accountability, the client might be able to implement effective policies and procedures within its organisation. When the service organisation executes the client's transactions and maintains accountability, the client may deem it necessary to rely on policies and procedures at the service organisation.

5. While planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client would need to consider the following, as appropriate:

- Nature of the services provided by the service organisation.
- Terms of contract and relationship between the client and the service organisation.
- The material financial statement assertions that are affected by the use of the service organisation.
- Inherent risk associated with those assertions.
- Extent to which the client's accounting and internal control systems interact with the systems at the service organisation.
- Client's internal controls that are applied to the transactions processed by the service organisation.
- Service organisation's capability and financial strength, including the possible effect of the failure of the service organisation on the client.

Information about the service organisation such as that reflected in user and technical manuals, if any.

Information available on general controls and computer systems controls relevant to the client's applications.

6. The auditor of the client would also consider the availability of third-party reports from service organisation's auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organisation and about its operation and effectiveness.

Consideration of the above may lead the auditor to decide that the control risk assessment will not be affected by controls at the service organisation; if so, further consideration of this SA is unnecessary.

7. If the auditor of the client concludes that the activities of the service organisation are significant to the entity and relevant to the audit, the auditor should obtain sufficient information to understand the accounting and internal control systems of the service organisation and to assess control risk at either the maximum, or a lower level if tests of control are performed.

8. If the information is insufficient, the auditor of the client would consider the need to request the service organisation to have its auditor perform such procedures as to supply the necessary information in the forms of reports mentioned at paragraph 12. If such reports are not made available within a reasonable time, the auditor of the client would consider the need to visit the service organisation to obtain the relevant information. An auditor of the client wishing to visit a service organisation may advise the client to request the service organisation to give the auditor of the client access to the necessary information.

9. The auditor of the client may be able to obtain an understanding of the accounting and internal control systems affected by the service organisation by reading the third-party report of the service organisation's auditor. In addition, when assessing control risk for assertions affected by the systems, controls of the service organisation, the auditor of the client may also use the service organisation auditor's report. **When the auditor of the client uses the report of a service organisation's auditor, the auditor of the client should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.**

10. The auditor of the client may conclude that it would be appropriate to obtain audit evidence from tests of control to support an assessment of control risk at a lower level.

Service Organisation Auditor's Reports

11. When using a service organisation auditor's report, the auditor of the client should consider the nature of and content of that report.

12. The report of the service organisation's auditor will ordinarily be one of two types as follows:

Type A - Report on Suitability of Design

(a) a description of the service organisation's accounting and internal control systems, ordinarily prepared by the management of the service organisation; and

(b) an opinion by the service organisation's auditor that:

  (i) the above description is accurate;

  (ii) the systems' controls have been placed in operation; and

(iii) the accounting and internal control systems are suitably designed to achieve their stated objectives.

Type B - Report on Suitability of Design and Operating Effectiveness

(a) a description of the service organisation's accounting and internal control systems, ordinarily prepared by the management of the service organisation; and

(b) an opinion by the service organisation's auditor that:

   (i) the above description is accurate;

   (ii) the systems' controls have been placed in operation;

   (iii) the accounting and internal control systems are suitably designed to achieve their stated objectives; and

   (iv) the accounting and internal control systems are operating effectively based on the results from the tests of control. In addition to the opinion on operating effectiveness, the service organisation's auditor would identify the tests of control performed and related results.

The report of the service organisation's auditor will ordinarily contain restrictions as to its use (generally to management of the service organisation and its customers, and the specified client's auditor).

13. The auditor should consider the scope of work performed by the service organisation's auditor and should assess the usefulness and appropriateness of reports issued by the service organisation's auditor.

14. While Type A reports may be useful to an auditor of the client in gaining the required understanding of the accounting and internal control systems, an auditor would not use such reports as a basis for reducing the assessment of control risk.

15. In contrast, Type B reports may provide such a basis since tests of control have been performed. When a Type B report is to be used as evidence to support a lower control risk assessment, the auditor of the client would consider whether the controls tested by the service organisation's auditor are relevant to the client's transactions (significant assertions in the client's financial statements) and whether the service organisation auditor's tests of control and the results are adequate. With respect to the latter, two key considerations are the length of the period covered by the service organisation auditor's tests and the time since the performance of those tests.

16. For those specific tests of control and results that are relevant, the auditor of the client should consider whether the nature, timing and extent of such tests provide sufficient appropriate audit evidence about the effectiveness of the accounting and

internal control systems to support the client auditor's assessed level of control risk.

17. The auditor of a service organisation may be engaged to perform substantive procedures that are of use to auditor of the client. Such engagements may involve the performance of procedures agreed upon by the client and its auditor and by the service organisation and its auditor.

18. When the auditor of the client uses a report from the auditor of a service organisation, no reference should be made in the client auditor's report to the service organisation's auditor's report.

Effective Date

19. This Auditing and Assurance Standard becomes operative for all audits related to accounting periods beginning on or after April 1, 2003.

Compatibility with International Standard on Auditing (ISA) 402

The auditing standards established in this Auditing and Assurance Standard are generally consistent in all material respects with those set out in ISA 402 "Audit Considerations Relating to Entities Using Service Organisations".

AAS 25

[New Number of the Standard SA 710]

COMPARATIVES

*The following is the text of the Auditing and Assurance Standard (AAS) 25[*] **(SA 710)**, "Comparatives", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibilities regarding comparatives. It does not deal with situations when summarized financial statements or data are presented with the audited financial statements.

2. ***The auditor should determine whether the comparatives comply, in all material respects, with the financial reporting framework relevant to the financial statements being audited.***

3. The existence of differences in financial reporting frameworks results in comparative financial information being presented differently in each framework. Comparatives in financial statements, for example, may present amounts (such as financial position, results of operations, cash flows) and appropriate disclosures of an entity for more than one period, depending on the framework. The frameworks and methods of presentation that are referred to in this SA are as follows:

(a) Corresponding Figures *where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures" for the purpose of this SA). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures; and*

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[*] Issued in September, 2002.

(b) Comparative Financial Statements *where amounts and other disclosures for the preceding period are included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.*

4. Comparatives are presented in compliance with the relevant financial reporting framework. The essential audit reporting differences are that:

(a) for corresponding figures, the auditor's report only refers to the financial statements of the current period; whereas

(b) for comparative financial statements, the auditor's report refers to each period that financial statements are presented.

5. This SA establishes standard on the auditor's responsibilities for comparatives and for reporting on them under the 'corresponding figures' framework. This SA does not establish standards on the auditor's responsibilities when the 'comparative financial statements' framework is used for presentation of comparative financial information. It is recognised that such framework for presentation of comparative financial information is not widely prevalent in India. Appendix I to this SA discusses these different reporting frameworks.

Auditor's Responsibilities

6. ***The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting framework.*** *The extent of audit procedures performed on the corresponding figures is significantly less than that for the audit of the current period figures and is ordinarily limited to ensuring that the corresponding figures have been correctly reported and are appropriately classified. This involves the auditor assessing whether:*

(a) accounting policies used for the corresponding figures are consistent with those of the current period or whether appropriate adjustments and/or disclosures have been made; and

(b) corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and/or disclosures have been made.

7. When the financial statements of the prior period have been audited by another auditor, the incoming auditor should assess whether the corresponding figures meet the conditions specified in paragraph 6 above. The auditor should also comply with the requirements of Auditing and Assurance Standard (AAS) 22 ***(SA510)****, "Initial Engagements-Opening Balances".*

8. When the financial statements of the prior period have not been audited, the incoming auditor nonetheless should assess whether the corresponding figures meet the conditions specified in paragraph 6 above. The auditor should also comply with the requirements of Auditing and Assurance Standard (AAS) 22 ***(SA 510)****, "Initial Engagements-Opening Balances".*

9. If the auditor becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, the auditor should perform such additional procedures as are appropriate in the circumstances.

Reporting

10. ***When the comparatives are presented as corresponding figures, the auditor's report should not specifically identify comparatives because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.*** *However, the auditor's report would make specific reference to the corresponding figures in the circumstances described in paragraphs 11, 12, 14(b), 15 and 16.*

11. ***When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification in the audit report[27] is:***

(a) ***unresolved, and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or***

(b) ***unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.***

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[27] *Auditing and Assurance Standard (AAS) 28,* "Auditor's Report on Financial Statements*", deals with the concept of "modified audit report". An auditor's report is considered to be modified when it includes:*

Matters that do not affect the auditor 's opinion

(a) emphasis of matter

Matters that do affect the auditor 's opinion

(a) qualified opinion,

(b) disclaimer of opinion, or

(c) adverse opinion.

Illustrative audit reports for situations discussed above are given in Appendix II to this SA.

12. When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, the auditor may include an emphasis of matter paragraph dealing with the situation.

13. In performing the audit of the current period financial statements, the auditor, in certain unusual circumstances, may become aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued.

14. ***In such circumstances, the auditor should examine that:***

(a) ***appropriate disclosures have been made; or***

(b) ***if appropriate disclosures have not been made, the auditor should issue a modified report on the current period financials modified with respect to the corresponding figures included therein.***

15. If, in the circumstances described in paragraph 13, appropriate disclosures have been made in the current period financial statements, the auditor may include an emphasis of matter paragraph describing the circumstances and referencing to the appropriate disclosures. Appropriate disclosures could be in the form of proforma comparative information being presented in the notes to the financial statements. Proforma comparative information would help the reader of the financial statements to clearly perceive the effect of misstatement on the corresponding figures.

Incoming Auditor-Additional Requirements

Prior Period Financial Statements not Audited

16. ***When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited.*** *Such a statement does not, however, relieve the auditor of the requirement to perform appropriate procedures regarding opening balances of the current period. Disclosure in the financial statements that the corresponding figures are unaudited is encouraged.*

Effective Date

17. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 2003.

Compatibility with International Standard on Auditing (ISA) 710

Comparative Financial Statements Framework

This Auditing and Assurance Standard does not establish standards on the auditor's responsibilities when the 'comparative financial statements' framework is used for presentation of comparative financial information. This is a material departure from the standards set out in ISA 710 "Comparatives". It is recognised that such framework for presentation of comparative financial information is not widely prevalent in India.

Incoming Auditor—Additional Requirements

ISA 710 requires that in situations where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should request management to revise the corresponding figures or if management refuses to do so, the auditor appropriately modifies the audit report. This requirement of ISA does not find a place in AAS 25 ***(SA 710)*** *in view of the current legal position prevailing in the Country under which the auditor is not expected to request the management to revise the corresponding figures.*

ISA 710 recognises that in some reporting frameworks the incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period. According to the ISA, when the auditor decides to refer to another auditor, the incoming auditor's report should indicate:

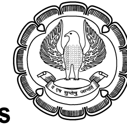
(a) that the financial statements of the prior period were audited by another auditor;

(b) the type of report issued by the predecessor auditor and, if the report was modified, the reasons therefor; and

(c) the date of that report.

In India, the incoming auditor is not permitted to refer to the predecessor auditor's report on the corresponding figures in his audit report. Therefore, this requirement of ISA has not been made part of AAS 25 ***(SA 710).***

The other auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 710 "Comparatives".



APPENDIX I

Discussion of Financial Reporting Frameworks for Comparatives

1. *Comparatives covering one or more preceding periods provide the users of financial statements with information necessary to identify trends and changes affecting an entity over a period of time.*

2. *Under financial reporting frameworks (both implicit and explicit), comparability and consistency are desirable qualities for financial information. Defined in broadest terms, comparability is the quality of having certain characteristics in common and comparison is normally a quantitative assessment of the common characteristics. Consistency is a quality of the relationship between two accounting numbers. Consistency (for example, consistency in the use of accounting principles from one period to another, the consistency of the length of the reporting period, etc.) is a prerequisite for true comparability.*

3. *There are two broad financial reporting frameworks for comparatives: the corresponding figures and the comparative financial statements.*

4. *Under the corresponding figures framework, the corresponding figures for the prior period(s) are an integral part of the current period financial statements and have to be read in conjunction with the amounts and other disclosures relating to the current period. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.*

5. *Under the comparative financial statements framework, the comparative financial statements for the prior period(s) are considered separate financial statements. Accordingly, the level of information included in those comparative financial statements (including all statement amounts, disclosures, footnotes and other explanatory statements to the extent that they continue to be of significance) approximates that of the financial statements of the current period.*

APPENDIX II

Illustrative Auditor's Report

Illustration 1.Illustrative Audit Report for the circumstances described in paragraph 11(a). (Prepared under the reporting framework of Section 227 of the Companies Act, 1956)

*Auditor's Report to the Members of ………………(*name of the Company*)*

1. *We have audited the attached Balance Sheet of……………..(*name of the Company*), as at 31st March, 20X1 and also the Profit and Loss Account for the year ended on that date annexed thereto[28]. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

2. *We conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.*

3. *As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988[29] issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure[30] a statement on the matters specified in paragraphs 4 and 5 of the said Order.*

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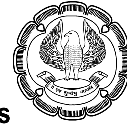
[28] Refer footnote 1 of AAS 28, "The Auditor's Report on Financial Statements".

[29] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has been replaced by the Companies (Auditor's Report) Order, 2003 by Department of Company Affairs' Notification dated June 12, 2003.

[30] Alternatively, instead of giving the comments on the Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003 issued by the Institute of Chartered Accountants of India.



4 .Further to our comments in the Annexure referred to above, we report that:

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) 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 the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with);

(iii) The Balance Sheet and Profit and Loss Account dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);

(iv) On the basis of written representations received from the directors, as on 31st March, 20X1, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 20X1 from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(v) As discussed in Note YY of Schedule ZZ to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with Accounting Standard 6 on Depreciation issued by the Institute of Chartered Accountants of India. This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the period ended 31st March 20X1 should be increased by Rs.XXXX and the loss for the previous period ended 31st March 20X0 should be increased by Rs.XXXX. The fixed assets as at 31st March 20X1 should be reduced by accumulated depreciation of Rs.XXXX and the fixed assets for the previous period ended 31st March 20X0 should be reduced by accumulated depreciation of Rs.XXXX. The accumulated loss should be increased by Rs.XXXX for the period ended 31st March 20X1 and by Rs.XXXX for the previous period ended 31st March 20X0.

(vi) Except for non-provision of depreciation referred to in the preceding paragraph, in our opinion, the Balance Sheet and Profit and Loss Account comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956.

5. In our opinion, and to the best of our information and according to the explanations given to us, except for the effect on the financial statements of non-provision of depreciation referred to in paragraph 4(vi) foregoing, the said financial statements, read together with

the other notes thereon 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 31st March 20X1, and

(b) in the case of the Profit and Loss Account, of the loss for the year ended on that date.

For ABC and Co.
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation[31])

Address:

Date:

Illustration 2 : Illustrative report for the circumstances described in paragraph 11(b). (prepared under the reporting framework of Section 227 of the Companies Act, 1956)

*Auditor's Report to the Members of ………………(*name of the Company*)*

1. *We have audited the attached Balance Sheet of……………….(*name of the Company*), as at 31st March, 20X1 and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*
2. *We conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.*

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[31] Partner or Proprietor, as the case may be.

3. *As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988[32]] issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure[33] a statement on the matters specified in paragraphs 4 and 5 of the said Order.*

4. *Further to our comments in the Annexure referred to above, we report that:*

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) 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 the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with);

(iii) The Balance Sheet and Profit and Loss Account dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);

(iv) It was not possible for us to obtain external confirmations about accounts receivable balances amounting to Rs. XXXXXX as at 31st March 20X0. Owing to the nature of company's records, we were unable to satisfy ourselves about the valuation and existence of accounts receivable and provisioning thereon. Since provisioning on accounts receivable enter into the determination of the results of operations and the balances are included in determination of state of affairs, we were unable to determine the effect of valuation and provisioning on the financial statements for the period ended 31st March 20X0. Our audit report on the financial statements for the period ended 31st March 20X0 was modified accordingly.

(v) In our opinion, the Balance Sheet and Profit and Loss Account dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

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[32] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has been replaced by the Companies (Auditor's Report) Order, 2003 by Department of Company Affairs' Notification dated June 12, 2003.

[33] Alternatively, instead of giving the comments on the Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

(vi) On the basis of written representations received from the directors, as on 31st March 20X1, and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 20X1 from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

5. In our opinion, and to the best of our information and according to the explanations given to us, except for the effect on the corresponding figures for period ended 31st March 20X0 of the adjustments, if any, to the results of operations for the ended 31st March 20X0 and to the state of affairs as on that date, which we might have determined to be necessary had we been able to obtain external confirmations about accounts receivable balances amounting to Rs. XXXXXX as at 31st March 20X0, the said financial statements, read together with the other notes thereon 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 31 March, 20X1, and

(b) in the case of the Profit and Loss Account, of the loss for the year ended on that date.

For ABC and Co.
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation[34])

Address:

Date:

[34] Partner or Proprietor, as the case may be.

AAS 26

[New Number of the Standard SA 210]

TERMS OF AUDIT ENGAGEMENT

The following is the text of the Auditing and Assurance Standard (AAS) 26[*] ***(SA 210),*** *"Terms of Audit Engagement" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

From the date this Auditing and Assurance Standard becomes effective, the Guidance Note on Audit Engagement Letters issued by the Institute shall stand withdrawn.

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on:

   (a) agreeing the terms of the engagement with the client; and

   (b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance[35].

2. **The auditor and the client should agree on the terms of the engagement.** The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

3. This SA is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The Standard is also applicable to related services.

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[*] Issued in January, 2003.

[35] Refer to Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services for the meaning of the term "assurance" and the type of engagements that provide a lower level of assurance than an audit.

When other services such as tax, accounting, or management consultancy and other services[36] are to be provided, separate letters may be appropriate.

4. Though the objective and scope of an audit and the auditor's obligations are, normally, laid down in the applicable statute or regulations and the pronouncements of the Institute of Chartered Accountants of India, the audit engagement letters would be informative for the clients.

Audit Engagement Letters

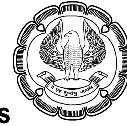
5. **In the interest of both client and auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstandings with respect to the engagement.** The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit and the extent of the auditor's responsibilities to the client.

Principal Contents

6. The form and content of audit engagement letter may vary for each client, but it would generally include reference to:

- The objective of the audit of financial statements.
- Management’s responsibility for the financial statements.
- Management's responsibility for selection and consistent application of appropriate accounting policies, including implementation of the applicable accounting standards alongwith proper explanation relating to material departures from those accounting standards.
- Management’s responsibility for preparation of the financial statements on a going concern basis.
- Management’s responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

[36] Code of Ethics issued by the Institute of Chartered Accountants of India defines the term "management consultancy and other services".



- Management's responsibility for the maintenance of adequate accounting records and internal controls for safeguarding the assets of the company and for preventing and detecting fraud or other irregularities.
- The scope of the audit, including reference to the applicable legislation, regulations, and the pronouncements of the Institute of Chartered Accountants of India.
- The fact that having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

7. The auditor may also include the following matters in the engagement letter:
   - Arrangements regarding the planning of the audit.
   - Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
   - Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.
   - Description of any other letters or reports the auditor expects to issue to the client.
   - Basis on which fees are computed and any billing arrangements.
8. When relevant, the following points could also be included in the engagement letter:
   - Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
   - Arrangements concerning the involvement of internal auditors and other staff of the client.
   - Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit, i.e., when the financial statements for the preceding period were audited by another auditor.
   - Any restriction of the auditor's liability when such possibility exists.

- A reference to any further agreements between the auditor and the client.

An example of an engagement letter for audit under a statute is set out in the Appendix.[37]

Audit of Components

9. When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include:

- Who appoints the auditor of the component.
- Whether a separate audit report is to be issued on the component.
- Legal requirements.
- The extent of any work performed by other auditors.
- Degree of ownership by parent.
- Degree of independence of the management of the component.

Recurring Audits

10. **On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.**

11. The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change of senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements or pronouncements of the Institute of Chartered Accountants of India, or changes in the existing ones.

Acceptance of a Change in Engagement

12. **An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.**

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[37] The formats of the engagement letters to be issued in case of compilation, agreed upon procedures or review are given in the AAS 31, Engagements to Compile Financial Information; AAS 32, Engagements to Perform Agreed Upon Procedures, and AAS 33, Engagements to Review Financial Statements, respectively.

13. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.

14. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting a change in the engagement. In contrast, a change would not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.

15. Before agreeing to change an audit engagement to a related service, an auditor who was engaged to perform an audit in accordance with SAs would consider, in addition to the above matters, any legal or contractual implications of the change.

16. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complies with the SAs applicable to the changed engagement, the report issued would be that appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

(a) the original engagement; or

(b) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

17. **Where the terms of the engagement are changed, the auditor and the client should agree on the new terms.**

18. **The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.** An example might be an audit engagement where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the client asks for the engagement to be changed to a review engagement to avoid a qualified, adverse or a disclaimer of opinion.

19. **If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as the board of directors or shareholders.**

Effective Date

20. This Auditing and Assurance Standard becomes operative for all audits relating to accounting periods beginning on or after 1st April, 2003.

Compatibility with International Standard on Auditing (ISA) 210

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 210 “Terms of Audit Engagements".

APPENDIX

Example of an Engagement Letter for an Audit under a Statute[38]

{The following letter is for use as a guide in conjunction with the considerations outlined in this SA and will need to be varied according to individual requirements and circumstances relevant to the engagement. This Appendix does not form part of the Standard.}

To the Board of Directors (or the appropriate representative of senior management).

You have requested that we audit the balance sheet of (Name of the Company) as at 31st March, 2XXX and the related profit and loss account and the (cash flow statement)[39] for the year ended on that date. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with the auditing standards generally accepted in India and with the requirements of the Companies Act, 1956. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also

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[38] In this illustration, the Companies Act, 1956.

[39] Only in cases where relevant.

includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

However, having regard to the test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements of financial statements, resulting from fraud, and to a lesser extent error, if either exists, may remain undetected.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which might come to our notice.

The responsibility for the preparation of financial statements on a going concern basis is that of the management. The management is also responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards. The management is also responsible for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

The responsibility of the management also includes the maintenance of adequate accounting records and internal controls for safeguarding of the assets of the company and for the preventing and detecting fraud or other irregularities. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949. The reviewer may examine our working papers during the course of the peer review.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records; documentation and other information are requested in connection with our audit.

Our fees will be billed as the work progresses.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.
Chartered Accountants
…………………………
(Signature)

Date :(Name of the Member)
Place :(Designation)[40]
Acknowledged on behalf of
ABC Company by
……………………..
(Signature)
Name and Designation
Date

[40] Partner or proprietor, as the case may be.

AAS 27

[New Number of the Standard SA 260]

COMMUNICATIONS OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

The following is the text of the Auditing and Assurance Standard (AAS) 27[*] ***(SA 260)*** *"Communications of Audit Matters with Those Charged with Governance" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on communications of audit matters arising from the audit of financial statements between the auditor and those charged with governance of an entity. These communications relate to audit matters of governance interest as defined in this SA. This SA does not provide guidance on communications by the auditor to parties outside the entity, for example, external regulatory or supervisory agencies.

2. The auditor should communicate audit matters of governance interest arising from the audit of financial statement with those charged with governance of an entity.

3. For the purpose of this SA, the term "governance" is used to describe the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance are, ordinarily, accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

4. For the purpose of this SA, "audit matters of governance interest" are those matters that arise from the audit of financial statements and are, in the opinion of the auditor, both

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[*] Issued in January, 2003

important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the attention of the auditor as a result of the performance of the audit. The auditor is not required, in an audit in accordance with auditing standards generally accepted in India[41], to design procedures for the specific purpose of identifying matters of governance interest.

Relevant Persons

5. The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are to be communicated.

6. The structure of governance may vary from entity to entity, depending upon size and legal constitution. For example, in case of companies, the Board of Directors and the committees constituted under the Board like the audit committee, ethics committee; in case of trusts, societies etc., the board of trustees or the management committee, etc.

7. The auditor uses judgement to determine those persons with whom audit matters of governance interest are communicated, taking into account, the governance structure of the entity, the circumstances of the engagement and relevant legislation, if any. The auditor also considers the legal responsibilities of those persons. The auditor also considers the importance and sensitivity of the audit matters of governance interest to be communicated. For example, in case of a company where the board of directors has established an audit committee under it, the auditor may decide to communicate with the audit committee, or with the whole board, depending on the importance of the audit matters of governance interest.

8. When the entity's governance structure is not well defined, or those charged with governance are not clearly identified by the circumstances of the engagement, or by legislation, the auditor comes to an agreement with the entity about with whom the audit matters of governance interest are to be communicated. Examples include some owner-managed entities, not for profit organisations, government agencies, etc.

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[41] Paragraph 15 of AAS 28, "*The Auditor's Report on Financial Statements*" describes auditing standards generally accepted in India.

9. To avoid misunderstandings, an audit engagement letter[42] may explain that the auditor will communicate only those matters of governance interest that come to attention as a result of the performance of an audit and that the auditor is not required to design procedures for the specific purpose of identifying matters of governance interest. The engagement letter may also:

- Describe the form in which any communication on audit matters of governance interest will be made;
- Identify the relevant persons with whom such communications will be made;
- Identify any specific audit matters of governance interest which it has been agreed are to be communicated.

10. The effectiveness of communications is enhanced by developing a constructive working relationship between the auditor and those charged with governance. This relationship is developed while maintaining an attitude of professional independence and objectivity.

Audit Matters of Governance Interest to be Communicated

11. The auditor should consider audit matters of governance interest that arise from the audit of financial statements and communicate them with those charged with governance. Such matters may include:

- The general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements;
- The selection of or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements;
- The potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements;
- Adjustments to financial statements arising out of audit that have, or could have, a significant effect on the entity's financial statements;
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- Disagreements with management about matters that, individually or in aggregate,

[42] Refer Auditing and Assurance Standard (AAS) 26, *"Terms of Audit Engagement",* issued by the Council of the Institute of Chartered Accountants of India.

could be significant to the entity's financial statements or the auditor's report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter;

- Expected modifications to the auditor's report;
- Other matters warranting attention by those charged with governance, such as material weaknesses in internal control, questions regarding management integrity, and fraud involving management;
- Any other matters agreed upon in the terms of the audit engagement.

12. As part of the auditor's communications, those charged with governance are informed that:

The auditor's communications of matters include only those audit matters of governance interest that have come to the attention of the auditor as a result of the performance of the audit;

An audit of financial statements is not designed to identify all matters that may be relevant to those charged with governance. Accordingly, the audit does not ordinarily identify all such matters.

13. **The auditor should communicate audit matters of governance interest on a timely basis.** This enables those charged with governance to take appropriate action.

14. In order to achieve timely communications, the auditor discusses with those charged with governance the basis and timing of such communications. In certain cases, because of the nature of the matter, the auditor may communicate that matter sooner than previously agreed.

Forms of Communication

15. **The auditor's communication with those charged with governance may be made orally or in writing.** The auditor's decision whether to communicate orally or in writing is affected by factors such as:

The size, operating structure, legal structure, and communications processes of the entity being audited;

The nature, sensitivity and significance of the audit matters of governance interest to be communicated;

The arrangements made with respect to periodic meetings or reporting of audit matters of governance interest;

The amount of on-going contact and dialogue the auditor has with those charged with governance.

16. **When audit matters of governance interest are communicated orally, the auditor should document in the working papers the matters communicated and any responses to those matters.** This document may take the form of minutes of the auditor's discussion with those charged with governance. In certain circumstances, depending on the nature, sensitivity, and significance of the matter, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communication on audit matters of governance interest.

17. Ordinarily, the auditor initially discusses audit matters of governance interest with management, except those matters relating to questions related to management's competence or integrity. In case of matters relating to questions related to management's competence or integrity, the auditor discusses the audit matters with those charged with governance. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.

Other Matters

18. **If the auditor considers that having regard to the facts and circumstances of the case a modification[43] of the auditor's report on financial statements is required, as described in AAS 28 (SA 700), "The Auditor's Report on Financial Statements", communications between the auditor and those charged with governance cannot be regarded as a substitute.**

19. The auditor considers whether audit matters of governance interest previously communicated may have an effect on the current year's financial statements. The auditor considers whether the point continues to be a matter of governance interest and whether to communicate the matter again with those charged with governance.

Confidentiality

20. The requirements of professional pronouncements, legislation or regulation may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest. The auditor refers to such requirements before communicating with those charged with governance. In some circumstances, the potential conflicts with the

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[43] Paragraph 31 of AAS 28, *"The Auditor's Report on Financial Statements"* deals with the concept of "modified audit report".

auditor's ethical and legal obligations of confidentiality and reporting may be complex. In these cases, the auditor may wish to consult a legal counsel.

Laws and Regulations

21. The requirements of professional pronouncements, legislation or regulation may impose obligation on the auditor to make communications on governance related matters. For example, the requirements of regulators, such as report under Section 619 (3) of the Companies Act, 1956, in case of Public Sector Undertakings and Long Form Audit Report in the case of Public Sector Banks, may impose obligation on the auditor to make communications on governance related matters. These additional communication requirements are not covered by this SA; however, they may affect the content, form and timing of communications with those charged with governance.

Effective Date

22. This Auditing and Assurance Standard is effective for all audits relating to accounting periods beginning on or after 1st April, 2003.

Compatibility with International Standard on Auditing (ISA) 260

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 260 "Communications of Audit Matters with Those Charged with Governance".

AAS 28

[New Number of the Standard SA 700]

THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

*The following is the text of the Auditing and Assurance Standard (AAS) 28[*] **(SA 700),** "The Auditor's Report on Financial Statements" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this auditing and assurance standard (SA) is to establish standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. Much of the standards laid down by this SA can be adapted to auditor's reports on financial information other than financial statements.

2. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

3. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements.

4. The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

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[*] Issued in January, 2003. From the date this AAS becomes effective, the Format of Audit Report (Revised), (published in April, 2002 issue of the 'The Chartered Accountant, p.1229) and the Announcement regarding revision of Format of Audit Report, (published in December, 2002 issue of the 'The Chartered Accountant', p.616) shall stand withdrawn.

Basic Elements of The Auditor's Report

5. The auditor's report includes the following basic elements, ordinarily, in the following layout:

(a) Title;

(b) Addressee;

(c) Opening or Introductory Paragraph

 (i) identification of the financial statements audited;

 (ii) a statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph (describing the nature of an audit)

 (i) a reference to the auditing standards generally accepted in India;

 (ii) a description of the work performed by the auditor;

(e) Opinion paragraph containing

 (i) a reference to the financial reporting framework used to prepare the financial statements; and

 (ii) an expression of opinion on the financial statements;

(f) Date of the report;

(g) Place of signature; and

(h) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur.

6. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report. in such a case, the auditor should incorporate in his audit report, the matters specified by the statute or regulator and/or report in the form prescribed by them in addition to the requirements of this SA.

Title

7. The auditor's report should have an appropriate title. It may be appropriate to use the term "Auditor's Report" in the title to distinguish the auditor's report from reports that might be

issued by others, such as by the officers of the entity, the board of directors, or from the reports of others.

Addressee

8. The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the auditor's report is addressed to the authority appointing the auditor.

Opening or Introductory Paragraph

9. The auditor's report should identify the financial statements[44] of the entity that have been audited, including the date of and period covered by the financial statements.

10. The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

11. Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. This determination will be made in the context of the financial reporting framework that management chooses, or is required to use. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

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[44] The Council of the Institute has made Accounting Standard (AS) 3, Cash Flow Statements, mandatory for certain entities in respect of accounting periods commencing on or after 1.4.2001.

Further, the Council has also decided that AS 3 should also be treated as a "specified" accounting standard for the purpose of section 211 of the Companies Act, 1956 thereby making the Cash Flow Statements a part of the Balance Sheet and Profit and Loss Account. However, irrespective of the fact that the cash flow statement is considered to be a part of the Balance Sheet and Profit and Loss Account, the opening or the introductory paragraph of the auditor's report on financial statements of such companies and other entities for which AS 3 has been made mandatory, would also identify the Cash Flow Statement as a part of the financial statements audited apart from the Balance Sheet and Profit and Loss Account. Similar reporting considerations would also apply to the entities which, though not required to comply with AS 3 in view of its not being mandatory for them, voluntarily prepare the cash flow statements.

Further, in the above mentioned cases, the auditor's report on financial statements would also contain an expression of opinion on the true and fair view of the cash flows for the period under audit (refer to Appendix for an illustrative auditor's report on the financial statements in the case of a company for which AS 3 has been made mandatory).

12. An illustration of these matters in an opening (introductory) paragraph is:

"We have audited the attached Balance Sheet of ……… (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit."

Scope Paragraph

13. **The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India.** The reader needs this as an assurance that the audit has been carried out in accordance with established standards.

14. "Scope" refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. Auditing and Assurance Standard (AAS) 2 **(SA 200A),** "Objective and Scope of the Audit of Financial Statements", with regard to the determination of the "scope" states (paragraph 5):

"The scope of an audit of financial statements will be determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute."

15. The Auditing and Assurance Standards issued by the Institute of Chartered Accountants of India establish the auditing standards generally accepted in India.

16. **The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.**

17. The auditor's report should describe the audit as including:

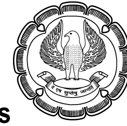
(a) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;

(b) assessing the accounting principles used in the preparation of the financial statements;

(c) assessing the significant estimates made by management in the preparation of the financial statements; and

(d) evaluating the overall financial statement presentation.

18. ***The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.***



19. An illustration of these matters in a scope paragraph is:

> *"We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion."*

Opinion Paragraph

20. ***The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements.***

21. The term used to express the auditor's opinion, "give a true and fair view", indicates, amongst other things, that the auditor considers only those matters that are material to the financial statements.

22. Paragraph 3 of Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services, issued by the Institute of Chartered Accountants of India, discusses the financial reporting framework. The paragraph reads as under:

> *"Financial Reporting Framework*
>
> *Financial statements are ordinarily prepared and presented annually and are directed towards the common information needs of a wide range of users. Many of those users rely on financial statements as their major source of information because they do not have the power to obtain additional information to meet their specific information needs. Thus, financial statements need to be prepared in accordance with one, or a combination of:*
>
> *(a) relevant statutory requirements, e.g., the Companies Act, 1956, for companies;*
>
> *(b) accounting standards issued by the Institute of Chartered Accountants of India; and*
>
> *(c) other recognised accounting principles and practices, e.g., those recommended in the Guidance Notes issued by the Institute of Chartered Accountants of India."*

23. An illustration of these matters in an opinion paragraph is:

"In our opinion and to the best of our information and according to the explanations given to us, the financial statements 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 ……….. (name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date."

24. In addition to an opinion on the true and fair view, the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statutes or law. For example, in the case of companies incorporated under the Companies Act, 1956, section 227(2) of the said Act requires that the auditor's report should state in his audit report, whether in the auditor's opinion and to the best of his information and according to the explanations given to the auditor, the financial statements give the information required by the Companies Act, 1956 in the manner so required[45]..

Date of Report

25. **The date of an auditor's report on the financial statements *is the date on which the auditor signs the report expressing an opinion on the financial statements.*** *The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date.*

26. ***Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.***

Place of Signature

27. **The report should name specific location, which is ordinarily the city where the audit report is signed.**

Auditor's Signature

28. **The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report should be signed in the personal name of the**

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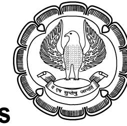
[45] Refer to Appendix for an illustration of the opinion paragraph in the case of a company incorporated under the Companies Act, 1956. Also refer footnote 1 for applicability of AS 3 to an entity and the auditor's duties and responsibilities in this regard.



auditor and in the name of the audit firm. The partner/proprietor signing the audit report should also mention the membership number assigned by the Institute of Chartered Accountants of India.

The Auditor's Report

29. **An *unqualified opinion* should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.** An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. An unqualified opinion also indicates that:

(a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

(b) the financial statements comply with relevant statutory requirements and regulations; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

30. The following is an illustration of a complete auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

"**Auditor's Report**

(Appropriate Addressee)

We have audited the attached Balance Sheet of .... *(Name of the entity)* as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto[46]. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial

[46] Refer to footnote 1.

statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India[47]:

(a) in the case of the Balance Sheet, of the state of affairs of ……….. (Name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

For ABC and Co.,
Chartered Accountants
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation)48
(Membership Number)

Place of Signature

Date

An illustration of auditor's report on the financial statements in the case of a company incorporated under the Companies Act, 1956 to which AS 3 is applicable is given in the Appendix.

Modified Reports[49]

31. An auditor's report is considered to be modified when it includes:

(a) Matters That Do Not Affect the Auditor's Opinion

emphasis of matter

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[47] *ibid.*

[48] Partner or proprietor, as the case may be.

[49] This AAS lays down the basic principles that govern the auditor's report on financial statements. The reporting requirements contained in other AASs issued by the Council of the Institute would also be applicable.

(b) Matters That Do Affect the Auditor's Opinion

qualified opinion

disclaimer of opinion

adverse opinion

Uniformity in the form and content of each type of modified report will enhance the user's understanding of such reports. accordingly, this SA includes suggested wordings to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

Matters That Do Not Affect the Auditor's Opinion

32. In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included preceding the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

33. ***The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem where the going concern question is not resolved and adequate disclosures have been made in the financial statements.***

34. ***The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements.*** *An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.*

35. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report is as follows:

"Without qualifying our opinion, we draw attention to Note X of Schedule …… to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

In our opinion ……….. (remaining words are the same as illustrated in the opinion paragraph — paragraph 30 above). *"*

(An illustration of an emphasis of matter paragraph relating to going concern is set out in AAS 16 ***(SA 570),*** *"Going Concern.")*

36. The addition of a paragraph emphasising a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

Matters that Do Affect the Auditor's Opinion

37. An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(a) there is a limitation on the scope of the auditor's work; or

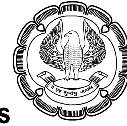
(b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed in paragraphs 42 - 47.

38. ***A*** **qualified opinion** ***should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being 'subject to' or 'except for' the effects of the matter to which the qualification relates.***

39. ***A*** **disclaimer of opinion** ***should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements.***

40. ***An*** **adverse opinion** ***should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.***



*41. **Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report.** In circumstances where it is not practicable to quantify the effect of modifications made in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.*

Circumstances That May Result in Other Than an Unqualified Opinion

Limitation on Scope

42. A limitation on the scope of the auditor's work may sometimes be imposed by the entity, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary. However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor should ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

43. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

*44. **When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.***

45. Illustrations of these matters are set out below :

Limitation on Scope — Qualified Opinion

"We have audited ……….. (remaining words are the same as illustrated in the introductory paragraph —paragraph 30 above).

Except as discussed in the following paragraph, we conducted our audit in accordance with ………. (remaining words are the same as illustrated in the scope paragraph — paragraph 30 above).

We did not observe the counting of the physical inventories as at 31st March 2XXX since that date was prior to the time we were appointed as auditors of …………(Name of the entity). *Owing to the nature of the entity's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.*

In our opinion and to the best of our information and according to the explanations given to us, subject to the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a ………… (remaining words are the same as illustrated in the opinion paragraph —paragraph 30 above)*."*

Limitation on Scope — Disclaimer of Opinion

"We were engaged to audit the attached Balance Sheet of ……….(Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for *the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. (Omit the sentence stating the responsibility of the auditor).*

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the entity.

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements. "

Disagreement with Management

46. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. ***If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.***

47. Illustrations of these matters are set out below:

Disagreement on Accounting Policies-Inappropriate Accounting Method—Qualified Opinion

"We have audited ……... (remaining words are the same as illustrated in the introductory paragraph — paragraph 30 above).

> *We conducted our audit in accordance with ……….* (remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).
>
> As stated in Note X of Schedule ……. to the financial statements, no depreciation has been provided for the period in the financial statements. This is contrary to Accounting Standard (AS) 6 on "Depreciation Accounting", issued by the Institute of Chartered Accountants of India and the accounting policy being followed by the entity according to which depreciation is provided on straight line basis. Had this accounting policy been followed, the provision for depreciation for the period would have been Rs............ This short provisioning for depreciation has resulted into the profit for the year, fixed assets and reserves and surplus being overstated by Rs……….
>
> Or
>
> As stated in Note X of Schedule …….. to the financial statements, hire purchase sales have been treated as outright sales by the entity and contrary to accepted accounting practice, the entire profit thereon has been taken into account. The profit relating to installment not due as at the date of the Balance Sheet and included in profit for the year amounted to Rs…….. This has resulted in the profit for the year, inventories and reserve and surplus being overstated by Rs ……
>
> *In our opinion and to the best of our information and according to the explanations given to us, subject to the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and ...* (remaining words are the same as illustrated in the

opinion paragraph-paragraph 30 above)."

Disagreement on Accounting Policies—Inadequate Disclosure-Qualified Opinion

"We have audited …….. (remaining words are the same as illustrated in the introductory paragraph — paragraph 30 above).

We conducted our audit in accordance with …….... (remaining words are the same as illustrated in the scope paragraph—paragraph 30 above).

On 15th January 2XXX, the ……….. (Name of the entity) *issued debentures in the amount of Rs.XXX for the purpose of financing plant expansion. The debentures agreement restricts the payment of future cash dividends to earnings after 31st March 2XXX. In our opinion, disclosure of this information is required by ....*

In our opinion and to the best of our information and according to the explanations given to us, subject to the omission of the information included in the preceding paragraph, the financial statements give a true and ………. (remaining words are the same as illustrated in the opinion paragraph, paragraph 30 above)."

Disagreement on Accounting Policies - Inadequate Disclosure - Adverse Opinion

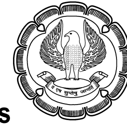
"We have audited the attached Balance Sheet of ………. (Name of the entity), *as at 31st March 2XXX, and also the Profit and Loss Account for the year ended on that date annexed thereto[50].These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

We conducted our audit in accordance with ……… (remaining *words are the same as illustrated in the scope paragraph—paragraph 30 above).*

(Paragraph(s) discussing the disagreement).

In our opinion and to the best of our information and according to the explanations given to us, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and

[50] Refer to footnote 3.



fair view in conformity with the accounting principles generally accepted in India[51]:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

Effective Date

48. This auditing and assurance standard becomes operative for all audits relating to accounting periods beginning on or after 1st april 2003. Earlier application of the SA is encouraged.

Compatibility with the International Standard on Auditing (ISA) 700

The auditing standards established in this auditing and assurance standard are generally consistent in all material respects with those set out in the international standard on auditing (ISA) 700, the auditor's report on financial statements, except the following:

(a) Due to the practices prevailing in India, the SA requires the auditor to mention the "place of signature" instead of the "auditor's address" in the auditors report.The place of signature is the name of specific location, which is ordinarily the city where the audit report is signed [see paragraph 27]. According to ISA 700, the expression "auditor's address" means the name of a specific location, which is ordinarily the city where the auditor maintains the office that has the responsibility for the audit.

(b) The SA requires the auditor to mention the membership number assigned by The Institute of Chartered Accountants of India [see paragraph 28]. ISA 700, however, does not contain any corresponding requirement.

(c) The SA requires that whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report [see paragraph 41]. ISA 700 does not require the auditor to quantify the possible effect(s) in aggregate on the financial statements.

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[51] *ibid.*

APPENDIX

Illustrative Auditor's Report on the Financial Statements in the Case of a Company Incorporated Under the Companies Act, 1956 to which AS 3 is applicable[52]

[see paragraph 30]

Auditor's Report

The Members of ………………(name of the Company)[53]

We have audited the attached Balance Sheet of ………………. (name of the company), *as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.We believe that our audit provides a reasonable basis for our opinion.

As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988[54] issued by the Central Government of India in terms of sub-section (4A) of section

[52] In case AS 3 is not applicable to a company and such company also does not voluntarily prepare the cash flow statement, the references to cash flow statement should be deleted from the entire report.

[53] Reference may also be made to the Statement on Qualifications in Auditor's Report and the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 issued by the Council of the Institute of Chartered Accountants of India.

[54] The Manufacturing and Other Companies (Auditor's Report) Order, 1988 has since been replaced by the Companies (Auditor's Report) Order, 2003 vide Department of Company Affairs' Notification dated June 12, 2003.

227 of the Companies Act, 1956, we enclose in the Annexure[55] a statement on the matters specified in paragraphs 4 and 5 of the said Order.

Further to our comments in the Annexure referred to above, we report that:

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) 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 the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with);[56]

(iii) The Balance Sheet, Profit and Loss Account and cash flow statement dealt with by this report are in agreement with the books of account (and with the audited returns from the branches);[57]

(iv) In our opinion, the Balance Sheet, Profit and Loss Account and cash flow statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

(v) On the basis of written representations received from the directors, as on 31st March 2XXX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(vi) In our opinion and to the best of our information and according to the explanations given to us, the said accounts 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[58]:

(a) in the case of the Balance Sheet, of the state of affairs of the company as at 31st March 2XXX;

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[55] Alternatively, instead of giving the comments on Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report. Members' attention in this regard is invited to the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India. It may also be noted that requirements of the Companies (Auditor's Report) Order, 2003 have not been reproduced in this illustration.

[56] Wherever applicable.

[57] *ibid*.

[58] *ibid.*

(b) in the case of the Profit and Loss Account, of the profit / loss[59] 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.

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation)[60]
Membership Number

Place of Signature
Date

[59] Whichever is applicable.
[60] Partner or Proprietor, as the case may be.

AAS 29

[New Number of the Standard SA 401]

AUDITING IN A COMPUTER INFORMATION SYSTEMS ENVIRONMENT

The following is the text of the Auditing and Assurance Standard (AAS) 29[*] **(SA 401),** *"Auditing in a Computer Information Systems Environment" issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read* in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on procedures to be followed when an audit is conducted in a computer information systems (CIS) environment. For the purposes of this SA, a CIS environment exists when one or more computer(s) of any type or size is (are) involved in the processing of financial information, including quantitative data, of significance to the audit, whether those computers are operated by the entity or by a third party.

2. The overall objective and scope of an audit does not change in a CIS environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. Accordingly, a CIS environment may affect:

- the procedures followed by the auditor in obtaining a sufficient understanding of the accounting and internal control system.
- the auditor's evaluation of inherent risk and control risk through which the auditor assesses the audit risk.

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[*] Issued in January, 2003.

- the auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

3. **The auditor should consider the effect of a CIS environment on the audit.** The auditor should evaluate, *inter alia*, the following factors to determine the effect of CIS environment on the audit:

(a) the extent to which the CIS environment is used to record, compile and analyse accounting information;

(b) the system of internal control in existence in the entity with regard to:

  (i) flow of authorised, correct and complete data to the processing center;

  (ii) processing, analysis and reporting tasks undertaken in the installation; and

(c) the impact of computer-based accounting system on the audit trail that could otherwise be expected to exist in an entirely manual system.

Skills and Competence

4. The auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the CIS environment. **The auditor should consider whether any specialised CIS skills are needed in the conduct of the audit.** Specialised skills may be needed, *inter alia*, to –

- obtain sufficient understanding of the effect of the CIS environment on accounting and internal control systems;
- determine the effect of the CIS environment on the assessment of overall audit risk and of risk at the account balance and class of transactions level; and
- design and perform appropriate tests of control and substantive procedures.

If specialised skills are needed, the auditor would seek the assistance of an expert possessing such skills, who may either be the auditor's staff or an outside professional. **If the use of such a professional is planned, the auditor should, in accordance with AAS 9 (SA 620), "Using the Work of an Expert", obtain sufficient appropriate audit evidence that the work performed by the expert is adequate for the purposes of the audit.**

Planning

5. **In accordance with the Auditing and Assurance Standard (AAS) 6 (SA 400), "Risk Assessments and Internal Control", the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and to determine**

the nature, timing and extent of the audit procedures. Such an understanding would help the auditor to develop an effective audit approach.

6. **In planning the portions of the audit which may be affected by the CIS environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of the data for use in the audit.** This understanding would include such matters as:

(a) the computer information systems infrastructure [hardware, operating system(s), etc., and application software(s) used by the entity, including changes therein since last audit if any].

(b) the significance and complexity of computerised processing in each significant accounting application. Significance relates to materiality of the financial statement assertions affected by the computerised processing. An application may be considered to be complex when, for example:

- the volume of transactions is such that users would find it difficult to identify and correct errors in processing.
- the computer automatically generates material transactions or entries directly to another application.
- the computer performs complicated computations of financial information and/or automatically generates material transactions or entries that cannot be (or are not) validated independently.
- transactions are exchanged electronically with other organisations [as in electronic data interchange (EDI) systems] without manual review for propriety or reasonableness.

(c) determination of the organisational structure of the client's CIS activities and the extent of concentration or distribution of computer processing throughout the entity, particularly, as they may affect segregation of duties.

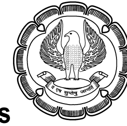
(d) determination of the availability of data. Source documents, computer files, and other evidential matter that may be required by the auditor may exist for only a short period or only in machine-readable form. Computer information systems may generate reports that might be useful in performing substantive tests (particularly analytical procedures). The potential for use of computer-assisted audit techniques may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of accounts or transactions.

7. **When the computer information systems are significant, the auditor should also obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risks.** The nature of the risks and the internal control characteristics in CIS environments include the following:

- *Lack of transaction trails:* Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
- *Uniform processing of transactions:* Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.
- *Lack of segregation of functions:* Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.
- *Potential for errors and irregularities:* The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

- *Initiation or execution of transactions:* Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.
- *Dependence of other controls over computer processing:* Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be



dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

- *Potential for increased management supervision*: Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.
- *Potential for the use of computer-assisted audit techniques*: The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Both the risks and the controls introduced as a result of these characteristics of computer information systems have a potential impact on the auditor's assessment of risk, and the nature, timing and extent of audit procedures.

8. While evaluating the reliability of the accounting and internal control systems, the auditor would consider whether these systems, *inter alia*:

(a) ensure that authorised, correct and complete data is made available for processing;

(b) provide for timely detection and correction of errors;

(c) ensure that in case of interruption in the working of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records;

(d) ensure the accuracy and completeness of output;

(e) provide adequate data security against fire and other calamities, wrong processing, frauds etc.;

(f) prevent unauthorised amendments to the programs; and

(g) provide for safe custody of source code of application software and data files.

Assessment of Risk

9. **The auditor should make an assessment of inherent and control risks for material financial statement assertions, in accordance with AAS 6 (SA 400), "Risk Assessments and Internal Control".**

10. The inherent risks and control risks in a CIS environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements, as follows:

- The risks may result from deficiencies in pervasive CIS activities such as program development and maintenance, system software support, operations, physical CIS security, and control over access to special-privilege utility programs. These deficiencies would tend to have a pervasive impact on all application systems that are processed on the computer.
- The risks may increase the potential for errors or fraudulent activities in specific applications, in specific databases or master files, or in specific processing activities. For example, errors are not uncommon in systems that perform complex logic or calculations, or that must deal with many different exception conditions. Systems that control cash disbursements or other liquid assets are susceptible to fraudulent actions by users or by CIS personnel.

11. As new CIS technologies emerge for data processing, they are frequently employed by clients to build increasingly complex computer systems that may include micro-to-mainframe links, distributed data bases, end-user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of computer information systems and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.

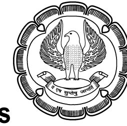
Audit Procedures

12. **In accordance with AAS 6 (SA 400), "Risk Assessments and Internal Control", the auditor should consider the CIS environment in designing audit procedures to reduce audit risk to an acceptably low level.** He should make enquiries and particularly satisfy himself whether:

(a) adequate procedures exist to ensure that the data transmitted is correct and complete; and

(b) cross-verification of records, reconciliation statements and control systems between primary and subsidiary ledgers do exist and are operative and that accuracy of computer compiled records are not assumed.

13. The auditor's specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. The auditor can use manual audit procedures, or computer-assisted audit techniques, or a combination of both to obtain sufficient evidential matter. However, in some accounting systems that use a computer for processing significant applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance.



Documentation

14. **The auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. In an audit in CIS environment, some of the audit evidence may be in the electronic form. The auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.**

Effective Date

15. This Auditing and Assurance Standard (SA) becomes operative for all audits related to accounting periods beginning on or after 1st April, 2003.

Compatibility with International Standard on Auditing (ISA) 401

The auditing standards established in this auditing and assurance standard are generally consistent in all material respects with those set out in international standard on auditing (ISA) 401 on auditing in a computer information systems environment except for the additional requirement related to "documentation" [see paragraph 14]. ISA 401 does not contain any requirement related to documentation.

AAS 30

[New Number of the Standard SA 505]

EXTERNAL CONFIRMATIONS

*The following is the text of the Auditing and Assurance Standard (AAS) 30[*] **(SA 505),** "External Confirmations", issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's use of external confirmations as a means of obtaining audit evidence.

2. **The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. The auditor should employ external confirmation procedures in consultation with the management.**

3. Auditing and Assurance Standard (AAS) 5 **(SA 500)**, "Audit Evidence" states that the reliability of audit evidence is influenced by its source and nature. It indicates that, in general, audit evidence from external sources is more reliable than audit evidence generated internally, and that written (documentary) audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related financial statement assertions to an acceptably low level.

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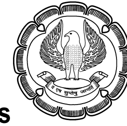
[*] Issued in August, 2003.



4. External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

5. The process of external confirmations, ordinarily, consists of the following:

- Selecting the items for which confirmations are needed.
- Designing the form of the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining response from the third party.
- Evaluating the information or absence thereof.

6. External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Stocks held by third parties.
- Property title deeds held by third parties.
- Investments purchased but delivery not taken.
- Loans from lenders.
- Accounts payable balances.
- Long outstanding share application money.

7. The reliability of the evidence obtained by external confirmations depends, among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control which the auditor exercises over confirmation requests and responses, the

characteristics of the respondents, and any restrictions included in the response or imposed by management.

Relationship of External Confirmation Procedures to the Auditor's Assessments of Inherent Risk and Control Risk

8. Auditing and Assurance Standard (AAS) 6 (Revised) **(SA 400),** "Risk Assessments and Internal Control" discusses audit risk and the relationship between its components: inherent risk, control risk, and detection risk. It outlines the process of assessing inherent and control risk to determine the nature, timing, and extent of substantive procedures to reduce detection risk, and therefore, audit risk, to an acceptable level.

9. AAS 6 (Revised) **(SA 400)** also indicates that the nature and extent of evidence to be obtained from the performance of substantive procedures varies depending on the assessment of inherent and control risks, and that the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform any substantive procedures. These substantive procedures may include the use of external confirmations for specific financial statement assertions.

10. Paragraph 48 of AAS 6 (Revised) **(SA 400)** indicates that the higher the assessment of inherent and control risk, the more audit evidence the auditor needs to obtain from the performance of substantive procedures. Consequently, as the assessed level of inherent and control risk increases, the auditor designs substantive procedures to obtain more evidence, or more persuasive evidence, about a financial statement assertion. In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.

11. The auditor should assess whether the evidence provided by the confirmations reduces audit risks for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and the auditor's assessment of the inherent and control risk. If the auditor concludes that the evidence provided by the confirmations alone is not sufficient, he should perform additional procedures.

12. The lower the assessed level of inherent and control risk, the less assurance the auditor needs from substantive procedures to form a conclusion about a financial statement assertion. For example, an entity may have a loan that it is repaying according to an agreed repayment schedule, the terms of which the auditor has confirmed in previous years. If the other work carried out by the auditor (including such tests of controls as are necessary) indicates that the terms of the loan have not changed and has lead to the level of inherent and control risk over the balance of the loan outstanding being assessed as low, the auditor might limit substantive procedures to testing details of the payments made, rather than again confirming the balance directly with the lender.

13. Unusual or complex transactions may be associated with higher levels of inherent or control risk than simple transactions. If the entity has entered into an unusual or complex transaction and the level of inherent and control risk is assessed as high, the auditor considers confirming the terms of transaction with the other parties in addition to examining documentation held by the entity.

Assertions Addressed by External Confirmations

14. AAS 5 **(SA 500)**, "Audit Evidence", categorises the assertions contained in the financial statements as existence, rights and obligations, occurrence, completeness, valuation, measurement, and presentation and disclosure. While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide evidence relevant to a particular financial statement assertion varies.

15. External confirmation of an account receivable provides strong evidence regarding the existence of the account as at a certain date. Confirmation also provides evidence regarding the operation of cut-off procedures. However, such confirmation does not ordinarily provide all the necessary audit evidence relating to the assertion regarding valuation, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

16. Similarly, in the case of goods held on consignment, external confirmation is likely to provide strong evidence to support the assertions related to existence and the rights and obligations, but might not provide evidence that supports the assertions related to valuation.

17. The relevance of external confirmations to auditing a particular financial statement assertion is also affected by the objective of the auditor in selecting information for confirmation. For example, when auditing the assertion regarding the completeness of accounts payable, the auditor also needs to obtain evidence that there is no material unrecorded liability. Accordingly, sending confirmation requests to an entity's principal suppliers, asking them to provide copies of their statements of account directly to the auditor, even if the entity's records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

18. When obtaining evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

Timing of External Confirmations

19. The auditor may request external confirmations either as at the date of the financial statements or as at any other selected date which is reasonably close to the date of financial

statements. The date may be, alternatively, settled by the auditor in consultation with the management. Where the auditor decides to request for confirmations as at date which is other than the date of the financial statements, the auditor would need to examine the movement in the concerned account(s) that occur between the date of the confirmations and the date of the financial statements. For example, when the auditor uses confirmation as at a date prior to the balance sheet to obtain evidence to support a financial statement assertion, the auditor would obtain sufficient appropriate audit evidence that transactions relevant to the assertions in the intervening period have not been materially misstated. For practical reasons, when the level of inherent and control risk is assessed at less than high, the auditor may decide to confirm balances at a date other than the period end, for example, when the audit is to be completed within a short time after the balance sheet date. As with all types of pre-year-end work, the auditor would consider the need to obtain further audit evidence relating to the remainder of the period also.

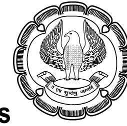
Design of the External Confirmation Request

20. The auditor should design external confirmation requests to the specific audit objective. When designing the request, the auditor considers the assertions being addressed and the factors that are likely to affect the reliability of the confirmations. Factors such as the form of the external confirmation request, prior experience on the audit or similar engagements, the nature of the information being confirmed, and the intended respondent, affect the design of the requests because these factors have a direct effect on the reliability of the evidence obtained through external confirmation procedures. The other factors which have an effect on the design of an external confirmation request include effectiveness of the internal control system of the entity, apparent possibility of disputes, inaccuracies and irregularities in the accounts, the possibility that the request will receive a consideration and the materiality of the amount involved.

Nature of Information Being Confirmed

21. In designing the request, the auditor considers the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of the evidence obtained. For example, certain respondents' accounting systems may facilitate the external confirmation of single transactions rather than of entire account balances. In addition, respondents may not always be able to confirm certain types of information, such as the overall accounts receivable balance, but may be able to confirm individual invoice amounts within the total balance.

22. The auditor's understanding of the client's arrangements and transactions with the third parties is important in determining the information to be confirmed. **The auditor should**



obtain an understanding of the substance of such transactions and arrangements to decide about the information to be included in the request for confirmation. The auditor also considers the possibility of oral modifications in the arrangements and transactions and, accordingly, requests the management to provide him the details thereof.

23. Confirmation requests ordinarily include authorization of the entity's management to the respondent to disclose the information to the auditor. Respondents may be more willing to respond to a confirmation request containing management's authorization, and in some cases may be unable to respond unless the request contains such authorization.

Prior Experience

24. **The auditor should consider the information from audits of earlier years.** This information would, normally, include the misstatements, inaccuracies or irregularities identified by the auditor or those pointed out by the third parties in the earlier years, the response rate etc.

Form of Confirmation Request—Use of Positive and Negative Confirmations

25. The auditor may use positive or negative external confirmation requests or a combination of both.

26. A positive external confirmation request asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information. The use of a positive confirmation is preferable when individual account balances are large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccurate or irregular. A response to a positive confirmation request is ordinarily expected to provide reliable audit evidence. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The auditor is not ordinarily able to detect whether this has occurred. The auditor may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.

27. A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response has been received to a negative confirmation request, the auditor remains aware that there will be no explicit evidence that intended third parties have received the confirmation requests and verified that the information contained therein is correct or that the confirmation was sent by

the respondent but not received by him. Accordingly, the use of negative confirmation requests ordinarily provides less reliable evidence than the use of positive confirmation requests, and the auditor considers performing other substantive procedures to supplement the use of negative confirmations.

28. Negative confirmation requests may be used to reduce audit risk to an acceptable level when:

(a) the assessed level of inherent and control risk is low;

(b) a large number of small balances is involved;

(c) a substantial number of errors is not expected; and

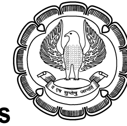
(d) the auditor has no reason to believe that respondents will disregard these requests.

29. A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

Characteristics of Respondents

30. The reliability of evidence provided by a confirmation is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual. For example, when confirming that a covenant related to an entity's long-term debt has been waived, the auditor directs the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

31. The auditor also assesses whether certain parties may not provide an objective or unbiased response to a confirmation request. Information about the respondent's competence, knowledge, motivation, ability or willingness to respond may come to the auditor's attention. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional procedures are necessary. The auditor also considers whether there is sufficient basis for concluding that the confirmation request is being sent to a respondent from whom the auditor can expect a response that will provide sufficient appropriate evidence. For example, the auditor may encounter significant unusual year-end transactions that have a material effect on the financial



statements, the transactions being with a third party that is economically dependent upon the entity. In such circumstances, the auditor considers whether the third party may be motivated to provide an inaccurate response.

The External Confirmation Process

32. **When performing confirmation procedures, the auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.** Maintaining control means maintaining direct communications between the intended recipients and the auditor to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The auditor may give a list of accounts selected for confirmation to the management for preparing requests for confirmations, which should be properly addressed and stamped, alternatively, the auditor may request the management to furnish duly authorised confirmation letters and fill in the names, addresses and other relevant details relating to the accounts selected by him. **The auditor should, however, ensure that it is the auditor who sends out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies and the undelivered confirmations are delivered directly to the auditor. The auditor considers whether replies have come from the purported senders.**

No Response to a Positive Confirmation Request

33. **The auditor should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.**

34. When using a confirmation request other than a negative confirmation request, the auditor, generally, follows up with a second and sometimes third request to those parties from whom replies have not been received or, alternatively, contact the recipient of the request to elicit a response. Where the auditor is unable to obtain a response, the auditor would need to use alternative audit procedures. The nature of alternative procedures varies according to the account and assertion in question. In the examination of accounts receivable, alternative procedures may include examination of subsequent cash receipts, examination of shipping documentation or other client documentation to provide evidence for the existence assertion, and sales cut-off tests to provide evidence for the assertion related to completeness. In the examination of accounts payable, alternative procedures may include examination of subsequent cash disbursements or correspondence from third parties to provide evidence of

the existence assertion, and examination of other records, such as goods received notes, to provide evidence of the assertion regarding completeness.

Reliability of Responses Received

35. **The auditor should consider whether there is any indication that external confirmations received may not be reliable. The auditor should also consider the authenticity of the response and perform appropriate procedures to dispel any doubts.** The auditor may choose to verify the source and contents of a response in a telephone call to the purported sender. In addition, the auditor would also request the purported sender to mail the original confirmation directly to the auditor. With ever-increasing use of technology, the auditor needs to consider validating the source of replies received in electronic format (for example, fax or electronic mail). **Oral confirmations should be documented in the work papers.** If the information in the oral confirmations or that received though a fax is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor since in such cases it is difficult to ascertain the source of the response.

Causes and Frequency of Exceptions

36. **When the auditor forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to obtain sufficient appropriate audit evidence.** In forming the conclusion, the auditor considers the:

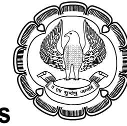
(a) reliability of the confirmations and alternative procedures;

(b) nature of any exceptions, including the implications, both quantitative and qualitative of those exceptions; and

(c) evidence provided by other procedures.

Based on this evaluation, the auditor would determine whether additional audit procedures are needed to obtain sufficient appropriate audit evidence.

37. Any discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor might have a bearing on the assertions and the accounts within the given assertion not selected for external confirmation. **The auditor, in such a case, should request the management to verify and reconcile the discrepancies. The auditor should also consider what further tests can be carried out to satisfy himself as to the correctness of related assertion.**



38. The auditor should also consider the causes and frequency of exceptions reported by respondents. An exception might indicate a misstatement in the entity's records, in which case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor would reconsider the nature, timing and extent of audit procedures necessary to provide the evidence required. **If the responses received indicate a pattern of misstatements, the auditor should reconsider his assessment of inherent and control risk and also consider the effect on his audit procedures.**

Evaluating the Results of the Confirmation Process

39. **The auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited.** In conducting this evaluation, the auditor considers the guidance provided by AAS 15, **(SA 530)** "Audit Sampling”.

Management Requests

40. **When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such request.** The management, for example, might make such a request on the grounds that due to a dispute with the particular debtor, the request for confirmation might aggravate the sensitive negotiations between the entity and the debtor. The auditor, in such a case, would examine any available evidence to support management’s request, say, examining the correspondence between the management and the debtor. **If the auditor agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management’s request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.**

41. **If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report. The auditor should, however, in this case also, document the request made by the management along with the reasons given by the management therefor as**

well as his own reasons for not acceding to the management's request.

42. When considering the reasons provided by management, the auditor would apply professional skepticism and consider whether the request has any implications regarding management's integrity. The auditor would also consider whether management's request might indicate the possible existence of fraud or error. If the auditor believes that fraud or error exists, the auditor would consider the requirements of AAS 4 **(SA 240),** "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements". The auditor would also need to consider whether the alternative procedures will provide sufficient appropriate evidence regarding that matter.

Effective Date

43. This Auditing and Assurance Standard is effective for audits related to accounting periods beginning on or after 1st April, 2003.

Compatibility with International Standard on Auditing (ISA) 505

The auditing standards established in this SA are generally consistent in all material respects with the International Standard on Auditing (ISA) 505, "External Confirmations", except the following:

(a) The SA requires the auditor to obtain an understanding of the substance of transactions and agreement with the third parties to decide about the information to be included in the request for confirmation (see paragraph 22). ISA 505 does not contain any requirements in this regard.

(b) The SA requires the auditor to consider the information from audits of earlier years (see paragraph 24). This requirement is not present in ISA 505.

(c) The SA requires the auditor to request the management to verify and reconcile the discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor. The SA further requires the auditor to consider what further tests can be carried out to satisfy him self as to the correctness of related assertions (see paragraph 37). This requirement is not present in ISA 505.

AAS 34

[New Number of the Standard SA 501]

AUDIT EVIDENCE – ADDITIONAL CONSIDERATIONS FOR SPECIFIC ITEMS

The following is the text of the auditing and assurance standard (AAS) 34[*] ***(SA 501),*** *"audit evidence – additional considerations for specific items", issued by the council of the institute of chartered accountants of India. This standard should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

Introduction

1. The purpose of this Auditing and Assurance Standard (SA) is to establish standards on the auditor's responsibilities, audit procedures and provide additional guidance to that contained in AAS 5 **(SA 500),** "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures. Application of the standards and guidance provided in this SA will assist the auditor in obtaining audit evidence with respect to the specific financial statement amounts and other disclosures. This SA comprises the following parts:

Part A: Attendance at Physical Inventory Counting

Part B: Inquiry Regarding Litigation and Claims

Part C: Valuation and Disclosure of Long-term Investments

Part D: Segment Information

Part A: Attendance at Physical Inventory Counting

2. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting.**

Definitions

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[*]Issued in March, 2005.

3. Definitions regarding “Inventory” are given in Accounting Standard (AS) 2, Valuation of Inventories, issued by the Institute of Chartered Accountants of India, and are adopted for the purposes of this SA[61]

4. **Physical verification of inventories is the responsibility of the management of the entity.** Management ordinarily establishes procedures under which inventory is physically counted at least once in a year (end of the year, generally, or as near the end of the year as possible) to serve as a basis for preparation of the financial statements or to ascertain the reliability of the perpetual inventory system.

5. **When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable, due to factors such as the nature and location of the inventory.** The attendance at such physical inventory counting will enable the auditor to inspect the inventory, to observe compliance with the operation of management’s procedures for recording and controlling the results of the count and to provide evidence as to the reliability of management’s procedures.

6. **If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded.**

7. **Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation.** For example, the auditor should examine a sample of documents evidencing the movement of inventory into and out of stores shortly before and after the cut – off date, and verify whether the inventory represented by those documents were included or excluded, as appropriate during the inventory count.

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[61] Paragraph 3 of the Accounting Standard (AS) 2, Valuation of Inventories, states as follows:

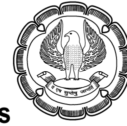
“3. The following terms are used in this Statement with the meanings specified:

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.”



8. In planning attendance at the physical inventory count or the alternative procedures, the auditor would consider the following:

The nature of the accounting and internal control systems used regarding inventory.

Inherent, control and detection risks, and materiality related to inventory.

Whether adequate procedures are established and proper instructions issued for physical inventory counting.

The timing of the count.

The locations at which inventory is held and its nature.

Whether an expert's assistance is needed.

When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement and the assessment of inherent and control risk at different locations.

9. The auditor would review management's instructions regarding:

(a) The application of control procedures, for example, collection of used stock-sheets, accounting for unused stock-sheets, tagging and count and re-count procedures;

(b) Accurate identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, inventory owned by a third party, for example, on consignment and inventory in transit; and

(c) Appropriate arrangements made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

10. The auditor would also consider cut-off procedures including details of the movement of inventory just prior to, during and after the count to ensure that such movements are appropriately included and/or excluded, as applicable from such inventory. For example,

(a) goods purchased but not received are included in the inventories; and

(b) goods sold but not despatched are excluded from the inventories.

11. When the quantities are to be determined by a physical inventory count and the auditor attends such a count, or when the entity operates a perpetual inventory system and the auditor attends a count one or more times during the year, the auditor would ordinarily observe count procedures and perform test counts.

12. If the entity uses procedures to estimate the physical quantity, such as estimating a coal pile, the auditor would need to be satisfied regarding the reasonableness of those procedures.

13. To obtain assurance that management's procedures are adequately implemented, the auditor would observe physical verification procedures performed by the employees and

perform test counts. When performing counts, the auditor would test both the completeness and the accuracy of the count records by tracing items selected from those records to the physical inventory sheets and items selected from the physical inventory to the count records. Where tagging method of physical count of inventory is used, the auditor would verify the tag reconciliation prior to the counting or before finalising the count. The auditor would consider the extent to which copies of such count records need to be retained for subsequent audit procedures, testing and comparison.

14. For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded.

15. When the entity operates a perpetual inventory system, which is used to determine the period end balance, the auditor would assess whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.

16. The auditor performs audit procedures over the final inventory listing to assess whether it accurately reflects actual inventory counts.

17. When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/arrange with the entity for sending requests for such confirmation as to the quantities and condition of inventory held on behalf of the entity. Further, depending on materiality of this inventory the auditor would also consider the following:

The conduct of the third party in the past with the entity and independence of the third party.

Observing, or arranging for another auditor to observe, the physical inventory count.

Obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded.

Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.

Subsequent receipt of goods from third parties.

Management Representations

18. **The auditor should obtain a written representation from management concerning:**

(a) **the completeness of information provided regarding the inventory; and**

(b) **assurance with regard to adherence to laid down procedures for physical inventory count.**

Audit Conclusions and Reporting

19. **If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.**

Part B: Inquiry Regarding Litigation and Claims

Definitions

20(a) "Litigation" means a lawsuit or legal action including all proceedings therein.

(b) "Claims" means a right to payment or right to an equitable remedy for breach of performance.

21. Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed and/or provided for in the financial statements.

22. **The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements.** Such procedures would include the following:

Make appropriate inquiries of management including obtaining representations.

Review board /committee minutes and correspondence with the entity's lawyers.

Examine legal and other relevant expense accounts.

Use any information obtained regarding the entity's business including information obtained from discussions with in-house legal department, if any.

23. When litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims. Such communication will assist in obtaining sufficient

appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

24. **The letter seeking direct communication with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims should be prepared by management. The auditor should maintain control over the process of preparation and sending of the letter. The letter should request the entity's lawyers and such other professionals to whom the entity engages for litigation and claims to communicate directly with the auditor.** The letter would ordinarily specify the following:

A list of litigation and claims.

Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.

A request that the entity's lawyer confirm:

- the reasonableness of management's assessments;
- provide the auditor with further information if the list is considered to be incomplete or incorrect; and
- provide updated information as and when requested by the auditor upto the date of the audit report.

25. The auditor considers the status of legal matters up to the date of the audit report. In some instances, the auditor may need to obtain updated information from lawyers.

26. In certain circumstances, for example, where the matter is complex or there is disagreement between management and the entity's lawyers and such other professionals to whom the entity engages for litigation and claims, it may be necessary for the auditor to meet with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims to discuss the likely outcome of litigation and claims. Such meetings would take place with management's permission and, preferably, with a representative of management in attendance.

27. **If management refuses to give the auditor permission to communicate with the entity's lawyers, this would constitute a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion as the case may be.** Where a lawyer or a professional refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative procedures, the auditor would consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

Management Representations

28. **The auditor should obtain a written representation from management concerning the completeness and adequacy of information provided regarding the identification of litigation and claims, estimates of financial implications, including costs, etc.**

Part C: Valuation and Disclosure of Long-Term Investments

29. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for valuation and disclosure of long term investments.**

Definitions

30. Definition regarding "Long Term Investments" is given in Accounting Standard (AS) 13, Accounting for Investments, issued by the Institute of Chartered Accountants of India and is adopted for the purposes of this SA.[62]

31. **When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.**

32. Audit procedures regarding long-term investments ordinarily include obtaining audit evidence with respect to their ownership and existence as to whether the entity has the ability to continue to hold the investments on a long term basis and discussing with management whether the entity will continue to hold the investments as long-term investments and obtaining written representations to that effect.

33. Other procedures would ordinarily include:

(a) In the case of quoted securities, considering related financial statements and other information, such as market quotations, which provide an indication of value and comparing such values to the carrying amount of the securities up to the date of the auditor's report.

(b) In case of unquoted securities, ascertaining the method adopted by the entity for determining the value of such securities as at the year end. The auditor should examine whether the method adopted by the entity is one of the recognised

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[62] Paragraph 3 of Accounting Standard (AS) 13, Accounting for Investments, states as follows:

"3. The following terms are used in this Statement with the meanings assigned:

A *Current Investment* is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

A *long term investment* is an investment other than a current investment."

methods of valuation of securities such as Profit Earning capacity Value method, break-up value method, capitalisation of yield method, yield to maturity method, etc.

(c) In the case of investments other than in the form of securities, ensuring that the market value has been ascertained on the basis of authentic market reports, and /or based on expert's opinion, if warranted.

34. If such values do not exceed the carrying amounts, the auditor would consider whether a write-down is required. If there is an uncertainty as to whether the carrying amount will be recovered, the auditor would consider whether appropriate adjustments and/or disclosures have been made.

Management Representations

35. **The auditor should obtain a written representation from management regarding :**

(a) **the completeness of information provided regarding valuation and disclosure of long term investments;**

(b) **the valuation of long term investments in the financial statements including adequacy of provision for diminution in such values, wherever required; and**

(c) **the intention of the management to continue to hold long-term investments as long-term investments.**

Audit Conclusions and Reporting

36. If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence, valuation of long term investments or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.

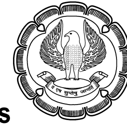
Part D: Segment Information

37. **The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for appropriate disclosure of segment information.**

Definitions

38. "Segment Information" means the information to be disclosed in respect of reportable segments as given in Accounting Standard (AS) 17, "Segment Reporting", issued by the Institute of Chartered Accountants of India or as defined in the financial reporting framework applicable to the entity.

39. **When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its disclosure in accordance with the applicable identified financial reporting framework.**



40. The auditor considers segment information in relation to the financial statements taken as a whole, and is not required to apply auditing procedures that would be necessary to express an opinion on the segment information standing alone. Audit procedures regarding segment information ordinarily consist of analytical procedures and other audit tests appropriate in the circumstances.

41. The auditor would discuss with management the methods used in determining segment information, and consider whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework and test the application of such methods. The auditor would consider sales, transfers and charges between segments, elimination of inter-segment amounts, comparisons with budgets and other expected results, for example, operating profits as a percentage of sales, and the allocation of assets and costs among segments including consistency with prior periods and the adequacy of the disclosures with respect to inconsistencies.

Management Representations

42. **The auditor should obtain a written representation from management concerning:**

(a) **the completeness of information regarding segments and disclosure thereof; and**

(b) **appropriateness of the selected segments based on risks and returns; and**

(c) **the organizational structure of an enterprise and its internal financial reporting system and any deviations therefrom.**

Audit Conclusions and Reporting

43. **If the auditor is unable to obtain sufficient appropriate audit evidence concerning segment information or concludes that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as may be appropriate.**

Effective Date

44. **This Auditing and Assurance Standard becomes operative for all audits related to accounting periods beginning on or after 1 April 2005.**

Compatibility with the International Standard on Auditing (ISA) 501

The auditing standards established in this SA are generally consistent in all material respects with those set out in ISA 501, “Audit Evidence – Additional Considerations for Specific Items" except the following:

(a) Due to practical reasons, paragraph 23 of the SA requires that when litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers. The auditor need not necessarily communicate with the entity's lawyers and such other professionals to whom the entity engages for litigation and claims in case the auditor is able to obtain the sufficient appropriate audit evidence regarding the identification of litigation and claims involving the entity which may have a material effect on the financial statements. The ISA on the other hand requires that the auditor should communicate with the entity's lawyers to obtain sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

(b) Each part of the SA contains the requirements related to obtaining the management representations [see paragraphs 18, 28, 35 and 42]. There is, however, no such requirement in the ISA.

PART II

GUIDANCE NOTES

1. GUIDANCE NOTE ON AUDIT OF FIXED ASSETS*

The following is the text of the Guidance Note on Audit of Fixed Assets issued by the Auditing Practices Committee[1] of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs..

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices. (SAPs)[2] so that these may be issued by the Council of the Institute." Para.2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. Chapter 3 of the existing "Statement on Auditing Practices" related to "Fixed Assets" provides guidance in respect of both accounting and auditing aspects of fixed assets. The accounting aspects of fixed assets form the subject matter of an Accounting Standard on "Accounting for Fixed Assets" which is being prepared by the Accounting Standards Board of the Institute of Chartered Accountants of India. This Guidance Note on Audit of Fixed Assets therefore supersedes auditing aspects of the said Chapter 3 of the existing Statement[3].

3. This Guidance Note, however, does not supersede the Institute's publications which provide guidance on audit of fixed assets with special reference to certain statutes, e.g., the Statement on Manufacturing and Other Companies (Auditor's Report) Order, 1975.

4. In the event of a possible or perceived contradiction between the Guidance Note and a Statement on Standard Auditing Practices (SAP) issued by the Institute, the practices laid down in the SAP will prevail.

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* Issued in April, 1985.

[1] Now known as Auditing and Assurance Standards Board (AASB).

[2] Now known as Auditing and Assurance Standards (SAs).

[3] The Department of Company Affairs has notified the Companies (Auditor's Report) Order, 2003 in June 2003 in terms of the powers given to it under section 227(4A) of the Companies Act, 1956.

Introduction

5. Fixed assets are assets held for the purpose of providing or producing goods or services and are not meant for sale in the normal course of business. Therefore, an asset can be classified as a fixed asset or otherwise, depending upon the use to which it is put or intended to be put. For example, assets which are classified as fixed assets in one type of business may be considered as current assets in another. Similarly, the same asset may be classified differently in an enterprise at different points of time.

6. Fixed assets normally constitute a significant portion of the total assets, particularly in a manufacturing enterprise. Audit of fixed assets, therefore, assumes considerable importance.

7. The following features of fixed assets have an impact on the related audit procedures:

(i) By their very nature, fixed assets are turned over much slower than current assets. Normally, fixed assets are carried over from year to year.

(ii) The average unit of fixed assets is normally of a relatively larger rupee value.

(iii) Since fixed assets are high value items, their acquisition is more effectively controlled. The control aspect assumes special significance where fixed assets are self-constructed.

(iv) In an inflationary situation, normally, the book values of fixed assets are considerably lower than their replacement values.

Internal Controls

8. An auditor should review the system of internal controls relating to fixed assets, particularly the following:

(i) *Control over expenditure incurred on fixed assets acquired or self-constructed*--an effective method of exercising this control is capital budgeting, which, apart from ensuring proper authorisation of the expenditure incurred, also shows, in general, how effectively such expenditure is being controlled through periodical comparisons of actuals with budgeted figures.

(ii) *Accountability and utilisation controls*-accountability over each fixed asset (or each class of fixed assets) is established, among other things, by maintaining, appropriate records. This facilitates control aspects of custodianship of such assets, for example, physical verification by the management or establishment of procedures relating to disposal of fixed assets. On the other hand, utilisation controls ensure that the individual fixed assets have been properly used for meeting the objectives of the enterprise.

(iii) *Information controls*-these controls ensure that reliable information is available for calculating and allocating depreciation, recording disposals or retirements, preparing tax returns, establishing the amount of insurance coverage, filing insurance claims controlling repairs and maintenance charges etc.

Verification

9. Verification of fixed assets consists of examination of related records and physical verification. The auditor should normally verify the records with reference to the documentary evidence and by evaluation of internal controls. Physical verification of fixed assets is primarily the responsibility of the management.

Verification of Records

10. The opening balances of the existing fixed assets should be verified from records such as the schedule of fixed assets, ledger or register balances.

11. Acquisition of new fixed assets and improvements in the existing ones should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds.

12. Self-constructed fixed assets, improvements and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work-order records and independent confirmation of the work performed.

13. The auditor should scrutinise expense accounts (e.g. Repairs and Renewals) to ascertain that new capital assets and improvements have not been included therein.

14. Where fixed assets have been written-off or fully depreciated in the year of acquisition/construction, the auditor should examine whether these were recorded in the fixed assets register before being written-off or depreciated.

15. In respect of fixed assets retired, i.e., destroyed, scrapped or sold, the auditor should examine (a) whether the retirements have been properly authorised and appropriate procedures for invitation of quotations have been followed wherever applicable; (b) whether the assets and depreciation accounts have been properly adjusted; (c) whether the sale proceeds, if any, have been fully accounted for; and (d) whether the resulting gains or losses, if material, have been properly adjusted and disclosed in the Profit and Loss Account.

16. It is possible that certain assets destroyed, scrapped or sold during the year have not been recorded. The auditor may use the following procedures to ascertain such omissions:

(i) Review work orders/physical verification reports to trace any indicated retirements.

(ii) Examine major additions to ascertain whether they represent additional facilities or replacement of old assets, which may have been retired.

(iii) Make enquiries of key management and supervisory personnel.

(iv) Obtain a certificate from a senior official and/or departmental managers that all assets scrapped, destroyed or sold have been recorded in the books.

17. The ownership of assets, like land and buildings should be verified by examining title deeds. In case, the title deeds are held by other persons, such as solicitors or bankers, confirmation should be obtained directly by the auditors through a request signed by the client.

Physical Verification

18. It is the responsibility of the management to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by observing the verification being conducted by the management wherever possible and by examining the written instructions issued to the staff by the management and the relevant working papers. The auditor should also satisfy himself that the persons conducting the verification, whether the employees of the enterprise or outside experts (if employed), had the necessary competence.

19. The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land. Where the fixed assets can be moved and where verification of all assets cannot be conducted at the same time, they should be marked with distinctive numbers.

20. The auditor should examine whether the frequency of verification was reasonable in the circumstances of each case. Where the assets are few and can be easily verified, an annual verification may be considered as reasonable. However, where the assets are numerous and

difficult to verify, a verification, say, once every three years by rotation - so that all assets are verified at least once in every three years – may be sufficient.

21. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with. In this regard the auditor has to use his judgement as to whether having regard to the circumstances, the discrepancy is material enough to warrant an adjustment in the accounts and/or modification in the internal control system.

Valuation and Disclosure

22. The auditor should satisfy himself that the fixed assets have been valued and disclosed in the financial statements according to the generally accepted bases of accounting which are determined by law, professional pronouncements[4] and prevailing practices.

23. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted bases of accounting for depreciation.

24. Revaluation of fixed assets implies restatement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of fixed assets, technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisals appear reasonable and based on adequate facts, he is entitled to accept the revaluation made by the experts.

25. Where several assets have been purchased for a consolidated price, the auditor should examine the method by which the consideration has been apportioned to the various assets. In case this has been done on the basis of an expert valuation, he should examine whether the same appears reasonable and based on adequate facts.

26. Where an enterprise owns assets jointly with others (otherwise than as a partner in a firm) the auditor should examine the relevant documents such as title deeds, agreements etc., in order to ascertain the extent of the enterprise's share in such assets.

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[4] An illustrative list of professional pronouncements on the subject is given in Appendix A.

2. GUIDANCE NOTE ON AUDIT OF INVENTORIES*

*The following is the text of the Guidance Note on Audit of Inventories, issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Inventories, Chapter 5 of the *Statement on Auditing Practices*, titled "Inventories", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

Introduction

3. Inventories are tangible property held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumable stores and spare parts meant for replacement in the normal course.[5] Inventories normally comprise raw materials

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* Issued in November, 1994.

** Now known as the Auditing and Assurance Standards Board (AASB).

[5] Servicing equipment, stand-by equipment and specialised spares of machinery (which are in the nature of 'insurance spares') are normally capitalised.

including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.[6]

4. Inventories normally constitute a significant portion of the total assets, particularly in the case of manufacturing and trading entities as well as some service rendering entities. Audit of inventories, therefore, assumes special importance.

5. The following features of inventories have an impact on the related audit procedures:

(i) By their very nature, inventories normally turn over rapidly.

(ii) Inventories are susceptible to obsolescence and spoilage. Further, some of the items of inventory may be slow-moving while others may follow a seasonal pattern of movement.

(iii) Inventories are normally movable in nature, although there may be some instances of immovable inventories also, e.g., in the case of an entity dealing in real-estate.

(iv) All the items of inventory may not be located at one place but may be held at different locations such as factories and warehouses, or with third parties such as selling agents.

(v) The individual items of inventory may not be significant in value, but taken together, they normally constitute a significant proportion of total assets and current assets of manufacturing, trading and certain service entities.

(vi) Physical condition (e.g., stage of completion of work-in-process in certain industries) and existence of certain items of inventories may be difficult to determine.

(vii) Valuation of inventories may involve varying degrees of estimation, including expert opinions, e.g., in the case of jewelry.

Internal Control Evaluation

6. The auditor should study and evaluate the system of internal control relating to inventories, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to inventories[7]:

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[6] The audit procedures, relating to shares debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are similar to those followed for audit of investments. Accordingly, this Guidance Note does not apply in respect of audit of shares, debentures and other securities held as stock-in-trade.

(a) The control procedures should provide for segregation of such functions whose combination may permit the commitment or concealment of fraud or error; for example, persons undertaking the physical verification of stocks should be different from those responsible for store-keeping in respect of those stocks.

(b) The stores procedures should provide for the use of pre-numbered standardized forms.

(c) There should be a system of cross-checking the data generated by different operating departments.

7. The auditor should also review specific controls over receipts, issues, physical inventories, and inventory records.

Verification

8. As in the case of other assets, the responsibility for properly determining the quantity and value of inventories rests with the management of the entity. It is, therefore, the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will normally include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence.

9. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, Audit Evidence). In carrying out an audit of inventories, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Existence	-	that all recorded inventories exist as at the year-end.
Ownership	-	that all inventories owned by the entity are recorded and that all recorded inventories are owned by the entity.

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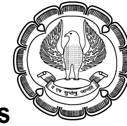
[7] The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative discussion on internal controls in relation to inventories.



Valuation - that the stated basis of valuation of inventories is appropriate and properly applied, and that the condition of inventories is recognised in their valuation.

Verification of inventories may be carried out by employing the following procedures:

(a) examination of records;

(b) attendance at stock-taking;

(c) obtaining confirmations from third parties;

(d) examination of valuation and disclosure; and

(e) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

Examination of Records

10. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

11. The auditor may come across cases where the entity does not maintain detailed stock records other than the basic records relating to purchases and sales. In such situations, the auditor would have to suitably extend the extent of application of the audit procedures discussed in paragraphs 12-22 and 30.

Attendance at Stock-taking

12. Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the stock-taking. The extent of auditor's attendance at stock-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity and of the analytical review procedures.

13. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity.

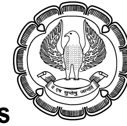
14. There are two principal methods of stock-taking : periodic stocktaking and continuous stock-taking. Under the first method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date before or shortly after the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous stock-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous stock-taking methods for certain stocks and carry out a full count of other stocks at a selected date.

15. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. An illustrative set of instructions which may be useful in most cases is given in Appendix I to this Guidance Note.

16. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the physical condition of inventories.

17. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or dispatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movements. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (e.g., issues from stores to production departments).

18. The auditor should also examine whether the entity has instituted appropriate cut-off procedures to ensure that –



(a) goods purchased but not received have been included in the inventories and the liability has been provided for;

(b) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking.

19. The auditor should review the original physical verification sheets and trace selected items including the more valuable ones into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., stock statements submitted to banks.

20. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for.

21. Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed in paragraphs 16-20 above, pay greater attention to ascertaining whether the management:

(a) maintains adequate stock records that are kept up-to-date;

(b) has satisfactory procedures for physical verification of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and

(c) investigates and corrects all material differences between the book records and the physical counts.

22. The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

Confirmations from Third Parties

23. Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. A proforma letter of request for confirmation to

be used in such cases is given in Appendix II to this Guidance Note. Similarly, the auditor should also obtain confirmation from such third parties for whom the entity is holding significant amount of stocks. Appendix-III to this Guidance Note gives a proforma letter of request for confirmation to be used for this purpose.

Examination of Valuation and Disclosure

24. The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis.

25. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles[8] involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, "Valuation of Inventories", issued by the Council of the Institute of Chartered Accountants of India.

26. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the stock sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories.

27. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may examine the variances from actuals and, where these are significant, ensure that appropriate adjustment is made to the inventories.

28. The auditor should examine the evidence supporting the assessment of net realizable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realizable value.

29. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays dawn any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

[8] It may be mentioned that the Manufacturing and Other Companies (Auditor's Report) Order, 1988 uses the words "normally accepted accounting principles".

Analytical Review Procedures

30. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories:

(i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;

(ii) comparison of closing stock quantities and amounts with those of the previous year;

(iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;

(iv) comparison of the composition of the closing stock (e.g., raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;

(v) comparison of current year gross profit ratio with the gross profit ratio for the previous year;

(vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;

(vii) comparison of yield with the corresponding figure for the previous year;

(viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;

(ix) comparison of significant ratios relating to inventories with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

Special Considerations in Case of Work-In-Process

31. In general, the audit procedures regarding work-in-process are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-process for assessing the appropriateness of its valuation. For this

purpose, the auditor may examine the production/costing records (e.g., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary.

32. In certain cases, due to the nature of the product and the manufacturing process involved, physical verification of work-in-process may be impracticable. In such cases, the auditor should lay greater emphasis on ascertaining whether the system, from which the work-in-process is ascertained, is reliable. It may also be useful for the auditor to examine the subsequent records of production/sales.

Management Representations

33. The auditor should obtain from the management of the entity, a written statement describing in detail, the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding inventories is given in Appendix IV to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in a composite representation letter usually issued by the management to the auditor.

Documentation

34. The auditor should maintain adequate working papers regarding audit of inventories. He should maintain on his audit file a summary of each inventory as also the details regarding the extent of his verification. The management representation letter concerning inventories should also be maintained on the audit file.

APPENDIX I

Illustrative Set of Instructions to be Issued by the Client to its Staff Responsible for Stock-Taking

(Ref. Paragraph 15)

This Appendix contains an illustrative set of instructions which may be issued by the client to the staff responsible for stock-taking. The Appendix also lists special instructions in respect of stocks held by others and work-in process.

The annual physical examination of inventories of the entity is to be carried out on 31st March. The work will commence at 8.00 A.M. on 31st March, and there will be no movement of inventories during their physical examination.

1. Mr. AB will be in overall charge of the physical counting.
2. Messrs............., Auditors, will depute their staff to observe the work performed by us. It should be remembered that they are not responsible for any part of the stock-taking.
3. You are responsible for the physical counting of all stocks in (state here the exact area for which the person is responsible e.g., Block B of Godown No. 2, or in the open yard on south of factory, etc.). You are not concerned with similar items of stock which may be stored at other locations.

How to proceed with the work

4. At 8 A.M. you should present yourself in the office of Mr. AB where you will be handed over a bunch of inventory tags. You should ensure that you have in your possession a sufficient number for your needs. You should also have in your possession a pen, blank papers, a measuring tape, ... (state here any other instrument which is required for measurement, counting, weighing etc.). Please ensure that for all items in your area for which weighing or measuring is required, the necessary apparatus is available.

Procedure for tagging

5.1 You should place a tag on each pile, box, bin, etc., which is counted by you after recording the quantity, description, part number, condition of the stocks to the extent known (e.g., damaged stocks), etc., on the tag. You should proceed in proper order so as to ensure that no items are omitted. When the work of counting is completed you should hand over the remaining tags including soiled and damaged tags to Mr. PQ.

5.2 All items are required to be measured, weighed or counted in order to ascertain the exact quantity on hand. However, in respect of small items of in significant value, such as bolts, nuts (state here any other items which are known to be of small value), the quantities on hand may be estimated without actual counting etc. In the latter case, please state "estimated" on the tag.

5.3 Please ensure that proper identification is made by part number, description, etc., and that in the case of work-in-process, the last operation performed is clearly specified in accordance with the schedule attached to this Memorandum. No movement of any stock from one location to another should take place during the period of stock checking.

5.4 Where bin cards are kept on the bins or job tickets are attached to items in process, you should not merely copy the quantities shown on those documents to the tag without verification. All alterations made on the tags should be initialled and quantities should be recorded in ink.

5.5 Mr. PQ is responsible for the control over tags in use. For this purpose, he should prepare a schedule in the attached Form.

5.6 After obtaining the permission of the auditors[9], instructions will be issued for the removal of the tags and a suitable person should be sent around in each department to detach the detachable portion of the tags, leaving the counterpart in the proper position. When they are collected, all such tags should be brought back to a central location, placed in serial order and tallied with the schedule prepared by Mr. PQ. After this has been done, the tags will be released to the Accounts Department which is concerned with the preparation of the inventory. Later on, when the inventory has been prepared, a check should be possible to see whether all the tags have been listed.

5.7 After the work of counting has been completed, Mr. AB, who is in overall charge of stock-taking, will make a visit to each area in order to ascertain that all bins, boxes, etc., bear a tag and make a check of the quantities shown therein. At this point, the auditors will carry out further observation and make such test checks as they consider necessary.

5.8 The counterparts of the tags should be left on the relevant bins or piles for a period of at least one month and the quantity shown on the counterparts of the tag should be used as the opening balance of the bin card for the subsequent period.

Procedure for preparing stock sheets

6.1 Separate listings under the following broad heads should be prepared:

(i) Raw materials, including components
(ii) Work-in-process
(iii) Finished goods, including by-products
(iv) Maintenance supplies and stores and spare parts
(v) Loose tools

Defective, damaged, obsolete, excess or slow-moving stocks should be listed separately under each of the above categories.

[9] It is presumed that the auditors or their representatives are present at the time of stock-taking.

6.2 It should be examined that the stock cards, bin cards, tags or other stock records are posted up-to-date so that items can be traced and verified in these records, simultaneously with the physical checking of stocks.

6.3 A list of excesses and shortages should be drawn up at the time of physical stock-taking.

6.4 Stocks belonging to third parties and remaining in custody of the entity should be separately identified from the entity's own stock. A separate listing should be prepared for all such items of stocks.

6.5 Defective, damaged, obsolete, excess or slow-moving stocks should be kept separate from other items.

6.6 Counters and checkers should sign or initial the stock sheets for the work done by them.

Stocks held by others

7.1 The following steps be taken for stocks belonging to the entity but held by others:

(i) A separate listing for such stocks be prepared.

(ii) A letter should be sent to such persons to confirm the stocks held by them directly to the auditor.

(iii) An authority to inspect stocks held by third parties should be given to the auditor where the same is considered necessary by the auditor.

(iv) An independent record for such goods be kept by the entity.

7.2 The above steps should also be taken for stocks given on loan or received on loan.

Work-in-Process

8.1 With regard to work-in-process, the following instructions be given to the staff members concerned:

(i) A separate listing for work-in-process be prepared.

(ii) The internal records kept by the entity be written up-to-date.

(iii) If the amount of work-in-process is determinable from production records, the same be kept up-to-date.

(iv) A list of opening work-in-process be kept ready at the time of stock-taking.

APPENDIX II

Illustrative Letter of Confirmation of Inventories Held by Others

[Ref. Paragraph 23]

(Letterhead of Entity)

[Date]

[Name and address of holder of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning our inventories held by you for [state here the purpose of holding of inventories by the third party] as of the close of business on ....

According to our records, you held the following inventories as of that date:

Description	Quantity
....	....
....	....

In case you identify certain items of inventories as defective or damaged, the details thereof may be furnished separately, indicating the quantities and giving a general description of the condition of such items. Also, please confirm that our inventories held by you are free of any charge or encumbrance.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

APPENDIX III

Illustrative Letter of Confirmation – Inventories Held by the Entity on Behalf of Others

[Ref. Paragraph 23]

[Letterhead of Entity]

[Date]

[Name and address of owner of inventories]

Dear Sir,

For audit purposes, kindly furnish directly to our auditors (name and address of the auditors) details concerning your inventories held by us for [state here the purpose of holding of inventories by the entity as of the close of business on ____________.

According to our records, we held the following inventories as of that date:

Description	Quantity
....	....
....	....

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

APPENDIX IV

Representation Letter for Inventories

[Ref. Paragraph 33]

The following is a sample representation letter for inventories. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X limited as of....., 19…, and for the year then ended, we make, to the best of our knowledge and belief, the following representations concerning inventories.

1. Inventories at the year-end consisted of the following:

Raw Materials (including components)		Rs.________
Work-in-Process		Rs.________
Finished Goods (including by-products)		Rs.________
Maintenance supplies and Stores and Spare Parts		Rs.________
Loose Tools		Rs.________
Others (specify each major head separately)		Rs.________
	Total	Rs.________

2. All quantities were determined by actual physical count or weight or measurement that was taken under our supervision and in accordance with written instructions, on .... (date/dates of physical verification), except as follows:[10]

....

....

[10] Where physical verification of inventories is carried out at a date other than the closing date, this paragraph may be modified as below:

> Inventories recorded in the books as at...........(date of balance sheet) aggregating to Rs. .... are based upon the physical inventories taken as at .... (date of physical verification) by actual count weight or measurement. The material discrepancies noticed on physical verification of stocks as compared to book records have been properly dealt with in the books of account and subsequent transactions recorded in the accounts fairly reflect the changes in the inventories up to ·......... (balance sheet date).

3. Except as set out below, all goods included in the inventory are the property of the entity and are not subject to any charge, and none of the goods are held as consignee for others or as bailee:

....

....

4. All inventories owned by the entity, wherever located, have been recorded, including goods sent on consignment.

5. Inventories do not include goods sold to customers for which delivery is yet to be made.

6. Inventories have been valued on the following basis/bases:

   Raw Materials (including components)

   Work-in-Process

   Finished Goods (including by-products)

   Maintenance supplies and Stores and Spare Parts

   Loose Tools

   Others (specify each major head separately)

   (In describing the basis/bases of valuation, the method of ascertaining the cost (e.g. FIFO, Average Cost or LIFO) should also be stated. Similarly, the extent to which overheads have been included in the cost should also be stated.)

7. The following provisions have been made in respect of excess, slow moving, damaged, or obsolete inventories and these, in our view, are adequate.

....

....

8. No item of inventories has a net realizable value in the ordinary course of business which is less than the amount at which it is included in inventories.

9. The basis/bases of valuation is/are the same as that/those used in the previous year, except as set out below:

Class of	Basis of valuation		Effect of change in
Inventory	This year	Last year	Basis of Valuation
....	....	....	....
....	....	....	....

Yours faithfully,

(Signature of responsible official of the entity)

Clarification[11]

Auditor's Duties where Inventories are Stated to be "As Valued and Certified by the Management" in Financial Statements

(Refer Paragraph 33)

It has been observed that in some cases, inventories are described in the financial statements as "Stocks (as valued and certified by the management)". The use of such an expression may lead the users of the financial statements to believe that the auditor merely relies on the management's certificate without carrying out any other appropriate audit procedures to satisfy himself about the existence and valuation of inventories.

The Institute of Chartered Accountants of India has issued a Guidance Note on Audit of Inventories, which recommends the procedures to be followed by the auditors in conducting the audit of inventories. Para 33 of the Guidance Note, *inter alia*, recommends as below:

> *"The auditor should obtain from the management of the entity, a written statement describing in detail the location of inventories, methods and procedures of physical verification and valuation of inventories. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to inventories, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information."*

In view of the above, the Council of the Institute hereby clarifies that despite the expression "as valued and certified by the management", the duties and responsibilities of the auditors with regard to audit of inventories are not diminished. Thus, in order that the auditor's role with regard to inventories is properly appreciated by the users of the financial statements, the auditor may advise his clients to omit the words "as valued and certified by the management", when describing inventories in the financial statements.

[11] Published in September, 1999 issue of "The Chartered Accountant", p.66.

3. GUIDANCE NOTE ON AUDIT OF INVESTMENTS*

*The following is the text of the Guidance Note on Audit of Investments issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

1. Para 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary.

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee, It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn.[12] With the issuance of this Guidance

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* Issued in November, 1994.

** Now known as the Auditing and Assurance Standards Board (AASB).

[12] This Guidance Note does not deal with special aspects of audit of investments of retirement benefit plans, life insurance enterprises, mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956. The special aspects of audit of investments of some of these institutions have been dealt with in other publications of the Institute, e.g., *Guidance Note on Audit of Banks, Guidance Note on Audit of Companies Carrying on General Insurance Business, Guidance Note on Companies Carrying on Life Insurance Business.* It may also be noted that in the case of certain types of entities, e.g., companies, banks, insurance companies, co-operative societies, etc., the question of compliance with the legal requirements assumes special importance. Appendix I to this Guidance Note contains a brief description of the main provisions of the statutes governing these types of entities in so far as they relate to investments. It may be emphasised that the Appendix is only illustrative and not exhaustive. Moreover, the legal requirements may change from time to time and, therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

Note on Audit of Investments, Chapter 4 of the *Statement on Auditing Practices,* titled "Investments", shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

Introduction

3. Investments are assets held by an entity for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing entity[13] Investments are classified as 'current investments' and 'long term investments'. A *current investment* is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. A *long term investment* is an investment other than a current investment.[14]

4. The following features of investments have an impact on the related auditing procedures:

(a) Investments constitute a significant portion of the total assets of certain entities like banks, insurance companies, investment companies, trusts, etc. In other cases, the nature, quantum and type of investments may vary from case to case.

(b) Documentary evidence is generally available for audit verification. A detailed record of acquisition, disposal, etc., of the investments is usually maintained.

(c) The market values of investments may keep on fluctuating. While in the case of some investments, such fluctuations may not be wide, in the case of others, they may be significant.

(d) Physical location of documents of title to investments may be different from the one where the acquisition, disposal and recording thereof take place.

(e) Many investments are readily marketable or can be converted into cash.

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[13] It may be clarified that the term 'investments' covers only to such securities as are beneficially owned by the entity and not those held by it on behalf of others.

[14] It may be clarified that inventories, as defined in Accounting Standard (AS) 2, *Valuation of Inventories,* issued by the Institute of Chartered Accountants of India are not investments. However, the recommendations of this Guidance Note also apply, to the extent relevant to shares, debentures and other securities held as stock-in-trade. Fixed assets (other than investment properties), as defined in Accounting Standard (AS) 10, *Accounting for Fixed Assets,* issued by the Institute, are also not investments.

Internal Control Evaluation

5. The auditor should study and evaluate the system of internal control relating to investments to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to investments.[15]

(a) *Control over acquisition, accretion and disposal of investments*: There should be proper authority for sanction, acquisition and disposal of investments (including renunciation of rights). It should also be ensured that investments are made in accordance with the legal requirements governing the entity as also with its internal regulations, e.g., the provisions of the articles of association, rules and regulations, trust deed, etc.

(b) *Safeguarding of investments:* The investments should be in the name of the entity as far as possible. The legal requirements in this behalf, if any, should be complied with. There should exist a proper system for the safe custody of all scrips or other documents of title to the investments belonging to the entity.

(c) *Controls relating to title to investments:* It should be ensured that in cases where the title does not pass on to the entity immediately on acquisition, the same is transferred to the entity in due course of time, along with the benefits that might have accrued since the acquisition of the investments. It should be ensured that there is no undue time-lag in the execution of various stages of the transactions.

(d) *Information controls:* These controls should ensure that reliable information is available for recording acquisitions (including by way of conversion of securities, right issues or other entitlements, under schemes of amalgamation, acquisition, etc.), accretions and disposals, and for ascertaining the market values etc. Detailed records regarding acquisition, disposal etc. of the investments should be maintained along with proper documentation.

[15] The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire,* issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia,* an illustrative list of internal controls in relation to investments.

Verification

6. The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Verification of investments may be carried out by employing the following procedures:

(a) verification of transactions;

(b) physical inspection;

(c) examination of valuation and disclosure; and

(d) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

7. The investments of an entity may take various forms, e.g., they may be in the form of Government securities, shares and debentures, immovable properties, etc. The following paragraphs discuss the audit steps for verifying investments, with special reference to investments in the form of shares, debentures and other securities.

Verification of Transactions

8. The auditor should ascertain whether the investments made by the entity are within its authority. In this regard, the auditor should examine whether the legal requirements governing the entity, insofar as they relate to investments, have been complied with and the investments made by the entity are not *ultra vires* the entity. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict, qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the entity.

9. The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence. The auditor should pay special attention to ascertaining whether the investments have been purchased or sold cum-dividend/ex-dividend, cum-interest/ex-interest, cum-right/ex-right or cum-bonus/ex-bonus. He should check whether proper adjustments in this regard have been made in the cost/sales value of securities purchased or sold.

10. In the case of a rights issue, the offer to the entity contained in the letter of rights should be examined. Where the rights have been renounced or otherwise disposed of or not

exercised, the auditor should examine the relevant decision of the appropriate authority in this behalf, as also that the sale proceeds, if any, have been duly accounted for.

11. As regards bonus shares, the intimation to the entity regarding such issue should be examined with a view to ascertaining the receipt and recording of the requisite number of shares by the entity.

12. Where the amounts of purchases or sales of investments are substantial, the auditor may check the prices paid/received with reference to the stock exchange quotations, where available, on or about the date of purchase or sale.

Physical Inspection

13. The auditor should carry out a physical inspection of investments in the form of shares, debentures and other securities. (Special considerations apply in the case of investments in the form of immovable properties, as discussed in paragraph 24.) In the case of certain entities (e.g., insurance companies), physical inspection of investments is a statutory requirement.

14. The depository services and scripless trading are becoming increasingly popular in India. Depository services involve custody of documents of title to investments such as certificates, scrips and deeds and thus avoid their physical handling by the investor. The Public Debt Office of the Reserve Bank of India offers such services to facilitate trading in Government Securities. Authorised institutions such as banks, financial institutions etc., which have individual ledger accounts with the Public Debt Office can trade in government securities between themselves by issuing and accepting Bankers' Receipts. In case of such transactions, the auditor should verify the periodic reconciliation of balances as per the records of the entity and those as per the Public Debt Office.

15. Apart from the Public Debt Office, there are now a number of other custodial organisations whose services are being utilised by banks, large investors, institutional investors, mutual funds etc. The concept of the National Depository System (NDS) is also under development. This system is aimed at eliminating physical movement of securities for purchases and sales. Wherever the services of any of these custodial or depository organisations are being used by the entity under audit, the auditor should redesign his audit procedures to ensure that there is an effective system of periodic reconciliation of balances as per the records of the entity and those as per the records of the custodial or depository organisation. The auditor should also examine the certificates issued by such organisations confirming the holdings of the entity. The concept of scripless trading being introduced by the National Stock Exchange and the OTC Exchange of India also envisage elimination of

movement of title deeds of securities. In such cases, the auditor should verify the interim and other acknowledgments issued by dealers as well as the year-end confirmation certificates of the depository organisations.

16. The investments held by the entity in its own custody should normally be examined at the close of business on the last day of the year. In case this is not possible, the auditor should carry out the inspection on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc. Where a substantial number of investments are kept by the entity in its custody, the auditor should carry out a surprise inspection of the investments on hand at least once in the year in addition to his year-end examination. He should take particular care to see that only the investments belonging to the entity are produced to him. This aspect assumes special importance in the case of entities like banks which hold investments on their own account, in the form of securities lodged by the customers against loans and advances, and on behalf of the PMS clients.

17. Where investments are held by any other person on behalf of the entity, e.g., by banks, the auditor should examine the certificates received from them. Such certificates should preferably be received directly by the auditor. A suggested form of bank confirmation certificate is given in Appendix II to this Guidance Note.

18. In case investments are held by persons other than banks, the auditor should ensure that there is justification for it, e.g., securities in the custody of brokers or with the company concerned for transfer, consolidation, splitting up conversion, etc. Evidence of securities held with others should be examined and, in appropriate cases, physical inspection of the relevant documents may be made, to the extent possible, in the course of audit. Where the investments are recorded at an office other than the one where the documents of title thereto are physically located, the local auditor may be requested to verify the same.

19. If the investments are held otherwise than in the name of the entity (e.g., in the name of nominees/trustees), the auditor should ascertain the reasons for the same and examine the relevant documentary evidence (e.g., written confirmations from the nominees, trustees, etc.) supporting the real/beneficial interest of the entity in the investments.

20. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, in the case of a company, the auditor should also carry out the procedures outlined in paragraphs 21-23 below.

21. Where shares are held not in the name of the company but in the name of a director, officer, etc., the auditor should examine whether the declaration referred to in section 187-C of the Companies Act, 1956 has been properly made.

22. The auditor should keep in mind the provisions of section 227(1A)(c) which requires that the auditor of a company, not being an investment company within the meaning of section 372 of the Companies Act, 1956 or a banking company, should enquire whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company.[16]

23. In case the entity is a finance, investment, chit fund, *nidhi* or mutual benefit company and is dealing or trading in shares, securities, debentures or other investments, the auditor has to state in his report (by virtue of the requirements of the Manufacturing and Other Companies (Auditor's Report) Order, 1988[17], issued under section 227(4A) of the Companies Act, 1956) whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein as also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemptions granted under section 49 of the Companies Act, 1956.[18]

Immovable Properties

24. Where immovable properties are held as investments, the auditor should verify them in the same manner as in the case of immovable properties held as fixed assets.[19]

Examination of Valuation and Disclosure

25. The auditor should satisfy himself that the investments have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices

[16] For a detailed discussion on this aspect reference may be made to the *Statement on Qualifications in Auditor's Report,* issued by the Institute of Chartered Accountants of India.

[17] Currently, the Companies (Auditor’s Report) Order, 2003 is in force in terms of section 227(4A) of the Companies Act, 1956.

[18] For a detailed discussion on this aspect, reference may be made to the Statement on the Companies (Auditor’s Report) Order, 2003, issued by the Institute of Chartered Accountants of India.

[19] Reference may be made in this regard to the *Guidance Note on Audit of Fixed Assets,* issued by the Institute of Chartered Accountants of India.

and relevant statutory requirements, if any.[20] Appendix III to this Guidance Note discusses, by way of illustration, the disclosure requirements of some of the Acts. The auditor should also examine whether the method of valuation followed by the entity is consistently applied.

26. The auditor should examine whether, in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty, brokerage, etc., is included in the cost of investments.

27. The auditor may ascertain the market value of the quoted securities from official quotations of the stock exchange. In case of unquoted securities, the auditor should ascertain the method adopted by the entity for determining the market value of such securities. He should examine whether the method adopted by the entity is one of the recognised methods of valuation of securities such as break-up value method, capitalisation of yield method, yield to maturity method, etc. In the case of investments other than in the form of securities (e.g., rare paintings), the auditor should examine that the market value has been ascertained on the basis of authentic market reports.

Analytical Review Procedures

28. As a measure of judging the overall reasonableness of the amounts attributed to investments, the auditor may relate the amount of income received from investments with the corresponding figures of investments and compare this ratio with the similar ratio for the previous years. For this purpose, investments may be classified into appropriate categories. Thus, in the case of fixed interest-bearing securities, the auditor may relate the amount of interest earned with the face value of the related securities. In the case of other securities, the auditor may review the schedule of dividend and other returns and the schedule of investments prepared by the entity and judge their reasonableness.

Management Representations

29. The auditor should obtain from the management of the entity a written statement regarding classification and valuation of investments for Balance Sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to investments, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management

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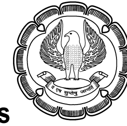
[20] Reference may be made in this regard to Accounting Standard 13, *Accounting for Investments,* issued by the Institute of Chartered Accountants of India.



representation letter regarding investments is given in Appendix IV to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

Documentation

30. The auditor should maintain adequate working papers regarding audit of investments. Among others, he should maintain on his audit file, the management representation letter concerning investments.

APPENDIX I

Legal Requirements Relating to Investments

(Ref. Paragraph 2)

This Appendix contains an illustrative description of the legal provisions regarding investments as contained in the Companies Act, 1956, Banking Regulation Act, 1949, Insurance Act, 1938, and the Cooperative Societies Act, 1912. It may be emphasised that this Appendix is only illustrative in nature and is not intended to give an exhaustive description of all the relevant legal requirements applicable to different types of entities. Moreover, the legal requirements may change from time to time and therefore, this Appendix should not be construed as representing the correct legal position at all points of time.

Provisions of the Companies Act, 1956

The main relevant sections are section 49, section 108, section 292, section 293(1)(c) and section 372, besides requirements of inquiry/reporting under sections 227(1A) and 227(4A).

Section 49 provides that, subject to certain exceptions, investments made by a company on its own behalf shall be made and held by it in its own name.

Section 108 lays down the mode of transfer of shares and debentures and prescribes the period of validity of blank transfers. Sections 108A-108I lay down certain restrictions on acquisition and transfer of shares.

Section 292 provides that the power to invest the funds of a company shall be exercised by its Board of Directors on behalf of the company only by means of resolutions passed at meetings of the Board. However, the Board may, by a resolution passed at a meeting, delegate this

power to any of its committees, the managing director, the manager or any other principal officer of the company. In such case, every resolution delegating the power to invest the funds of the company shall specify the total amount upto which the funds may be invested and the nature of the investments which may be made, by the committee or the person to whom the power to invest is so delegated.

Section 293(1)(c) provides that the Board of Directors of a public company, or of a private company which is a subsidiary of a public company, shall not invest otherwise than in trust securities, the amount of compensation received by it in respect of the compulsory acquisition of any undertaking or of any premises or properties used for any such undertaking except with the consent of the company in a general meeting.

Section 372 provides that a company, whether by itself or together with its subsidiaries, shall not be entitled to acquire, by way of subscription, purchase or otherwise, the shares of any other body corporate except to the extent and except in accordance with the restrictions and conditions, specified in the section.

Provisions of the Banking Regulation Act, 1949

Section 19 of the Act provides that no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less. The above restriction, however, does not apply to the holding by a banking company of shares in its subsidiary. A banking company is also prohibited from holding shares, whether as pledgee, mortgagee or absolute owner, in any company in the management of which, any managing director or manager of the banking company is in any manner concerned or interested.

Section 24 of the Banking Regulation Act provides that every banking company shall maintain in India in cash, gold or unencumbered approved securities, an amount which shall not, at the close of business on any day, be less than twenty-five per cent or such other percentage not exceeding forty, as the Reserve Bank of India may from time to time specify, of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight.

The above provisions also apply to the State Bank of India and its subsidiaries and the nationalised banks.

Provisions of the Insurance Act, 1938

Section 27(B) of the Insurance Act, 1938 provides that no insurer carrying on general insurance business can invest or keep invested any part of his assets otherwise than in any of the approved investments or in other investments which satisfy certain conditions or in certain prescribed assets which are deemed to be approved investments for the purposes of this section.

A general insurance company can invest any part of its assets in investments other than the investments mentioned above, provided that (i) the total amount of all such investments does not exceed 25 per cent of its assets and (ii) the making or the continuance of the investment is with the consent of all the directors, present and eligible to vote, at a meeting, special notice of which, has been given to all directors, then in India. All such investments including investments in which any director is interested must be reported without delay to the Controller of Insurance with full details of the investments and the extent of any director's interest in any such investment.

An insurer cannot invest or keep invested any part of his assets in the shares of any one banking company or investment company more than (a) ten per cent of his assets, or (b) two per cent of the subscribed share capital and debentures of the banking company or investment company concerned, whichever is less.

Further, an insurer cannot invest or keep invested any part of his assets in the shares or debentures of any one company other than a banking company or investment company more than (a) ten per cent of his assets, or (b) ten per cent of the subscribed share capital and debentures of the company, whichever is less.

Where an investment is in partly paid-up shares, the uncalled liability on such shares shall be added to the amount invested, for the purpose of determining whether such investment exceeds the limits referred to above. However, an insurer can subscribe to the right shares notwithstanding the limits specified above.

These limits do not apply to an investment made by an insurer in the shares of any other insurance company carrying on insurance or re-insurance business in India.

The Controller of Insurance can waive for a specified period and with certain conditions, the limits specified above if, on an application from the insurer, he is satisfied that special grounds exist warranting such waiver.

An insurer cannot invest or keep invested any part of his assets in the shares or debentures of any private company.

Provisions of the Cooperative Societies Act, 1912

Section 32 of the Cooperative Societies Act, 1912 provides that a registered society can invest or deposit its funds only:

(a) in Government Savings Banks;

(b) in any of the securities specified in section 20 of the Indian Trusts Act, 1882;

(c) in the shares or on the security of any other registered society;

(d) with any bank or person carrying on the business of banking, approved for this purpose by the Registrar; or

(e) in any other mode permitted by the rules.

APPENDIX II

Illustrative Letter of Confirmation – Investments Held by Banks

(Ref. Paragraph 17)

[Letterhead of entity]

[Date]

.... (Bank)

....

Dear Sirs,

For audit purpose, kindly send directly to our auditors (name and address of the auditors) a certificate regarding all the shares, debentures and other securities belonging to us but lying with you as (i) security against loans and advances to us, or (ii) in safe custody account at the close of business on ……….

For your convenience, we enclose in duplicate a form in which the certificate may be sent. Please send one copy to our auditors, retaining the other for your records. Should you find the space on the form insufficient to contain all the relevant information, please attach a separate statement.

We would request you to state NIL wherever applicable.

Yours faithfully,

(to be signed by person authorised to operate accounts)

APPENDIX III

Disclosure Requirements Relating to Investments

(Ref. Paragraph 25)

To illustrate the manner of disclosure of investments in the financial statements, this Appendix discusses the requirements of the Companies Act, 1956, the Banking Regulation Act, 1949, and the Insurance Act, 1938, insofar as they relate to disclosure of information regarding investments in the financial statements prepared and presented in accordance with the provisions of these statutes. As regards the co-operative societies, the form and content of their financial statements are governed by the rules framed by the State Government concerned. It may be emphasised that, in every case, there should be an adequate disclosure of all relevant information to facilitate proper understanding of the financial statements by the users.

Requirements of the Companies Act, 1956

Schedule VI to the Companies Act, 1956 requires the disclosure of investments in the balance sheet as below:

(1) Investments in Government or Trust Securities.

(2) Investments in shares, debentures or bonds (showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares and showing also in similar details investments in shares, debentures or bonds of subsidiary companies).

(3) Immovable properties.

(4) Investments in the capital of partnership firms.

The above particulars have to be given showing the nature of investments and mode of valuation, for example, cost or market value. Further, the aggregate amount of the company's quoted investments and the market value thereof have to be shown. The aggregate amount of the company's unquoted investments is also required to be shown.

A statement of investments (whether shown under "Investments" or under "Current Assets" as stock-in-trade, separately classifying trade investments and other investments) is required to be annexed to the balance sheet, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures investments have been made (including all investments whether existing on the balance sheet date or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each such body

corporate. In the case of an investment company, i.e., a company whose principal business is the acquisition of shares, stocks, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the share of each partner) are required to be given in the statement.

Requirements of the Banking Regulation Act, 1949

The Third Schedule to the Banking Regulation Act, 1949, requires the investments to be classified under the following heads for the purpose of balance sheet presentation:

I. Investments in India in

(i) Government securities

(ii) Other approved Securities

(iii) Shares

(iv) Debentures and Bonds

(v) Subsidiaries and/or joint ventures

(vi) Others (to be specified)

Total:

II. Investments outside India in

(i) Government securities (including local authorities)

(ii) Subsidiaries and/or joint ventures abroad

(iii) Other investments (to be specified)

Total:

Grand Total: (I &II)

Requirements of the Insurance Act, 1938

The First Schedule to the Insurance Act, 1938 requires the disclosure of investments of an insurer as below: ·

- Deposit with the Reserve Bank of India (Securities to be specified)
- Indian Government Securities
- State Government Securities

- British, British Colonial and British Dominion Government Securities
- Foreign Government Securities
- Indian Municipal Securities
- British and Colonial Securities
- Foreign Securities
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the Indian Government or a State Government
- Bonds, Debentures, Stocks and other securities whereon interest is guaranteed by the British or any Colonial Government
- Bonds, Debentures, stocks and other securities whereon interest is guaranteed by any Foreign Government
- Debentures of any railway in India
- Debentures of any railway out of India
- Preference or guaranteed shares of any railway in India
- Preference or guaranteed shares of any railway out of India
- Railway Ordinary Stocks (i) in India (ii) out of India
- Other Debentures and Debenture stock of companies incorporated (i) in India (ii) out of India
- Other guaranteed and preference stocks and shares of companies incorporated (i) in India (ii) out of India
- Other ordinary stocks and shares of companies incorporated (i) in India (ii) out of India
- Holdings in Subsidiary companies

The book value and the market value have to be shown in respect of the investments. Where the market value is ascertained on a basis other than the published quotations, the manner in which such value has been arrived at, is also required to be disclosed.

APPENDIX IV

Representation Letter for Investments

(Ref. Paragraph 29)

The following is a sample representation letter for investments. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

(Letterhead of Entity)

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Limited as of .... 19…., and for the year then ended, we confirm to the best of our knowledge and belief, the following representations concerning investments.

1. The current investments as appearing in the balance sheet consist of only such investments as are by their nature readily realisable and intended to be held for not more than one year from the respective dates on which they were made. All other investments have been shown in the balance sheet as 'long-term investments'.

2. Current investments have been valued at the lower of cost and fair value. Long-term investments have been valued at cost, except that any permanent diminution in their value has been provided for in ascertaining their carrying amount.

3. In respect of offers of right issues received during the year, the rights have been either been subscribed to, or renunciated or allowed to lapse. In no case have they been renunciated in favour of third parties without consideration which has been properly accounted for in the books of account.

4. All the investments produced to you for physical verification belong to the entity and they do not include any investments held on behalf of any other person.

5. The entity has clear title to all its investments including such investments which are in the process of being registered in the name of the entity or which are not held in the name of the entity. There are no charges against the investments of the entity except those appearing in the records of the entity.

Yours faithfully,

(Signature of responsible official of the entity)

4. GUIDANCE NOTE ON AUDIT OF DEBTORS, LOANS AND ADVANCES*

*The following is the text of the Guidance Note on Audit of Debtors, Loans and Advances issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

1. Paragraph 2.1 of the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Paragraph 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Debtors, Loans and Advances, Chapter-7 of the *Statement* on *Auditing Practices,* titled 'Debtors, Loans and Advances', shall stand withdrawn. In due course of time, the entire *Statement* of *Auditing Practices* shall be withdrawn.

Introduction

3. Debtors, loans and advances may constitute a significant proportion of the total assets of an entity. Debtors represent the amounts due to an entity for goods sold or services rendered or in respect of other similar contractual obligations, but do not include the amounts which are in the nature of loans or advances. Loans represent the claims of an entity in respect of such contractual obligations as moneys lent. Advances represent payments made on account of, but before completion of, a contract or before acquisition of goods or receipt of services. For purposes of this

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* Published in June, 1994 issue of 'The Chartered Accountant'.

** Now known as the Auditing and Assurance Standards Board (AASB).

Guidance Note, debtors, loans and advances include instruments such as bills of exchange, promissory notes and similar other instruments, evidencing debtors, loans and advances.

4. An important feature of debtors, loans and advances which has a significant effect on the related audit procedures is that these assets are represented only by documentary evidence; they have no physical existence. Moreover, the documentary evidence is generally in the form of invoices, loan documents, etc., prepared by the entity itself. The auditor should take these factors into account in designing his audit procedures.

Internal Control Evaluation

5. The auditor should study and evaluate the system of internal control relating to debtors, loans and advances, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to debtors, loans and advances.[21]

(a) In respect of debtors

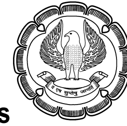
(i) The basis on which credit limits for customers are to be determined should be clearly laid down. The credit limits fixed in respect of individual customers should be approved by an official independent of the sales department. These limits should be checked before orders are accepted from the customers. There should also be a system of periodic review of the credit limits.

(ii) The procedure should ensure prompt recording of debts and realisations and of linking receipts with outstandings.

(iii) There should be a procedure for preparation of aging schedule of debtors at regular intervals. The schedules should be reviewed by a responsible official and necessary action initiated in respect of overdue accounts.

(iv) Statements of account should be sent to all debtors at periodic intervals. They should be prepared and despatched by a person independent of the ledger-keeper. The debtors should be requested to confirm the balances as per the statements with reference to their own records. The confirmations received should be reviewed by a person independent of the ledger-keeper and the

[21] The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chattered Accountants of India in 1976, which contains an illustrative discussion on internal controls in relation to debtors and loans and advances.



person responsible for preparing the statements of account, and necessary action taken in case of discrepancies.

(v) All material adjustments in debtors' accounts, particularly those relating to rebates, allowances, commissions etc., should require approval of the competent authority. Similarly, any write-off of bad debts should require approval of the competent authority.

(vi) There should be a system of periodic reconciliation of various debtor balances with related control accounts.

(b) In respect of loans and advances

(i) As far as possible, the system should specify the following:

- total amount up to which loans may be made;
- the purposes for which loans may be made;
- maximum amount of loans which may be made for each such purpose in individual cases;
- the terms on which such loans may be made;
- the persons who are authorized to make loans;
- procedure for ensuring compliance with relevant legal requirements.

(ii) All variations in the terms of loans and advances should be duly approved in writing by the competent authority.

(iii) Where security is taken against the loans, the form and adequacy of security should be reviewed by a responsible official.

(iv) The loan and security documents should be kept in safe custody of a responsible official. A record of all such documents should be maintained and the documents should be periodically verified with reference to such records.

(v) The system should provide for identification of cases where principal and/or interest have become overdue or where any other terms are not being complied with.

(vi) Confirmation of balances should be obtained at periodic intervals in the same manner as in the case of debtors.

Verification

6. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence).* In carrying out an audit of debtors, loans and advances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Existence	-	that all amounts recorded in respect of debtors, loans and advances are outstanding as at the date of the balance sheet.
Completeness	-	that there are no unrecorded debtors, loans and advances.
Valuation	-	that the stated basis of valuation of debtors, loans and advances is appropriate and properly applied, and that the recoverability of debtors, loans and advances is recognised in their valuation.
Disclosure	-	that the debtors, loans and advances are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

Verification of debtors may be carried out by employing the following procedures:

(a) examination of records;

(b) direct confirmation procedure (also known as 'circularisation procedure');

(c) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor.

Examination of Records

7. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

8. The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with the related control accounts. Any differences in this regard should be examined.

9. Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant debtors, the auditor should

also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

10. While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects:

(a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.

(b) Whether the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.

(c) Whether transfers from one account to another are properly evidenced.

(d) Whether provisions for allowances, discounts and doubtful debts are required. In this regard, the auditor should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.

11. The following are some of the indications of doubtful and uncollectible debts, loans and advances:

(a) The terms of credit have been repeatedly ignored.

(b) There is stagnation, or lack of healthy turnover, in the account.

(c) Payments are being received but the balance is continuously increasing.

(d) Payments, though being received regularly, are quite small in relation to the total outstanding balance.

(e) An old bill has been partly paid (or not paid), while later bills have been fully settled.

(f) The cheques received from the debtor have been repeatedly dishonoured.

(g) The debt is under litigation, arbitration, or dispute.

(h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.

(i) Amounts due from employees, which have not been repaid on termination of employment.

(j) Collection is barred by statute of limitation.

12. Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorisation should be inspected.

13. In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

14. The auditor should examine whether the contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.[22]

Special Considerations in Case of Loans and Advances

15. In general, the procedure outlined above in regard to debtors is also applicable in the case of loans and advances. However, in the case of loans and advances, the auditor may find greater documentary evidence (in the form of loan and security documents and related correspondence) on which he can place reliance.

16. In the case of loans and advances, an important aspect to be examined by the auditor is whether the entity is empowered to make loans. In many cases, the statute governing the entity may contain restrictions or conditions about the amount of loans, purposes for which loans may be granted, parties to which loans may be granted etc. Similarly, the internal regulations of the entity may also prescribe the procedure to be followed for making the loans. For instance, in the case of companies, sections 292, 295 and 370 place restrictions on the making of loans by companies.[23] The competence of the borrower to receive the loan may also affect the legality and, hence, the recoverability of the loan. The auditor should examine the loan documents and other evidence with reference to the above while determining the legality and recoverability of the loans made by the entity.

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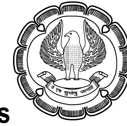
[22] Reference may be made in this regard to Accounting Standard (AS) 4, *Contingencies and Events Occurring* after *the Balance Sheet Date,* issued by the Institute of Chartered Accountants of India.

[23] For a detailed study of this aspect, reference may be made to the Institute's publication titled *A Guide* to *Company Audit.* Similarly, in the case of entities like banks, insurance companies, etc., reference may be made to the relevant publication(s) of the Institute, e.g., *Guidance Note* on *Audit of Banks, Guidance Note on Audit of Companies Carrying* on *General Insurance Business, Guidance Note on Companies Carrying on Life Insurance Business, Guide to Audit of Cooperative Societies,* etc.



17. The auditor should ascertain whether the parties to whom loans and advances have been made have complied with the terms and conditions relating to payment of interest, repayment of loans or adjustment of advances, etc. In the case of defaults, e.g., where the repayment of loans or advances or the payment of interest are overdue, the auditor should consider whether such defaults are indicative of unwillingness or inability of the parties concerned to make the payment.

18. The auditor should pay particular attention to loans and advances given to parties in whom directors or persons who are substantial owners of the entity are interested. He should ascertain the purpose of such loans and advances, the terms and conditions on which they have been made as also their recoverability.

19. The auditor should also examine any other aspects required to be examined or reported upon by the relevant statute. For example, the auditor of a company covered by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, is required to state in his report whether the terms and conditions on which loans and advances have been made are *prima facie* prejudicial to the interests of the company. Similarly, clause (a) of sub-section (1A) of section 227 of the Companies Act, 1956, requires the auditor to inquire "whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

Direct Confirmation Procedure

20. The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. It must be recognised, however, that mere confirmation of balance by a debtor does not by itself ensure ultimate recovery. Moreover, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the debtors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

21. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the

reason as being the fact that there is a dispute with the particular debtor and the request for confirmation may aggravate sensitive negotiations between the entity and the debtor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the debtor. In such a case, alternative procedures should be applied to debtors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

22. The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

23. The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially misstated.

24. The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or ·(b) the 'negative' form of request, wherein the debtor is requested to respond only if he disagrees with the balance shown.

25. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.

26. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of

confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances. An illustrative negative form of request letter is given in Appendix II to this Guidance Note.

27. In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

28. Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should select accounts in respect of which provisions have been made or balances have been written off during the period under audit or earlier years and request confirmation of the balance without considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with nil balances. The nature of the entity's business (e.g., the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

29. In appropriate cases, the debtor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the entity's usual trade terms.

30. The method of selection of the debtors to be circularised should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

31. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those debtors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant debtors from whom he receives no replies despite reminders. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

32. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

Analytical Review Procedures

33. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances:

(a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;

(b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;

(c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule with the corresponding figures for the previous year;

(f) comparison of significant ratios relating to debtors, loans and advances with the similar ratios for other firms in the same industry, if available;

(g) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

Disclosure

34. The auditor should satisfy himself that the debtors, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

Management Representations

35. The auditor should obtain from the management of the entity, a written statement regarding recoverability of debtors and loans and advances and their classification for balance sheet purposes. While such a representation letter serves as a formal acknowledgment of the management's responsibilities with regard to debtors, loans and advances, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial information. A sample management representation letter regarding debtors, loans and advances is given in Appendix III to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

Documentation

36. The auditor should maintain adequate working papers regarding audit of debtors, loans and advances. Among others, he should maintain on his audit file, the confirmations received as well as any undelivered letters of request for confirmation. The management representation letter concerning debtors, loans and advances should also be maintained on the audit file.

APPENDIX I

Illustrative Letter of Confirmation to be Sent to Debtors Positive Form

[Ref. Paragraph 25]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of Rs................. due by you as on ...., as shown by our books, is correct. The details of the balance are as under:[24]

Invoice No.	*Date*	Order Reference or Acceptance or Tender No. etc. (To be used Particularly for Government Customers)	Amount
		Total	_________
		Less : Advance received	_________
		Net Amount due by you (Rs.)	_________

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

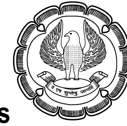
Kindly return this form in its entirety.

Yours Faithfully,

(Signature of responsible official of the entity)

....

[24] In case the list of invoices forming the balance is too large, these details may not be given.



(Do not perforate the form at this point)

(Name and Address of entity)

(A) We confirm that the above stated amount is correct as at ______

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at _________ as per our records are as below:

Invoice No.	Date	Order Reference	Amount
		Total	_________
		Less: Advanced paid	_________
		Net Amount due from us (Rs.)	_________
		Net Amount due from us (Rs.)	_________

Date (Signature of debtor/responsible official)

APPENDIX II

Illustrative Letter of Confirmation to be Sent to Debtors Negative Form

[Ref. Paragraph 26]

[Letterhead of Entity]

[Date]

[Name and address of debtor]

Dear Sir,

For audit purposes, kindly write directly to our auditors (name and address of the auditors) if the balance of Rs.   due by you as on _______ as shown by our books, is not correct, giving details of the differences. The details of the balance are as under:[25]

Invoice No.	*Date*	*Order Reference or Acceptance or Tender No. etc. (To be used particularly for Government Customers)*	*Amount*
		Total	_________
		Less: Advanced paid	_________
		Net Amount due by you (Rs.)	_________

If you do not notify our auditors of any difference within ten days of the date of this letter, it will be presumed that the balance stated above is correct.

A stamped envelope addressed to our auditors is enclosed for your convenience.

Yours faithfully,

(Signature of responsible official of the entity)

[25] In case the list of invoices forming the balance is too large, these details may not be given.

APPENDIX III

Representation Letter for Debtors, Loans and Advances

[Ref. Paragraph 35]

The following is a sample representation letter for debtors, loans and advances. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]

[Date]

[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of ....., 19.., and for the year then ended, we certify that the following items appearing in the books as at ....(date of the Balance Sheet) are considered good and fully recoverable with the exception of those specifically shown as "doubtful" in the Balance Sheet.

Sundry Debtors Rs.

Loans and Advances[26] Rs.

Yours faithfully,

(Signature of responsible official of the entity)

[26] It may be pointed out that a similar certificate regarding deposits made by the entity may also be obtained by the auditor in appropriate cases.

5. GUIDANCE NOTE ON AUDIT OF CASH AND BANK BALANCES*

*The following is the text of the Guidance Note on Audit of Cash and Bank Balances issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices,* issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Cash and Bank Balances, Chapter 6 of the *Statement on Auditing Practices*, titled 'Cash and Bank Balances', shall stand withdrawn.[27] In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

Introduction

3. Cash and bank balances may constitute a significant proportion of the total assets of an entity. An important feature of cash and bank balances which has a significant impact on the related audit procedures is that these assets are highly prone to misappropriation, misapplication and other forms of fraud.

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* Published in November, 1995 issue of 'The Chartered Accountant.

** Now known as the Auditing and Assurance Standards Board (AASB).

[27] The special aspects of audit of cash and bank balances in the case of banks are dealt with in the Guidance Note on Audit of Banks (edn. 2001).

4. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices 5, *Audit Evidence*). In carrying out an audit of cash and bank balances, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Existence	-	that recorded cash and bank balances exist as at the year-end.
Rights and obligations	-	that recorded cash and bank balances represent the assets of the entity.
Completeness	-	that there are no unrecorded cash and bank balances.

Besides the above, in certain situations, the auditor may also be particularly concerned with the valuation of cash and bank balances, e.g., in the case of foreign currency held by the entity or in the case of bank accounts designated in foreign currencies.

Internal Control Evaluation

5. The auditor should study and evaluate the system of internal control relating to cash and bank balances to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to cash and bank balances.[28]

(a) segregation of duties relating to authorisation of transactions, handling of cash/issuance of cheques and writing of books of account, and rotation of the duties periodically;

(b) proper authorisation of cash and banking transactions;

(c) daily recording of cash transactions;

(d) safeguards such as restrictive crossing of cheques, use of pre-printed, pre-numbered forms;

(e) periodic reconciliation of bank balances;

(f) reconciliation of cash-on-hand with book balance on a daily basis or at other appropriate intervals, including surprise checks by higher authorities;

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[28] The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the *Internal Control Questionnaire*, issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia*, an illustrative list of internal controls in relation to cash and bank balances.

(g) safe custody of cash, cheque books, receipt books etc.; and

(h) cash/fidelity insurance.

Verification

6. Verification of cash and bank balances may be carried out by employing the procedures described in paragraphs 7-27. It may, however, be emphasised that the nature, timing and extent of substantive procedures to be performed is a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

Verification of Cash Balances

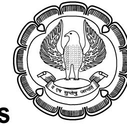
7. The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

8. All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be verified at the same time so as to avoid chances of cash balances of one entity being presented as those of another.

9. If IOUs ('I owe you') or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

10. The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

11. If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, he should carry out



surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

12. Where postdated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

Verification of Bank Balances

13. The auditor should advise the entity to send a letter to all its bankers to, directly confirm the balances to the auditor. The Appendix to this Guidance Note gives an illustrative proforma letter of request for confirmation to be used for this purpose. The request for confirmation should also cover dormant accounts as well as accounts closed during the year.

14. The auditor should examine the bank reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statements as at other dates during the year. It should be examined whether (i) cheques issued by the entity but not presented for payment, and (ii) cheques deposited for collection by the entity but not credited in the bank account, have been duly debited/credited in the subsequent period. For this purpose, the bank statements of the relevant period should be examined. If the cheques issued before the end of the year have not been presented within a reasonable time, it is possible that the entity might have prepared the cheques before the end of the year but not delivered them to the parties concerned. In such a case, the auditor should examine that the entity has reversed the relevant entries.

15. Where the auditor finds that post-dated cheques are issued by the entity, he should verify that any cheques pertaining to the subsequent period have not been accounted for as payments during the period under audit.

16. The auditor should pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/write-off.

17. The auditor should be alert to the possibility that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

18. Where a large number of cheques has been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques has subsequently remained unpaid/uncleared, this may indicate an intention of understating creditors/debtors or understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances.

19. The procedures discussed in paragraph 18 should also be considered by the auditor in cases where a large number of cheques is on hand at the date of the balance sheet and a sizable proportion of such cheques has subsequently remained undeposited/uncleared.

20. In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

21. In respect of fixed deposits or any other type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined.

22. Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

23. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

24. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

25. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

Examination of Valuation and Disclosure

26. The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.[29] In this regard, the auditor should examine that following items are not included in cash and bank balances:

(a) Temporary advances.

(b) Stale or dishonoured cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

27. The auditor should also examine that suitable disclosures as mentioned in paragraphs 20 and 24 above are made in relevant cases.

APPENDIX

Illustrative Letter of Confirmation – Bank Balances

(Ref. Paragraph 13)

[Letterhead of Entity]

[Name and Address of Bank] [Date]

Dear Sirs,

Please send directly to our auditors .... (name and address of the auditors) details of balances as at the close of business on [date] .... of all our accounts with you as well as details of charges held against such balances, with a copy to us. For your convenience, we enclose in duplicate a form in which details of our balances with you can be filled in. If you find the spaces on the form insufficient to contain all the relevant information, please attach a separate statement.

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[29] For valuation of foreign currency held as cash-in-hand and bank balances designated in foreign currencies, reference may be made to Accounting Standard 11, Accounting for the Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.

Please note that this request covers all our accounts with you as at the above-mentioned date, including any dormant accounts. We would also request you to give particulars of any of our accounts closed during the year. We would request you to state "Nil", wherever applicable.

Yours faithfully,
(Signature of person authorised to operate accounts)

____

Reply from
(Bank)

[Name and Address of Auditors]

Dear Sirs, Date: ________

Re : (Name of Client)

At the request of our clients, we submit below particulars of their accounts, Investments, bills, etc., as at the close of business on .... as shown by our records.

1. *Current Accounts in Credit*

   Designation of Account Amount

2. *Overdrawn Current Accounts, Overdraft Accounts or Cash Credit Accounts.*

   Designation of Account Amount Security held (give brief description. In the case of securities please list fully)

3. *Loan Accounts*

   Designation of Account Amount Security held (give brief description. In the case of securities please list fully)

4. *Fixed, Call and Short Deposit Accounts*

   Amount Interest Accrued to the closing date Due Date Particulars of any charges of liens

5. *Investments and Other Documents of Title Held in Safe Custody*

   Designation. Face value or number of shares held.

6. *Margin against letters of credit Guarantees issued, etc.*

Designation of Account	Amount	

7. *Bills for Collection*

Designation of Account	Amount	Due date

8. *Bills Discounted or Purchased.*

Name of Drawee	Amount	Due date

9. *Letters of Credit Open and Outstanding*

In favour of	Amount not utilised	Valid upto

10. *Guarantees given on behalf of clients*

In favour of	Amount.	Date of expiry

We certify that the above particulars are full and correct and do not exclude any other obligations of the entity to us.

Yours faithfully,

Name of Bank
Designation of Signatory

6. GUIDANCE NOTE ON AUDIT OF MISCELLANEOUS EXPENDITURE [REVISED][*]

Introduction

1. The following is the text of the Guidance Note on Audit of Miscellaneous Expenditure. This Guidance Note provides guidance on audit procedures to be applied while auditing miscellaneous expenditure. This Guidance Note also provides guidance for audit of items that generally constitute miscellaneous expenditure when Accounting Standard (AS) 26, Intangible Assets comes into effect or is voluntarily applied by an enterprise in accounting for intangible assets. This Guidance Note, however, does not provide any guidance on audit of intangible assets that are recognised in accordance with AS 26. The guidance provided herein is restricted to only those items which were hitherto (before application of AS 26—whether mandatory or otherwise) being classified as items of miscellaneous expenditure, but because of application of AS 26, accounting treatment of such items would change.

2. 'Miscellaneous expenditure' shown in the balance sheet of companies (or shown under this or some other appropriate heading in the balance sheet of other enterprises) embraces within its fold a variety of items of expenditure which are not entirely charged to income in the year in which they are incurred, but are carried forward in the balance sheet to be written-off in subsequent periods. Unless some benefit from the expenditure can reasonably be expected to be received in future and unless the amount of such benefit is reasonably determinable, there is no justification for carrying forward the expenditure for being written-off in subsequent periods. Also, the amount of expenditure to be carried forward should not exceed the expected future revenue/other benefits related to the expenditure.

3. The Guidance Note deals with the audit considerations related to the following items that normally constitute 'miscellaneous expenditure':

(a) preliminary expenses;

[*] Issued in September, 2003. The Guidance Note on Audit of Miscellaneous Expenditure shown in the Balance Sheet shall stand withdrawn in respect of audit of financial statements of enterprises for which AS 26, "Intangible Assets" has become mandatory and in respect of entity that has chosen to apply AS 26 to account for intangible assets.

(b) expenses including commission or brokerage on underwriting or subscription of shares or debentures including discount allowed on the issue of shares or debentures;

(c) research and development expenditure, etc.

4. The Council of the Institute of Chartered Accountants of India has issued Accounting Standard (AS) 26, 'Intangible Assets'. The objective of this AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The accounting standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets. Consequently, the accounting treatment of some of the items that generally constitute 'miscellaneous expenditure' would change as and when an enterprise adopts Accounting Standard 26 'Intangible Assets' to account for intangible assets.

5. Accounting Standard (AS) 26, 'Intangible Assets' comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory from that date. The Accounting Standard, however, encourages earlier application.

6. In respect of intangible items appearing in the balance sheet as on the aforesaid date, i.e., 1-4-2003 or 1-4-2004, as the case may be, the Standard has limited its application as stated in paragraph 99 of AS 26. From the date of this Standard becoming mandatory for the concerned enterprises, the following stand withdrawn:

(i) Accounting Standard (AS) 8, Accounting for Research and Development;

(ii) Accounting Standard (AS) 6, Depreciation Accounting, with respect to the amortisation (depreciation) of intangible assets; and

(iii) Accounting Standard (AS) 10, Accounting for Fixed Assets - paragraphs 16.3 to 16.7, 37 and 38.

7. Since AS 26, applies to different entity from different dates, it may happen that certain enterprises, till the date the standard becomes mandatory for them may continue to defer the expenditure incurred on items that normally constitute "miscellaneous expenditure". Once an entity applies AS 26 to account for intangible assets, the expenditure incurred on items that normally constitute miscellaneous expenditure shall be governed by the Standard, except in the case of already appearing miscellaneous expenditure in the balance sheet which is to be accounted for using paragraph 99 of AS 26.

8. The following features of miscellaneous expenditure have an impact on the related audit procedures.

(a) The items of expenditure included under this heading do not represent any tangible asset.

(b) The expenditure on these items is usually of a non-recurring nature.

(c) There is a justification for deferring the expenditure on the basis that the benefits from the expenditure can reasonably be expected as flowing into the future the amount of such benefits is reasonably determinable, and the amount of deferred expenditure does not exceed the expected future benefits related thereto.

(d) Unless some fresh expenditure is incurred, the balance in these items reduces each year by the amount written-off in the year.

9. The auditor's primary objective in audit of items that generally constitute miscellaneous expenditure is to satisfy himself that —

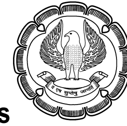
(a) in case where some items are shown in the balance sheet under the head Miscellaneous Expenditure whether it is proper to defer the expenditure;

(b) in case where some items are shown in balance sheet under the head 'Miscellaneous Expenditure', the period of amortisation of the expenditure is reasonable;

(c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;

(d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue/other benefits related to the expenditure continue to exceed the amount of unamortised expenditure.

(e) Where the entity has applied AS 26, for accounting for items that normally constitute miscellaneous expenditure, whether the same has been done in accordance with the Standard and the already appearing items under the head miscellaneous expenditure have been dealt with in accordance with paragraph 99 of AS 26.



Internal Control Evaluation

10. The auditor should study and evaluate the system of internal control relating to the various items of miscellaneous expenditure to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects.

(a) There should be a system of control over expenditure incurred on these items. An effective method of exercising such control is budgeting which, apart from ensuring proper authorisation of the expenditure incurred, also shows in general how effectively such expenditure is being controlled. This is accomplished through periodical comparisons of actual with budgeted figures.

(b) Accountability should be established over each item of such expenditure. This can be achieved, inter alia, by up-to-date maintenance of proper records.

(c) The system should ensure that reliable information (including reports of experts) is available for assessment of the results achieved against the objectives and estimates of the expenditure determined originally.

Verification

11. The nature, timing and extent of substantive procedures to be performed are matters of professional judgment of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

12. While verifying an item of miscellaneous expenditure in the year in which the relevant expenditure is incurred, the auditor should satisfy himself regarding the amount of such expenditure and its deferral as also regarding the reasonableness of the period of amortisation of the expenditure. Till the amount is fully amortised, the auditor should examine every year that a proper amount is amortised during the year by way of a charge to income for the year (and not as its appropriation). The auditor should also examine every year that the criteria which previously justified the deferral of the expenditure continue to be met. If those criteria no longer apply, the auditor should examine whether the unamortised balance has been charged as expense immediately. Where the auditor finds that the criteria for deferral continue to be met but the amount of unamortised balance of the expenditure exceeds the expected future revenue/other benefits related thereto, the auditor should examine whether such excess has been charged as an expense immediately.

13. The applicability of AS 26 on items that generally constitute miscellaneous expenditure and special considerations in audit of various items of miscellaneous expenditure when AS 26 is applied are discussed in subsequent paragraphs of this Guidance Note.

Preliminary Expenses

14. Preliminary expenses are the expenses relating to the formation of an enterprise. For example, in the case of a company, preliminary expenses would normally include the following.

(a) Legal cost in drafting the memorandum and articles of association.

(b) Fees for registration of the company.

(c) Cost of printing of the memorandum and articles of association and statutory books of the company.

(d) Any other expenses incurred to bring into existence the corporate structure of the company.

15. Paragraph 55 of AS 26 requires that expenditure on an intangible item should be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria laid down in paragraphs 19-54 of AS 26; or

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

16. Paragraph 56 of AS 26 provides some examples where the expenditure is recognised as an expense when it is incurred. The examples given include, expenditure on start-up of activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs).

17. Preliminary expenses, therefore, incurred on or after the date on which the Standard becomes mandatory for an enterprise or the preliminary expenses incurred on or after the date on which the enterprise opts to apply the Standard in the preparation and presentation of financial statements would be written off in the year in which they are incurred. The expenditure on preliminary expenses shall not be carried forward in the balance sheet to be written off in subsequent accounting periods.

18. Preliminary expenses already shown in the balance sheet on the date the Standard is first applied would be required to be accounted for in accordance with the requirements laid down by paragraph 99 of AS 26.

19. The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined. In addition to the audit procedures mentioned above, the auditor should also apply the following audit procedures with regard to preliminary expenditure:

(a) The auditor should verify whether the preliminary expenses incurred on or after the date the Standard is applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred.

(b) In the case of preliminary expenses already appearing in the balance sheet on the date the Standard is applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of the preliminary expenses is appropriate.

(c) The auditor should verify whether the carrying amount of the preliminary expenses already appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.

(d) The auditor should satisfy himself that the preliminary expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.

Expenses Related to Subscription or Issue of Shares

20. Expenses related to subscription or issue of shares include commission or brokerage on underwriting or subscription of shares or debentures, discount allowed on issue of shares or debentures. AS 26 excludes from its scope certain activities or transactions which are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such accounting issues, inter alia, are accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares.

21. The auditor should examine whether the payment of brokerage, commission, etc., is authorised by articles of association or other rules/regulations and is in accordance with the provisions of the relevant statute.

22. The auditor should also examine whether the rates of commission paid or payable to brokers and underwriters are in accordance with the disclosures made in the prospectus. The auditor should verify the commission with reference to the agreements with brokers and underwriters.

23. The auditor should examine the certificate issued by the merchant bankers with regard to commission payable to underwriters, and ensure that the payment made to underwriters is in accordance with such certificate.

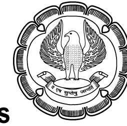
24. Other expenses on issue of shares or debentures, such as fees of the managers to the issue, fees of the registrars to the issue including mailing and handling charges, fees of the advisors to the issue, advertisement expenses, expenses on printing and supply of prospectus and application forms, expenses on printing of share/debenture certificates, etc., should be verified with reference to supporting documents such as invoices, agreements, etc. The auditor should also examine whether the limits on such expenses as laid down in the applicable statute have been complied with.

Research and Development Expenditure

25. Entities generally incur expenditure on research and development activities. Paragraph 41 of AS 26, Intangible Assets provides that no intangible asset arising from research or from the research phase of an internal project should be recognised and should therefore, be charged as an expenses, as and when incurred. According to AS 26, expenditure incurred in the development or during the development phase of an enterprise is required to be recognised as an intangible asset if, and only if, the requirements of paragraph 44 of AS 26 are met. It may be noted that the expenditure incurred on research or incurred during the research phase of an enterprise are required to be recognised as an expense when such expenses are incurred.

26. The expenditure, therefore, incurred in the development or during the development phase of an enterprise on or after the date on which the Standard becomes mandatory for an enterprise or the preliminary expenses incurred on or after the date on which the enterprise opts to apply the Standard in the preparation and presentation of financial statements would be recognised as an asset if the requirements of paragraph 44 of AS 26 are met. Where the expenditure qualifies to be recognised as an intangible asset then the requirements, related to carrying amount of the intangible asset, its amortisation and disclosures, laid down by AS 26 shall apply to the development expenditure.

27. The development expenditure shown in the balance sheet on the date on which the Standard is first applied shall be accounted for in accordance with the requirements of paragraph 99 of AS

26 from that date. If any expenditure incurred on the research or during the research phase of an enterprise already appears in the balance sheet, the same shall also be required to be accounted for in accordance with paragraph 99 of AS 26 from the date the Standard is first applied by the enterprise.

28. The auditor should perform the following audit procedures with regard to research and development expenditure:

(a) The auditor should verify the research expenditure and development expenditure with reference to supporting documents such as purchase invoices, agreements with third parties etc. A variety of expenses may be incurred by an enterprise during the research phase or development phase of an enterprise. The auditor should apply the procedures mentioned in the Guidance Note on Audit of Expenses with regard to the items of expenditure covered therein.

(b) The auditor should verify that the expenses incurred on research or incurred during the research phase of an internal project on or after the date the Standard is first applied by the enterprise are entirely charged to the profit and loss account in the year in which they are incurred;

(c) In the case of research and development expenses already appearing in the balance sheet on the date the Standard is first applied, the auditor should satisfy himself that the estimate made by the management of the enterprise of the useful life of such expenses is appropriate;

(d) The auditor should verify whether the carrying amount of the research and development expenses already appearing in the balance sheet is eliminated with a corresponding adjustment to the opening balance of the revenue reserve in case the amortisation period determined under paragraph 63 of AS 26 has already expired.

(e) The auditor should satisfy himself that the research and development expenses already appearing in the balance sheet are being amortised in accordance with the requirements of AS 26 in case the amortisation period determined under paragraph 63 of AS 26 has not expired.

(f) The auditor should also examine that the intangible asset recognised is accounted for in accordance with the requirements of AS 26.

(g) Where an intangible asset has been recognised, the auditor should verify whether the asset so recognised is tested for impairment in accordance with Accounting Standard (AS) 28, Impairment of Assets. The auditor should examine whether the test of

impairment is appropriate and where impairment has occurred, an impairment loss has be provided for in the financial statements.

Other Items

29. Expenditure during construction period includes a variety of expenditure. Some of the expenditure during construction period may also constitute miscellaneous expenditure. Where an enterprise applies AS 26 to account for intangible assets, either voluntarily or is required to do so by operation of the accounting standard itself, the accounting treatment of some of the items of expenditure during construction period might be governed by the principles enunciated in AS 26. The auditor, in such cases, should verify the expense incurred during the construction period with reference to the supporting documents, such as, invoices, contracts, etc., relating to those expenses. The auditor should also verify that the requirements of AS 26 have been complied with in accounting for such items.

30. In case where an enterprise does not apply AS 26 to account for intangible assets because it is not required to do so, the auditor apart from verifying the expense incurred during the construction period with reference to the supporting documents, such as, invoices, contracts, etc., relating to those expenses should also examine whether the deferral and the amortisation of expenditure incurred during the construction period are in accordance with recognised accounting policies and practices (see, for example, Guidance Note on Treatment of Expenditure During Construction Period, issued by the Institute of Chartered Accountants of India). Where the entity incurs heavy expenditure of a revenue nature during the year, the benefits of which are likely to extend beyond that year, the expenditure may sometimes be deferred and written-off over the number of years for which the benefits are expected to be derived by the entity. Some instances of such expenditure are removal of business from one location to another and massive advertisement in one year to introduce a product or develop a market. In such cases, the auditor should examine whether the deferred of the expenditure meets the relevant criteria and whether the amount of periodic write-off of the expenditure is appropriate.

Disclosures

31. The auditor should examine whether the financial statements contain adequate disclosures as required by AS 26. The auditor should also examine that the financial statements disclose the accounting policy with regard to miscellaneous expenditure. On the first occasion when AS 26 is applied by an enterprise for accounting for items of miscellaneous expenditure, the financial statements should also disclose the change in accounting policy with regard to miscellaneous expenditure in accordance with the requirements of paragraph 32 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

7. GUIDANCE NOTE ON AUDIT OF LIABILITIES*

*The following is the text of the Guidance Note on Audit of Liabilities issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

1. Para 2.1 of the *Preface to the Statements on Standard Auditing Practices* issued by the Institute of Chartered Accountants of India states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAPs or Guidance Notes as appropriate, on the matters covered by such Statements which would then stand withdrawn. With the issuance of this Guidance Note on Audit of Liabilities, Chapter 9 of the *Statement on Auditing Practices*, titled 'Liabilities', shall stand withdrawn. In due course of time, the entire *Statement on Auditing Practices* shall be withdrawn.

Introduction

3. Liabilities are the financial obligations of an enterprise other than owners' funds.

4. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable.

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* Published in December, 1995 issue of 'The Chartered Accountant'.

** Now known as the Auditing and Assurance Standards Board (AASB).

5. Special considerations may apply in the case of audit of liabilities of specialised entities like banks, financial institutions and venture capital funds.

6. Liabilities generally constitute a significant proportion of the total sources of funds of an entity. The audit of liabilities is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement of liabilities vitiates the true and fair view of the financial statements.

7. An important feature of liabilities which has a significant effect on the related audit procedures is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

8. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions [see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence*]. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself that all known liabilities are recorded and stated at fair and reasonable amounts.

Internal Control Evaluation

9. The auditor should study and evaluate the system of internal control relating to liabilities to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to liabilities.[30]

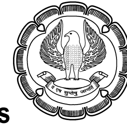
(a) In respect of loans and borrowings (including advances and deposits)

(i) As far as possible, the following should be clearly specified:

- the borrowing powers and limits;
- persons authorised and competent to borrow;
- terms of borrowings;
- procedure for ensuring compliance with relevant legal requirements/internal regulations.

(ii) Any variations in the terms of loans and borrowings should be truly approved/ratified in writing by competent authority.

[30] The extent of review of controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the Internal Control Questionnaire, issued by the Institute of Chartered Accountants of India, which contains, *inter alia,* an illustrative list of internal controls in relation to creditors and borrowings.



(iii) Security offered against loans and borrowings should be properly recorded and periodically reviewed.

(iv) The records and documents should be kept in proper custody and reviewed periodically.

(v) The system should bring out all cases of non-compliance with terms and conditions including amounts of principal and/or interest which have become overdue.

(vi) Confirmation of balances should be obtained at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.

(vii) There should be a proper procedure for year-end valuation of loans and borrowings, especially for those designated in foreign currencies.[31]

(b) In respect of Trade Creditors

(i) The procedure should ensure proper recording of transactions and facilitate the linking of payments with outstandings.

(ii) The payments made to creditors should be in line with the approved policies of the entity.

(iii) There should be specific procedures for payments against duplicate invoices or other duplicate records as well as for payments against accounts which have remained unclaimed for quite some time.

(iv) There should be a procedures for preparation of schedules of trade creditors at periodic intervals; this should be reviewed by a responsible person and necessary action initiated on overdue accounts.

(v) Statements of account should be called for creditors at periodic intervals and the discrepancies, if any, should be duly investigated and reconciled.

(vi) All adjustments in the creditors' accounts such as those relating to claims for returns, defectives, short receipts of goods, rebates, allowances and commissions etc., should require approval of competent authority. Similarly, any write-back of creditors' balances and escalation claims should be approved by competent authority.

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[31] Reference may be made in this regard to Accounting Standard 11 (revised 2003), *Effects of Changes in Foreign Exchange Rates*, issued by the Institute of Chartered Accountants of India.

(vii) There should be appropriate cut-off procedures in relation to transactions affecting the creditor accounts.

(c) In respect of other current liabilities, trade deposits and provisions

The internal control procedures as spelt out above for loans and borrowings and creditors broadly apply in relation to these items.

10. In respect of contingent liabilities, the auditor should examine whether the internal control system of the entity provides for a procedure for identifying and estimating such liabilities and for periodic review of the same.

Verification

11. Verification of liabilities may be carried out by employing the following procedures:

(a) examination of records;

(b) direct confirmation procedure;

(c) examination of disclosure;

(d) analytical review procedures,

(e) obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

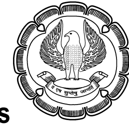
Examination of records

Loans and Borrowings

12. The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.

13. The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.

14. In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.



15. The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.

16. Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

17. In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

18. Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.

19. Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such instalments.

20. The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

21. The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

Trade Creditors and Other Current Liabilities

22. The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the creditor accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately before the year-end and verify that the related invoices have been recorded as purchases of the current year.

23. The auditor should check that the total of the creditors' balances agrees with the related control account, if any; the difference, if any, should be examined.

24. The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of creditors/acceptances.

25 The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.

26. While examining schedule of creditors and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:

(a) long outstanding items;

(b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;

(c) liabilities not correlated/adjusted against related advances;

(d) authorisation and correctness of transfers from one account to another.

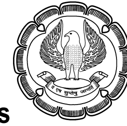
Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.

27. In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.

28. The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

Provisions

29. The term ‘provision’ means amounts retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy. Provisions include those in respect of depreciation or diminution in the value of assets, product warranties, service contracts and guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however, does not deal with provisions for depreciation or diminution in the value of assets.



30. The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.

31. *Provisions for Taxes and Duties*: The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

32. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date* issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

33. In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.[32]

[32] Reference may be made in this regard to the Accounting Standard (AS) 22, Accounting for Taxes on Income issued by the Institute of Chartered Accountants of India.

34. *Provision for Gratuity*: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or· in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity.[33] The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine whether the method followed by it for calculating the accruing liability for gratuity is rational.

35. *Provision for Bonus*: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

36. *Provision for Dividends*: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

37. *Other Provisions*: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

Contingent Liabilities

38. The term 'contingent liabilities' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not

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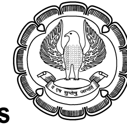
[33] Reference may be made in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*, issued by the Institute of Chartered Accountants of India.



merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities.[34] Some of the instances giving rise to contingent liabilities are:

(a) law suits, disputes and claims against the entity not acknowledged as debts:

(b) membership of a company limited by guarantee.

39. The following general procedures may be useful in verifying contingent liabilities.

(a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.

(b) Review of contracts, agreements and arrangements.

(c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.

(d) Review of terms and conditions of grants and subsidies availed under various schemes.

(e) Review of records relating to contingent liabilities maintained by the entity.

(f) Enquiry of, and discussions with, the management and senior officials of the entity.

(g) Representations from the management.

40. The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

Direct Confirmation Procedure

41. The verification of balances by direct communication with creditors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. However, the utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, that it is unlikely that adequate response would be received from the creditors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

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[34] Reference may be made in this regard to the Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*, issued by the Institute of Chartered Accountants of India.

42. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain creditors. In such cases, the auditor should consider whether there are valid grounds for such a request. For example, the management may explain the reason as being the fact that there is a dispute with the particular creditor and the request for confirmation may aggravate sensitive negotiations between the entity and the creditor. Before accepting a refusal as justified, the auditor should examine any available evidence to support the management's explanations, e.g., correspondence between the entity and the creditor. In such a case, alternative procedures should be applied to creditors not subjected to confirmation. In appropriate cases, the auditor may also need to re-consider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations,

43. The confirmation date, the method of requesting confirmations, and the particular creditors from whom confirmation of balances is to be obtained are to be determined by the auditor. While determining the information to be obtained, the form of confirmation, as well as the extent and timing of application of the confirmation procedure, the auditor should consider all relevant factors such as the effectiveness of internal control, the apparent possibility of disputes, inaccuracies or irregularities in the accounts, the probability that requests will receive consideration, and the materiality of the amounts involved.

44. The creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Where the auditor decides to seek confirmation from the creditors at a date other than the balance sheet date, he should examine the movements in creditor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that creditor balances stated in the balance sheet are not materially misstated.

45. The form of requesting confirmation from the creditors may be either (a) the 'positive' form of request, wherein the creditor is requested to respond whether or not he is in agreement with the balance shown, or(b) the ‘negative’ form of request, wherein the creditor is requested to respond only if he disagrees with the balance shown.

46. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reason to believe that there may be a substantial number of accounts in dispute or with inaccuracies

or irregularities. An illustrative positive form of request letter is given in Appendix I to this Guidance Note.

47. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the creditors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same: degree of assurance with respect to the creditor balances. An illustrative negative form of request letter is given in Appendix II to this Guidance Note.

48. In many situations, it may be appropriate to use the positive form for creditors with large balances and the negative form for creditors with small balances.

49. Where the number of creditors is small, all of them may be circularised, but if the creditors are numerous, this may be done on a sample basis. The sample list of creditors to be circularised, in order to be meaningful, should be based on a complete list of all creditor accounts. While selecting the creditors to be circularised, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and supplier accounts with debit balances. In addition, the auditor should select accounts in respect of which balances have been written back to the profit and loss account. In such cases, the auditor may decide that the balance as per the books of the entity may not be stated in the request letter sent to the creditors concerned; instead, the creditors may be asked to intimate the balance as per their records. The auditor may also consider including in his sample some of the accounts which have been fully squared up. The nature of the entity's business and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the creditors as a whole.

50. In appropriate cases, the creditor may be sent a copy of his complete ledger account for a specific period as shown in the entity's books. This procedure is more likely to reveal errors and fraud and may be particularly useful in the case of large accounts involving many entries, or where there is evidence that accounts are in dispute or are not being settled in accordance with the usual trade terms.

51. The method of selection of the creditors to he circularised should not be revealed to the entity until the trial balance of the creditors' ledger is handed over to the auditor. A list of creditors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should

maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

52. Where positive form of request is used, the auditor may, in appropriate cases, request the entity to follow up with a reminder to those creditors from whom he receives no replies. In exceptional circumstances, the auditor may also correspond directly with those significant creditors from whom he receives no replies despite reminders, with intimation to the entity. In the event of inadequacy of responses received, the auditor will have to increase the extent of examination of records and analytical review procedures beyond that planned originally.

53. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of creditors taken as a whole.

Examination of Disclosure

54. The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

55. In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

56. The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

57. The auditor should examine that the following have been disclosed in respect of contingent liabilities:

(a) nature of each contingent liability;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect or a statement that such estimate cannot be made.

Analytical Review Procedures

58. In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions:

(a) comparison of closing balances of loans and borrowings, creditors, etc., with the corresponding figures for the previous year;

(b) comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;

(c) comparison of actual closing balances of loans and borrowings, creditors, etc., with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule of creditors with the corresponding figures for the previous year;

(e) comparison of significant ratios relating to loans and borrowings, creditors, etc., with the similar ratios for other firms in the same industry, if available;

(f) comparison of significant ratios relating to loans and borrowings, creditors, etc. with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor

Special Considerations in the Case of a Company

59. In addition to the procedures described above, the auditor· should also employ the following procedures in the case of audit of a company.

(a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1(d) of the Companies Act, 1956 are complied with.

(b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.

(c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are *prime facie* prejudicial to the interest of the company.[35]

(d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.

(e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed thereunder regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.

(f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax. sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.[36]

(g) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and

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[35] Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

[36] Reference may also be made in this regard to the *Statement on the Companies (Auditor's Report) Order, 2003* issued by the Institute of Chartered Accountants of India.

any variations thereof and necessary approvals/clearances for· the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

Management Representations

60. The auditor should obtain from the management of the entity a written statement that all known liabilities have been recorded in the books and that all contingent liabilities have been properly disclosed. While such a representation letter serves as a formal acknowledgment of the management's responsibilities for proper accounting and disclosure of the relevant items, it does not relieve the auditor of his responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his opinion on the financial statement. A sample management representation letter regarding liabilities and contingent liabilities is given in Appendix III to this Guidance Note. It may be mentioned that the representations made in the letter can alternatively be included in the composite representation letter usually issued by the management to the auditor.

Documentation

61. The auditor should maintain adequate working papers regarding audit of liabilities and contingent liabilities. Among others, he should maintain on his audit file, confirmations received as well as any undelivered letters of request for confirmation. The management representation letter contingent liabilities and contingent liabilities should also be maintained on the audit file.

8. GUIDANCE NOTE ON AUDIT OF REVENUE*

*The following is the text of the Guidance Note on Audit of Revenue issued by the Auditing Practices Committee (APC)** of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.*

1. Para 2.1 of the 'Preface to the Statements on Standard Auditing Practices', issued by the Institute of Chartered Accountants of India, states that the "main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute." Para 2.4 of the Preface states that the "APC will issue Guidance Notes on the issues arising from the SAPs wherever necessary."

2. The Auditing Practices Committee has also taken up the task of reviewing the Statements on auditing matters issued prior to the formation of the Committee. It is intended to issue, in due course of time, SAs or Guidance Notes, as appropriate, on the matters covered by such Statements which would then stand withdrawn. Accordingly, with the issuance of this Guidance Note on Audit of Revenue, paragraph 11.1 of Chapter 11 of the Statement on Auditing Practices, titled 'Profit and Loss Account', shall stand withdrawn. In due course of time, the entire Statement of Auditing Practices shall be withdrawn.

Introduction

3. Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an entity from the sale of goods, from the rendering of services, and from the use by others of entity resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. The term 'revenue' covers only the gross inflow of cash, receivables or other consideration, as aforesaid, received or receivable by the entity on its own account. Amounts collected on behalf of third parties are excluded from revenue. For example, in an agency relationship, revenue from the view point of the

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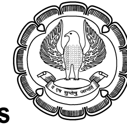
* Published in May, 1997 issue of 'The Chartered Accountant'.

** Now known as the Auditing and Assurance Standards Board (AASB).



agent is the amount of commission receivable by him and not the gross amount of cash, receivables or other consideration collected by him on behalf of the principal.

4. This Guidance Note deals with the audit of the following types of revenue (dealt with in Accounting Standard (AS) 9, *Revenue Recognition,* issued by the Institute of Chartered Accountants of India) arising in the course of the ordinary activities of an entity:

- Sale of goods.
- Rendering of services.
- Use by others of entity resources yielding interest, royalties and dividends.

5. In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see Statement on Standard Auditing Practices (SAP) 5, *Audit Evidence).* In carrying out an audit of revenue, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Occurrence	–	that recorded revenue arose from transactions which took place during the relevant period and pertain to the entity.
Completeness	–	that there is no unrecorded revenue.
Measurement	–	that revenue is recorded in the proper amounts and is allocated to the proper period.
Presentation and Disclosure	–	that revenue is disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

Internal Control Evaluation

6. The auditor should study and evaluate the system of internal control relating to revenue, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to revenue:[37]

[37] The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire" issued by the Institute of Chartered Accountants of India in 1976, which contains an illustrative list of internal controls in relation to sales.

(a) The systems and procedures relating to generation of revenue including authority to fix prices, offer discounts and other terms of sale.

(b) Accounting procedures relating to recognition of revenue.

(c) Existence of periodic reports on actual performance vis-à-vis budgets.

Verification

7. Verification of revenue may be carried out by employing the following procedures:

(a) examination of records;

(a) analytical review procedures.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls.

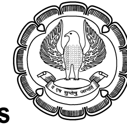
Examination of Records

8. The auditor should examine whether the basis of recognition of revenue by the entity is in accordance with the recognised accounting principles as laid down in Accounting Standard (AS) 9, *Revenue Recognition,* issued by the Institute of Chartered Accountants of India.

9. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to sales and sale returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the despatch documents (such as railway receipts) pertaining to a few days immediately before the year-end and verify that the related sale invoices have been recorded as sales of the current year.

10. The auditor should examine selected entries in the sales journal with reference to the related sale invoices, dispatch documents and other supporting documents such as the customers' orders, credit approval notes, etc. He should compare the actual price charged with the authorised price lists or with the authorisation by the appropriate official of the entity, as the case may be. The auditor should also trace the selected entries to the customers' account.

11. The auditor· should also examine selected despatch documents with reference to related sale invoices and the sales journal.



12. The auditor should examine selected entries in the sales return journal with reference to the receiving reports in respect of goods returned, credit notes and entries in the customers' accounts. Similarly, the auditor should examine selected credit notes with reference to entries in the sales return journal, receiving reports in respect of goods returned, and entries in the customers' accounts.

13. In respect of goods sent on approval, the auditor should particularly examine that revenue in respect of such goods is not recognised until (a) the goods have been formally accepted by the buyer, or (b) the buyer has done an act adopting the transaction, or (c) the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

14. In respect of sales to intermediate parties (i.e., where goods are sold to distributors, dealers or others for resale), the auditor should examine that revenue from such sales is not recognised until the significant risks and rewards of ownership have passed. However, in situations where an intermediate party is in substance an agent (e.g., a consignee), revenue should not be recognised until the related goods are sold to a third party.[38]

15. Where the consideration is receivable in installments and includes an element of interest, the auditor should examine that the revenue attributable to the sale excludes the interest element.

16. In respect of export sales, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic sales.

(a) The auditor should examine that revenue from export sales in which consideration is receivable in a foreign currency is recorded at an appropriate amount in accordance with Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*[39].

(b) The auditor should obtain a written representation from the management to the effect that the entity has complied with the legal and regulatory requirements relating to exports.[40]

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[38] Reference may be made to AS 1, *Disclosure of Accounting Policies,* for discussion on the concept of "substance over form".

[39] This Accounting Standard has been revised in 2003. The title of the revised Accounting Standard is "Effects of Changes in Foreign Exchange Rates".

[40] Reference may be made in this regard to AAS 11 **(SA 580),** *Representations by Management.*

17. In respect of revenue arising from services rendered (i.e., in the form of fees, commission, brokerage, etc.), the auditor should examine the related agreements and other documents. Similarly, in respect of revenue in the form of interest, dividends and royalties, the auditor should examine the related documents such as loan documents, lease agreements, etc. The auditor may also seek confirmatory certificates from the parties concerned.

18. The auditor should also verify realisations subsequent to the date of the balance sheet to identify items of unrecorded revenue.

Examination of Presentation and Disclosure

19. The auditor should satisfy himself that the revenue has been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

Analytical Procedures

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to revenue:

(a) Comparison, product-wise and location-wise, of revenue for the current year with the corresponding figures for previous years.

(b) Comparison of ratio of gross margin to sales for the current year with the corresponding figures for previous years.

(c) Comparison of ratio of sales returns to sales for the current year with the corresponding figures for previous years.

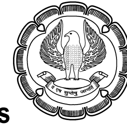
(d) Comparison of ratio of trade discount to sales for the current year with the corresponding figures for previous years.

(e) Comparison of ratio of excise duty/sales tax/export incentives to sales for the current year with the corresponding figures for previous years.

(f) Comparison, product-wise and location-wise, of quantity sold during the year with the corresponding figures for previous years.

(g) Product-wise reconciliation of quantity sold during the year with opening stock, purchases/production and closing stock.

(h) Comparison of dividend/interest/royalty for the current year with the corresponding figures for previous years.



(i) Comparison of ratio of income on investments to average investments for the current year (separately for each major type of investment) with the corresponding figures for previous years.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. Similarly, he may relate the wage payments to the quantum of output, and so on.

It may be clarified that the foregoing is only an illustrative list of analytical procedures, which an auditor may employ in carrying out an audit of revenue. The exact nature of analytical procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

Special Considerations in the Case of a Company

21. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. For example, as required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988, issued under section 227(4A) of the Act, the auditor should examine whether the transactions of sale of goods, materials and services and purchase of goods and materials, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Act, and exceeding the limits specified in the Order, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials or services or the prices at which transactions for similar goods or services have been made with other parties.[41]

Documentation

22. The auditor should maintain adequate working papers regarding audit of revenue.

[41] Reference may be made in this regard to Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

9. GUIDANCE NOTE ON AUDIT OF EXPENSES*

The following is the text of the Guidance Note on "Audit of Expenses" issued by the Auditing Practices Committee of the Council of the Institute of Chartered Accountants of India. This Guidance Note should be read in the context of the"Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Service", which sets out the audhority of SAs.

Introduction

1. An expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. The expression "cost" means the amount of expenditure incurred on or attributable to a specified article, product or activity.

2. Expenses are recognised by the following approaches:

   (a) *Identification with revenue transactions*

   Costs directly associated with the revenue recognised during the relevant period are considered as expenses and are charged to income for the period.

   (b) *Identification with a period of time*

   In many cases, although some costs may have connection with the revenue for the period, the relationship is so indirect that it is impracticable to attempt to establish it. However, there is a clear identification with a period of time.[42] Such costs are regarded as `period costs' and are expensed in the relevant period, e.g, salaries, telephone, travelling, depreciation on office building, normal interest, etc. Similarly, the costs, the benefits of which, do not clearly extend beyond the accounting period are also charged as expenses.

3. The following features of expenses affect the nature, timing and extent of the related audit procedures:

   (a) In the case of most items of expenses, documentary evidence originating from third parties is available.

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* Published in November, 2001 issue of 'The Chartered Accountant'.

[42] Reference may be made in this regard to Guidance Note on Accrual Basis of Accounting.

(b) The nature and relative significance of various items of expenses usually differ from one enterprise to another, depending primarily on the nature of operations carried out by them. For example, in the case of most manufacturing enterprises, the principal items of expenses would include the cost of raw materials consumed, labour cost and other conversion costs. On the other hand, in the case of a trading enterprise, the principal items of expenses would generally be the cost of goods sold. In the case of an enterprise supplying, providing, maintaining and operating any services, the principal items of expense would include personnel and professional expenses, office maintenance, etc.

(c) The amount of some expenses has a logical relationship with certain other financial statement items while the amount of some other expenses does not have such a relationship. For example, in an enterprise where the production process is standardised, the consumption of raw materials (and, therefore, the cost of raw materials consumed) has a logical relationship with the quantum of output. Similarly, the proportion of various constituents of cost of production is expected to remain more or less constant in the absence of known conditions to the contrary. Likewise, proportion of the amount of interest for a period to the amount of loans outstanding during the period is expected to vary within certain specific limits. On the other hand, the expenditure on research and development often has little relationship with other items in the financial statements.

(d) The amount of some items of expenses (e.g., gratuity, taxes, bonus, etc.) is significantly affected by applicable laws.

4. In an audit, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions (see SAP 5, *Audit Evidence*). In carrying out an audit of expenses, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to corroborate the management's assertions regarding the following:

Occurrence	that recorded expenses arose from transactions or events which took place during the relevant period and pertain to the entity.
Completeness	that there are no unrecorded expenses.
Measurement	that expenses are recorded in the proper amounts and are allocated to the proper period.
Presentation and Disclosure	that expenses are disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

5. In view of the divergence in the nature of expenses incurred by different enterprises, it is not possible to describe the audit procedures applicable in carrying out an audit of expenses in all situations. This Guidance Note provides guidance on procedures to be employed in carrying out an audit of expenses which would be applicable in the case of most enterprises. It is recognised, however, that audit procedures different from or additional to those described in this Guidance Note may be necessary in a particular case, depending upon its specific facts and circumstances.

Internal Control Evaluation

6. The auditor should study and evaluate the system of internal control relating to expenses, to determine the nature, timing and extent of his other audit procedures. He should particularly review the following aspects of internal control relating to expenses:[43]

(a) The systems and procedures relating to incurring of expenses including authorisation procedures.

(b) Accounting procedures relating to recognition of expenses.

(c) Existence of periodic reports on actual performance *vis a vis* budgets and internal management reports, if any.

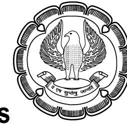
Verification

7. Verification of expenses may be carried out by employing the procedures, *viz*., (a) examination of records; and (b) analytical procedures. The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgment of the auditor which is based, *inter alia*, on the auditor's evaluation of the effectiveness of the related internal controls. The auditor should examine whether the basis of recognition of expenses by the entity is in accordance with the recognised accounting principles.

(a) Examination of Records

8. Examination of records and documents is one of the most important techniques of auditing. An auditor has to examine a large number of documents in the course of an audit since most transactions are supported only by documentary evidence. The accounting

[43] The extent of review of internal controls would depend upon the facts and circumstances of each case. Reference may be made in this regard to the "Internal Control Questionnaire", issued by the Institute of Chartered Accountants of India in 1976 which contains, *inter alia,* an illustrative list of internal controls in relation to petty cash, cash and bank payments, salaries and wages and purchases.



systems of business enterprises are so designed that documentary evidence is created in respect of each transaction. The auditor should carry out an examination of the relevant records to satisfy himself about the validity, accuracy and other assertions with regard to various expenses incurred by the entity. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

(b) Analytical Procedures

9. The auditor should conduct analytical procedures which involve analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.[44]

10. The following paragraphs describe the audit procedures applicable in respect of various items of expenses.

Goods and Raw Materials Consumed

11. The auditor's examination of the cost of goods, stores and materials consumed during the year would involve, *inter alia*, examination of purchases of goods and materials made during the year as well as of purchase returns and of opening and closing inventories.

Purchases and Purchase Returns

12. The auditor should examine whether the entity has instituted adequate cut-off procedures in relation to purchases and purchase returns. The objective of cut-off procedures is to ensure that the transactions pertaining to a period are recorded in that period and not in a preceding or subsequent period. The auditor should examine the efficacy of such procedures. The auditor can examine the selected receipt documents (such as goods received notes) pertaining to a few days immediately before the year-end and verify that the related purchase invoices have been recorded as purchases of the current year. The auditor should pay particular attention to the cut-off procedures relating to purchases, both indigenous and imported, to determine whether these procedures ensure recognition of purchases at the time the significant risks and rewards of ownership of the related goods pass on to the entity.

13. The auditor should examine selected entries in the purchase journal with reference to the related purchase invoices, receipt records and other supporting documents such as the purchase orders. The auditor should also trace the selected entries to the suppliers' account.

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[44] Refer to Auditing and Assurance Standard (AAS) 14 **(SA 520),** *Analytical Procedures*.

14. While examining purchase invoices, the auditor should examine whether subsidies, rebates, duty drawbacks or other similar items have been properly accounted for. As per AS 2, costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

15. The auditor should also examine selected receipt records with reference to related purchase invoices and the purchase journal.

16. The auditor should examine selected entries of purchase returns with reference to the goods returned notes, debit notes and entries in the suppliers' accounts. Similarly, the auditor should examine selected debit notes with reference to purchase returns, goods returned notes, and entries in the suppliers' accounts.

17. In case of transactions between related parties, the auditor should pay special attention to nature and description of such transactions.[45]

18. The auditor should obtain a representation from the management to the effect that the entity has complied with the legal and regulatory requirements, if any. When the auditor becomes aware of non-compliance, the auditor should obtain sufficient information to evaluate the possible effect in the financial statements. The auditor should also consider communication/reporting of non-compliance with the management including audit committee, users of financial statements and to regulatory authorities, as may be appropriate.[46]

19. In respect of imports, the auditor should carry out the following procedures in addition to the usual audit procedures applicable in respect of domestic purchases.

(a) Besides examining the usual documents relating to purchases, the auditor should also examine such documents as bill of lading, custom documents, etc., which are specific to import transactions.

(b) The auditor should pay special attention to the terms of import relating to the incidence of charges like insurance and freight, i.e., whether the imports are on C.I.F. basis, or F.O.B. basis, or some other basis.

(c) The auditor should examine that imports for which consideration is payable in a foreign currency are recorded at an appropriate amount in accordance with

[45] Refer to Accounting Standard (AS) 18, *Related Party Disclosures.*

[46] Refer to Auditing and Assurance Standard (AAS) 21 **(SA 250),** *Consideration of Laws and Regulations in an Audit of Financial Statements.*

Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates*.

20. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to purchases.

(a) Comparison, item-wise and location-wise, both quantity and value, of purchases for the current year/period with the corresponding figures for previous years/periods.

(b) Comparison of ratio of gross margin to sales for the current year/period with the corresponding figures for previous years/periods.

(c) Comparison of ratio of purchase returns to purchases for the current year/period with the corresponding figures for previous years/periods.

(d) Product-wise reconciliation of quantity sold during the year/period with opening stock, purchases/production and closing stock.

Apart from the above, the auditor may also work out quantitative ratios and reconciliations, e.g., he may relate the quantum of output to the quantum of input to judge its reasonableness. In case segment information is available, the above procedures may be carried out for each segment.

21. The auditor should also verify payments subsequent to the date of the balance sheet to identify any purchases which have not been recorded in the books of account.

Wages and Salaries

22. The auditor should examine the entries in the payroll/wage sheets with reference to relevant records, e.g., employee's records maintained by the personnel department showing details of pay such as basic pay, allowances, annual increments, leaves availed, etc. Special attention may also be paid by auditor in respect of new employees joining the entity during the year. Similarly, the payroll may also be examined with reference to the time records/attendance records and leave records maintained by the personnel department. The deductions made in respect of income-tax, provident fund, Employees' State Insurance (ESI), welfare schemes, health schemes, etc., may be examined with reference to the returns submitted to the authorities concerned and the receipts/acknowledgments issued by such authorities.

23. The auditor should examine whether any legal, regulatory or contractual requirements having a bearing on the rate or amount of wages and salaries have been complied with. Similar considerations would also apply to payments made to a contractor for hire of labour.

Such requirements would include, *inter alia*, the provisions of the Minimum Wages Act, 1948, agreement with the employees, award of competent authority and judicial rulings.

24. In the case of senior management officials, the auditor should pay particular attention to determining whether the salaries payable are as per the terms of contract with the employees concerned. Special requirements of terms of contract such as granting stock options (as per schemes formulated by SEBI), availing leave encashment, total amount payable annually including ex-gratia, etc., should be specifically looked into.

25. In the case of casual labour, besides carrying out the other audit procedures, the auditor should specifically examine the sanction of the competent authority for employment of such labour and ascertain whether such employees are retained as per the time rate or piece-rate basis. In appropriate cases, the auditor may pay a surprise visit to the sites where the casual labour is employed to assess the correctness of the attendance records maintained in respect of such labour. In cases where complete outsourcing of labour has been given to an outside agency, the terms of agreement and compliance thereof would be examined.

26. The auditor should obtain a list of employees who have retired or otherwise left the services of the entity during the period under audit and examine that they have not been included in the payroll.

27. In addition to the audit procedures discussed above, the following analytical procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to wages and salaries:

(a) comparison of wage bill for the year/period with the wage bill of previous years/periods;

(b) comparison of the monthly wages and salaries of a month with other months during the year/period and with the corresponding month of the previous years/periods;

(c) comparison of the wage bill for each department/unit for the current year/period with the corresponding figures for previous years/periods;

(d) comparison of the ratios of wages and salaries to sales for the current year/period with the corresponding figures for the previous years/periods;

(e) comparison of the ratio of wages and salaries to cost of production for the current year/period with the corresponding figures for previous years/periods;

(f) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the corresponding figures for previous years/periods;

(g) comparison of the ratio of contribution towards provident fund to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing provident fund;

(h) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the corresponding figure for previous years/periods;

(i) comparison of the ratio of contribution towards ESI to wages and salaries for the current year/period with the rate(s) of contribution specified under the law governing the ESI.

Bonus

28. In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965, and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

Retirement Benefits

29. The auditor should examine whether the entity is liable to pay any retirement benefits to its employees such as provident fund, superannuation/pension, gratuity, etc., whether in pursuance of requirements of any law and/or in terms of agreement with the employees[47]. If so, the auditor should examine whether the amount payable has been computed in accordance with the relevant legal and/or contractual requirements. In respect of gratuity/pension, the auditor should specifically examine whether the provision for accruing gratuity/pension liability has been made by the entity. The auditor should examine the adequacy of provision with reference to the actuarial certificate obtained by the entity[48]. In case the entity has not obtained such an actuarial certificate, the auditor should examine that the method followed by it, say, group gratuity insurance scheme taken by the entity, for calculating the accrued liability for gratuity is rational.

[47] Attention is invited in this regard to Accounting Standard (AS) 15, *Accounting for Retirement Benefits in the Financial Statements of Employers*.

[48] Attention is also invited in this regard to Auditing and Assurance Standard (AAS) 9 **(SA 620),** *Using the Work of an Expert*.

Other Conversion Costs

30. The auditor should verify the other conversion costs (such as power and fuel, processing charges, etc.) with reference to the supporting documents and related agreements. In case the material is sent outside to third parties for processing, necessary charges including existence of materials, wastage, etc., need to be ascertained and accounted for. In addition, the auditor may also compare the amount of expense on a particular item with the corresponding figure for previous years. Similarly, he may work out the ratios of different items of conversion costs to total cost of production for the current year and compare the same with the corresponding figures for previous years.

Establishment and General Administrative Expenses

31. The auditor should verify establishment expenses and general administrative expenses such as insurance, rent, rates, conveyance, travelling, telephone, entertainment, printing and stationery, general expenses, etc., with reference to the sanction of the competent authority, the supporting documents, related agreements and the rules and regulations followed by the entity. The auditor may also compare the amounts of these expenses with the corresponding figures for previous years. Similarly, he may work out the ratios of different items of expenses to sales for the current year and compare the same with the corresponding figures for previous years.

Interest and Financial charges

32. The auditor should verify the amount of interest expense for the year with reference to the terms and conditions of relevant agreements. The auditor may also work out the ratio of interest expense for the year to average interest-bearing loans and advances outstanding during the year and compare it with the corresponding figure for previous years and reconcile the same. The auditor should particularly examine that interest as well as other financing costs such as commitment fees on funds borrowed for a qualifying asset included in the gross book value of the asset to which they relate and have not been charged to the Profit and Loss Account of the period in which they are incurred.[49] If the entity has paid any penal interest, it should also be examined. Such interest should be disclosed as part of normal interest. The auditor should consider, having regard to the materiality, whether it requires separate disclosure.

[49] Attention is invited Accounting Standard (AS) 16, *Borrowing Costs*.

Depreciation

33. The auditor should check the calculation of depreciation. The total depreciation arrived at should be compared with that of previous years to identify reasons for variations. The auditor should particularly examine whether the depreciation charge having regard to rate of depreciation and method of depreciation followed consistently is adequate keeping in view the generally accepted bases of accounting for depreciation[50]. Alternatively, the auditor may consider qualifying his report. In case, assets have been revalued by entity during the year, the auditor should ensure that the depreciation has been computed properly.

Research and Development Expenses

34. The auditor should verify various items of expenses incurred on research and development with reference to supporting documents and related agreements. For example, the cost of materials consumed for research and development may be verified with reference to such documents as purchase invoices, goods received notes, records relating to issue of materials, etc. The auditor should particularly examine whether the accounting policy followed by the entity regarding treatment of research and development costs is in accordance with Accounting Standard (AS) 8, *Accounting for Research and Development.*

35. The auditor should examine whether the deferral meets the appropriate legal requirements, if any. If an accounting policy for deferral of research and developments is adopted, it should be applied to all such projects which meet the criteria laid down for deferral under AS 8. The auditor should examine whether the criteria laid down in AS 8 which previously justified the deferral of certain research and development costs no longer apply, the unamortised balance has been charged as an expense of the year. Similarly, the auditor should examine that where the criteria for deferral continue to be met but the amount of unamortised balance of the deferred research and development costs and other relevant costs exceed the expected future revenues/benefits related thereto, such excess has been charged as an expense immediately.

Repairs and Maintenance

36. The auditor should scrutinise the repairs and maintenance account to ascertain that new fixed assets and substantial improvements to existing assets have not been included in repairs and maintenance. The auditor should exercise special care particularly in case large amounts charged to the Profit and Loss Account.

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[50] Attention is also drawn to Accounting Standard (AS) 6, *Depreciation Accounting*.

Contingencies

37. In respect of product warranties, service contracts, performance warranties, etc., the auditor should examine whether provisions have been made in accordance with Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements and the assessment based on his past experience.

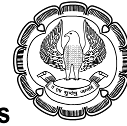
Taxes on Income

38. The auditor should examine that tax expense or tax saving has been properly computed and disclosed in the financial statements[51]. The tax expense for the period which comprises current tax and deferred tax is to be included in the determination of net profit or loss for the period under audit. In case of companies attracting minimum alternate tax, it has to be ensured that proper provision has been considered in the accounts. The auditor should examine that the deferred taxes have been recognised for all timing differences subject to consideration of prudence in respect of deferred tax assets as set out in Accounting Standard (AS) 22, *Accounting for Taxes on Income*. If there is a material departure from the provisions of AS 22, the auditor should qualify his report.

39. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether adjustment is required in the financial statements.

40. If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under relevant provisions of the Income-tax Act, 1961. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard 4, *Contingencies and Events Occurring After the Balance Sheet Date*). In determining whether a provision is required, the auditor should, among other procedures,

[51] Attention is drawn to Accounting Standard (AS) 22, *Accounting for Taxes on Income.*



make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

41. The auditor should obtain from the management, a statement showing the status of pending tax matters. He should examine the statements to assess the adequacy of provisions made in respect of those matters in the context of their current status.

Special Considerations in the Case of a Company

42. In the case of audit of a company, in addition to the procedures described above, the auditor should also carry out appropriate audit procedures in respect of matters which are specifically required to be examined under the provisions of the Companies Act, 1956. Some of the illustrative procedures specifically applicable in the case of audit of a company are described below. It may be clarified that the following is not an exhaustive list of additional procedures to be carried out in the case of audit of expenses in the case of a company.

(a) The auditor should examine whether the managerial remuneration paid or payable by the company is within the limits laid own under section 198 and Schedule XIII to the Companies Act, 1956. The auditor should also examine whether the remuneration paid or payable to the directors of the company, including any managing or whole-time director, has been determined by the Articles of Association of the company or by a resolution of the company passed in a general meeting. The auditor should also examine whether the remuneration of directors complies with the provisions of section 309 of the Companies Act, 1956. The auditor should further examine whether the computation of net profit for purposes of managerial remuneration is in accordance with sections 349 and 350 of the Companies Act, 1956.

(b) The auditor should examine whether the contributions, if any, made by the company to charitable and other funds not directly relating to the business of the company or the welfare of its employees comply with the provisions of section 293 of the Companies Act, 1956. According to this section, the board of directors of a public company cannot, except with the consent of the company in general meeting, contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed Rs.50,000 or 5 per cent of the average net profits of the company as determined in accordance with the provisions of section 349 and section 350 during the three financial years immediately preceding, whichever is greater. The auditor should examine whether the Memorandum of Association of the company empowers it to make contributions to charitable or other funds not

directly relating to the business of the company or the welfare of its employees. If the objects clause in the Memorandum does not contain such authority, the company has no power to make such contributions.

The auditor should ask the management to prepare a schedule of contributions to various funds covered by section 293 made during the year, giving the names of the institutions to which contributions have been made, the amounts paid and the dates on which the contributions were approved by the board of directors. He should also ask the management to prepare a computation showing the limits of permissible contributions which can be made under this section.

(c) The auditor should examine whether political contributions made by the company are within the limit prescribed in section 293A of the Companies Act, 1956.[52] Where the limit laid down under section 293A is adhered to and the facts are properly disclosed, the auditor has no further duty. Where, however, the facts regarding such contributions are not properly disclosed, the auditor should qualify his report and state the facts therein. Where the auditor has genuine doubt regarding the applicability of the Section, he should ensure that the fact is properly disclosed in his audit report.

Where the auditor is satisfied that political contributions have been made in excess of the limit prescribed in section 293A, he should bring this to the attention of the shareholders by qualifying his audit report and making a mention of the excess amount involved, if ascertainable.

The auditor should obtain a certificate from company's board of directors to the effect that all amounts of contributions to political parties or for any political purpose to any person falling under the provisions of section 293A have been brought into the books of account of the company and that no amounts of such nature other than those so included in the books have been paid/given, directly or indirectly.

(d) The auditor should examine whether the contribution, if any, to the National Defence Fund or any other fund approved by the Central Government for the purpose of national defence complies with the provisions of section 293B of the Companies Act, 1956. This section empowers the board of directors to make such contributions. It may be noted that unlike the contributions to charitable or other funds not directly relating to the business of the company or to the welfare of its employees, contributions to National Defence Fund (or other similar funds) can be made by a company even where the Memorandum of Association of the company

[52] Reference may be made in this regard to the Guidance Note on Section 293A of the Companies Act, 1956 and the Auditor.

does not specifically empower it in this regard. The auditor should examine whether the total amount or amounts contributed by the company to the National Defence Fund (or other similar funds) during the year have been suitably disclosed in the profit and loss account.

(e) In respect of payments to sole-selling agents, the auditor should examine whether the provisions of sections 294, 294A and 294AA have been complied with.

(f) The auditor should examine whether the provisions of section 297 have been complied with in appropriate cases. He should also examine compliance with the terms and conditions, if any, stipulated by the Central Government in its approval under the proviso to sub-section (1) of section 297.

(g) In case any partner or relative of a director of the company, any firm in which such director, or relative of such director, is a partner, any private company of which such director is a director or member, or any director, or manager of such a private company, holds any office or place of profit under the company or under any subsidiary of the company, the auditor should examine whether the provisions of section 314 have been complied with.

(h) The auditor should examine whether any personal expenses have been charged to revenue account.[53]

(i) The auditor should examine whether the transaction of purchase of goods and materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956, as aggregating during the year to Rs.50,000[*] (Rupees Fifty Thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials and services or the prices at which transaction for similar goods or service have been made with other parties.[54]

(j) The auditor should examine whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding as at the last day of financial year concerned, for a period of more

[53] Reference may be made in this regard to the Statement on the Qualification in Auditor's Report.

[54] This limit has been enhanced to Rs. five lacs by the Companies (Auditor's) Report Order, 2003.

than six months from the date they became payable have been reported under MAOCARO, 1988[55].

Examination of Presentation and Disclosure

43. The auditor should satisfy himself that the expenses have been properly classified and disclosed in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

Management Representation

44. The auditor should consider obtaining a management representation on expenses charged to the statement of profit or loss when other sufficient appropriate audit evidence cannot reasonably be expected to exist.[56]

Documentation

45. The auditor should maintain adequate working papers regarding audit of expenses.[57]

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[55] Reference may be made in this regard to the Statement on the Companies (Auditor's Report) Order, 2003.

[56] Replaced by the Companies (Auditor's Report) Order, 2003.

[57] Reference may be made in this regard to Auditing and Assurance Standard (AAS-11) **(SA 580),** *Representation by Management*.