CA FINAL
M-BOOK

HighbrowMENTOR
Knowledge Series

STANDARDS ON AUDITING
SA 200

CA KIT

AUTHOR

CA ASEEM TRIVEDI

SA-200

Overall Objectives of the Independent Auditor and the conduct of an Audit in accordance with standards on Auditing-[Effective Date: 01.04.2010]

Q.1. Why This SA?

This Standard on Auditing establishes the independent Auditor's overall responsibilities when conducting an Audit of Financial Statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent Auditor, and explains the nature and scope of an Audit designed to enable the independent Auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent Auditor applicable in all Audits, including the obligation to comply with the SAs.

Q.2. What are overall objectives of an Independent Auditor?

According to SA-200 the overall objectives of the Auditor are:

- To obtain reasonable assurance about whether the Financial Statements as a whole are free from material Misstatement, resulting from either due to fraud or error, by this means enabling the Auditor to express an opinion on whether the Financial Statements are prepared, in all material respects, in accordance with an applicable Financial Reporting Framework; and
- To report on the Financial Statements, and communicate as required by the SAs, in accordance with the Auditor's findings.

✍ **For example**: - If the Auditor is appointed under section 139 of Companies Act 2013 his objective will be to obtain reasonable assurance that whether Financial Statement of the company are giving true and fair view or not. Financial Statement are said to be giving true and fair view only when they are complying with requirements of Companies Act 2013 like schedule III, companies accounting standard rules 2006, schedule II, etc. Further Auditor has to report to members of the company in a manner specified in section 143 of Companies Act.

Q.3. What will be consequences if Auditor fails to achieve his objective?

According to SA-200 if Auditor is unable to obtain sufficient appropriate Audit Evidence to support his conclusions or we can say he is unable to obtain reasonable assurance he should either give a disclaimer of opinion or should withdraw from Engagement if permitted by law.

✍ **For example:** - If Auditee has provided Auditor photocopies of Books of Accounts and evidence for Audit as original Books of Accounts and evidence are ceased by income tax department, in such case, the Auditor should either give a disclaimer of opinion that he is unable to form and express opinion on Financial Statement or he may decide to withdraw from Engagement if permissible.

Q.4. Briefly explain the requirements of SA-200?

There are 5 requirements an Auditor has to fulfill according to SA-200:

- Ethical Requirements relating to an Audit of Financial Statements.
- Requirement to have an attitude of Professional Skepticism.
- Requirement to exercise Professional Judgment.
- Requirement to obtain Sufficient and Appropriate Audit Evidence.
- Requirement to follow all Standards on Auditing.

Q.5. What do you mean by Ethical Requirements?

Every member of the ICAI is subject to ethical behavior as described in code of ethics prescribed by ICAI. This code of ethics requires that Auditor shall subject to following Ethical Requirements while discharging his duties as an Independent Auditor.

1. Integrity: -means honest behaviour, loyal attitude towards users of Financial Statements;

✍ **For Example: -** Mr. Sawan Kumar practicing CA has accepted Audit of XY & Co. Chartered Accountants in which he is a partner. It seems that the cardinal principle to achieve the objective is independence of the Auditor. The interest as a partner will definitely override his objectivity as an Auditor. Hence, he must not accept the appointment.

2. Objectivity: - This could be achieved only by having independence of mind and independence is appearance of an Auditor.

3. Professional competence and due care: - This could be achieved by acquainting himself with the latest developments in the field of accounting and Auditing.

✍ **For Example:** - When it asked to Mr. Pawan, FCA why you did not followed SA-505 external confirmation to test the Balance Sheet of creditors.

He simply said I was unaware that any such pronouncement is issued by the ICAI. This means he is lacking in professional competence.

4. Confidentiality: - Should keep all information received from client and should not disclose the same unless it is not legal or professional requirement to do so.

✍ **For example:** Mr. Mihir is the Auditor of AT Limited, the manufacturers of packing boxes. For his Audit purpose, he obtained the knowledge of this business i.e. their customers, suppliers, technical experts etc. He helped his brother in setting up this business. This is violation of ethical standards of confidentiality.

5. Professional behaviour: There must be professional relation between Auditor and Auditee. There must not be any other interest to override the objectivity.

✍ **For Example: -** Mr. Rohit Roy, the owner of a small company, asked F&G Chartered Accountants, to conduct an Audit with a condition that Audit must be completed within two weeks so that

Statement of Profit and Loss and Balance Sheet are submitted to bank for loan. F&G accepted the Engagement and agreed to provide Audit report in time. Mr. Roy agreed to pay fee to F&G of Rs. 20,000, if loan is sanctioned. This is against the professional behaviour.

Further SQC-1 and SA-220 have suggested ways and means to achieve such independence and objectivity of Auditor.

Q.6. What do you mean by attitude of Professional Skepticism?

Professional Skepticism is an attitude of an Auditor enables him to become a questioning mind and being alert to conditions, which may indicate possible misstatement due to error or fraud, and helps him in a critical assessment of Audit evidence. According to SA 200 the Auditor shall plan and perform an Audit with professional scepticism so as to reduce risk of:

- Overlooking unusual circumstances.

- Over generalizing when drawing conclusions from Audit observations.
- Using inappropriate assumptions in determining nature timing and extent of Audit procedures & evaluating the results thereof.

Further it should be noted that professional scepticism helps Auditor to remain alert towards:

- Contradictory Audit evidence.
- Question of reliability of documents.
- Conditions indicating possible frauds.
- Circumstances suggesting need for Audit procedures in addition to those suggested in SAs.

✍ **For Example:** - The Audited Financial Statements of Shiv Limited show sales of Rs.100 crores for the year 2004-2005. Mr. A's (Auditor of Shiv Limited) article clerk stated that the sales are properly recorded. Subsequently, it was found that goods to the extent of Rs. 8,50,000 were sent on approval but included in the sales. It means no Professional Skepticism is exercised during the Audit.

Q.7. Does it mean that Auditor should place doubt over each record, information or document provided by the client to him?

Answer to this question is addressed in SA-200 according to it, "Auditor may accept records and documents as genuine unless the Auditor has reason to believe the contrary. Nevertheless, the Auditor is required to consider the reliability of information to be used as Audit Evidence. In cases of doubt about the reliability of information or indications of possible fraud (For Example, if conditions identified during the Audit cause the Auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the Auditor investigate further and determine what modifications or additions to Audit procedures are necessary to resolve the matter. Even if a belief that management and those charged with Governance are honest and have integrity does not relieve the Auditor of the need to maintain Professional Skepticism or allow the Auditor to be satisfied with less-than-persuasive Audit Evidence when obtaining reasonable assurance.

✍ **For Example: -** As Mr A is Auditor of Y ltd from last 3 years and every year after due examination he found Financial Statement true and fair and found management as honest and ethical does not mean that he should have a blind faith in Audit of current year over all the information provided by them.

Q.8. What is requirement of Professional Judgment?

Professional Judgement means the application of

- Relevant Training,
- Knowledge and
- Experience,
- Within the context provided by Auditing, accounting and ethical standards,

In making informed decisions about the courses of action that are appropriate in the circumstances of the Audit engagement.

This SA requires that the Auditor shall exercise professional judgment in planning and performing an Audit of Financial Statements. Its exercise depends on facts & circumstances known to the Auditor. Professional judgment is to be exercised throughout the Audit and to be appropriately documented. Professional Judgment plays significant role in taking decision about:

- Materiality & Audit risk.
- Nature timing and extent of Audit procedures.
- Evaluating sufficiency & appropriateness of Audit procedures.
- Evaluating management Judgment in applying applicable FRF.
- Drawing conclusions based on Audit evidence.

Q.9. Explain the requirements of Sufficient and Appropriate Audit Evidence?

According to SA-200 "Audit Evidence is necessary to support the Auditor's opinion and report." It is cumulative in nature and is primarily obtained from

Audit procedures performed during the course of the Audit. It may, however, also include information obtained from other sources like experience from previous Audit, information provided and prepared by employees, management and those charged with Governance of the Auditee. The sufficiency and appropriateness of Audit Evidence are interrelated. Sufficiency is the Measure of the quantity of Audit Evidence and appropriateness means quality of Audit Evidence (posers are given in previous chapter). Whether sufficient appropriate Audit Evidence has been obtained to reduce Audit Risk to an acceptably low level, and thereby enable the Auditor to draw reasonable conclusions on which to base the Auditor's opinion, is a matter of Professional judgment.

Q.10. What are the requirements of SA-200 to conduct of an Audit in accordance with SAs?

According to SA 200 the Auditor shall comply with all SAs relevant to the Audit. An SA is relevant to the Audit when the SA is in effect and the circumstances addressed by the SA exist in an Audit situation. The Auditor shall have an understanding of the entire text of an SA. Auditor shall comply with relevant SA unless:

- Entire SA is not relevant.
- Requirement is not relevant because it is conditional & condition does not exist.
- Departure from requirement in exceptional circumstances – perform alternative procedures to achieve aim of requirement.

Q.11. What is scope of an Audit of Financial Statements?

Scope of Audit means an area of work for the Auditor. Scope of Audit is primarily determined by following factors

- Terms of Engagement of the Auditor.
- Requirements of legislation.
- Standards on Auditing and other guidance by ICAI.

It should be noted that, terms of Engagement cannot have an overriding effect over the scope decided by the legislation or SAs.

✍ **For Example: -** BOD of RESPECTIVE LTD. appointed Mr. Y as their Auditor under section 139 of Companies Act, 2013 on the following terms:

1. You are requested to conduct physical verification of stock as it is recently done by our staff.
2. You will not be allowed to verify the section 189 register and fixed asset register.

In this case Management of the entity cannot decide the terms of Engagement of Auditor contrary to the statute under which the appointment of Auditor done or the scope of Audit as determined by the ICAI through its various statements made mandatory to follow by its member (i.e. Auditor).

Further, 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.

Following is not within the scope of Auditor it is within the scope of Management and Those Charged with Governance: -

1. Maintenance of Books of Accounts and records.
2. Formulation and Implementation of Internal Control system.
3. Selection and application of Accounting Policies.
4. Estimation of Accounting Estimates.
5. Preparation and presentation of Financial Statement.

It is important to note that, Auditors opinion is not an assurance about the future viability of the entity and neither itis an assurance about the future efficiency and effectiveness of the management. It is just an opinion about financial position up to the date and period covered under Audit.

✍ **Example:** - Managing Director of Muskan Ltd. is of opinion that our Financial Statements are not ready for the approval by the shareholders in AGM as Auditor was unable to find the Trial Balance difference of Rs.1,00,000. Hence, the Auditor should be held responsible for all this delay. In this case responsibility for preparation and presentation of FS is that of the management of the enterprise. The Audit of the Financial Statements does not relieve management of its responsibilities.

Q.12. Does the Auditor expected to, reduce Audit Risk to zero and can obtain absolute assurance that the Financial Statements are free from Material Misstatement due to Fraud or Error? Or what do you mean by Inherent Limitations of Audit?

Introduction:

Inherent limitations are such features of Audit that constrains the Auditor to obtain absolute assurance. It is because of these inherent limitations of Audit the practitioner cannot assure the users of Financial Statements that Financial Statements are absolutely free of (material) misstatements. As a result of these limitations Auditor is expected provide reasonable assurance which is high level of assurance i.e. reasonably high but not touching the levels of absoluteness.

According to SA-200 the Auditor is not expected to, and cannot, reduce Audit Risk to zero and cannot therefore obtain absolute assurance that the Financial Statements are free from material Misstatement due to fraud or error.

Inherent limitations mean limitations which cannot be overcome and which are with the subject since the inception or evolution of the subject. Following are contributors to inherent limitations to Audit:

1. Most of the Audit Evidence on which the Auditor draws conclusions and bases the Auditor's

opinion being persuasive rather than conclusive. Many a times evidence collected by the Auditor is of persuasive nature rather than conclusive i.e. it is left on the Auditor to decide what conclusion should be drawn or what steps should be taken further. Conclusive evidence help us reach conclusion with complete authority whereas in case of persuasive evidence we have to seek additional evidence to corroborate our understanding and support our conclusion and this may not be possible because of lack of resources or just because it is not possible given the situation.

2. The nature of financial reporting: - If in Financial Statement some items are valued only on the basis of managements estimate which are highly subjective in those cases Audit procedures are insufficient to find the reasonableness of such judgments.

   For Example:-Use of estimation and judgment by the management of the entity in numerous values reported in the Financial Statements e.g.

depreciation, provision for doubtful debt etc. This is one of major limitations of financial accounting

3. The nature of Audit procedures: - For example: Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, Audit procedures used to gather Audit Evidence may be ineffective for detecting an intentional Misstatement that involves, For Example, collusion to falsify documentation, which may cause the Auditor to believe that Audit Evidence is valid when it is not. The Auditor is neither trained as nor expected to be an expert in the authentication of documents. Further Auditor has no legal power to search forcefully, which may be necessary for such an investigation.
4. The need for the Audit to be conducted within a reasonable period of time and at a reasonable cost. Because of the inherent limitations of an Audit, there is an unavoidable risk that some material misstatements of the Financial

Statements may not be detected, even though the Audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material Misstatement of the Financial Statements resulting from fraud or error does not by itself indicate a failure to conduct an Audit in accordance with SAs.

Inherent Limitations at a glance: -

- Persuasive rather than conclusive evidence
- The nature of financial reporting
- The nature of Audit procedures
- To complete Audit in reasonable period of time and at a reasonable cost.

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CASE STUDY

Q.13. Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction level of detection of frauds & error to an extent of 60% analyze the Risk of Material Misstatement and find out the overall Audit Risk ?

According to SA-200, the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk, has two components:

Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement*Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components Inherent risk and Control risk. The relationship can be defined as Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%. Hence control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk

40% X 25 % = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows

Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

PRACTICE PROBLEMS

Q.14. Mr. X, a practicing CA, accepted the Audit of PQR Ltd. Where his wife is Managing Director. Comment?

Accepting the Audit is against the principle Ethical Requirements given in SA-200. Further, clause (1) of part II of the Second schedule of the CA Act defines under council general guidelines that it will be a professional misconduct see code of ethics of the same publication for details.

Q.15. Mr. Hurry Worry the owner of a small company, asked Lazy & Co Chartered Accountants, to conduct an Audit within one week so that Financial Statement will be ready for the Income Tax Return as the date of filing return is near. Lazy & co. demanded for double fee as compare to previous year and accepted the Engagement. Comment?

Accepting the Audit on double fee to complete it in a hurry by itself shows that Lazy & Co. created an interest against their duty hence it is against the principles Ethical Requirements under SA -200.

Q.16. On subsequent discovery of Misstatement regarding non provision of Impairment loss Auditor gave his clarification that " I was not aware that AS-28 made applicable from this year" Next time we will definitely be conscious about the same. Comment

According to SA-200 Auditor must be acquaint about the latest development in the field of accounting and Auditing. Ignorant about the applicability of AS shows lack of skill in the Auditor and it is against the principle of professional competence.

Q.17. Mr. Mahesh, the Auditor, engaged recently qualified Chartered Accountant as paid assistant to conduct the Audit of

Bharat Starch Limited. Mr. Mahesh signed the Audit report in anticipation that the other CA must have conducted Audit as per Auditing practices as he is recently passed out his CA final exams conducted according to revised SAs. Later on material Misstatement was found in Financial Statement. Mr. Mahesh claims that he is not responsible because he engaged qualified Chartered Accountant for the purpose of Audit.

Auditor continues to be liable for his opinion on Financial Statement irrespective of the fact that he had relied on work performed by other. It is irrelevant whether the other person is CA or not. Although if the other person is CA the extent of evaluation of the work performed by him will not more extensive, but in any case, blind faith on anyone's work is not permitted as Auditor shall have an attitude of PROFESSIONAL SKEPTICISM.

Q.18. A senior assistance of PQR Co. CA drew up his Audit programme without evaluating internal controls of Titu Ltd. When the partner asked him for the reason, he stated that the controls were developed by the general manager (finance) of Titu ltd. Who is also a CA and had written a few books on "Internal controls" and therefore there was no need to review the said area.

Appropriate designing of internal control is not by itself a guarantee that the same is applied at full extent. Auditor shall apply test of control before relying on the same and should assess the Audit Risk also as required under SA-200.

Q.19. Managing Director of M & M ltd. is of opinion that our Financial Statements are not ready for the approval by the shareholders in AGM as Auditor was unable to find the Trial Balance difference

of Rs.100000. Hence, Auditor should be held responsible for all this delay.

As per SA-200, responsibility to prepare and present Books of Accounts is that of management. Auditor has only objective to form and express opinion after due verification.

Q.20. As Auditor signed Financial Statements and issued Audit report, he is jointly responsible along with the management for the Financial Statements. Is it true?

Auditor is responsible for Financial Statement to the extent explanation and information provided to him by the management for his Audit. Due to inherent limitations of Audit, there may be some material Misstatement remained undiscovered. Hence, Auditor is not responsible to give absolute assurance about the Financial Statement. On the other hand, management is absolutely responsible for the Financial Statements.

Q.21. Mr. X a partner of X & Co., Chartered Accountants died of a heart attack on 30.03.04 after completing the entire routine Audit work of T Ltd. Mr. Y one of the partners of the firm, therefore signed the accounts of T Ltd. without reviewing the finalization work done by the assistants. State with reasons your views.

As per SA-200, Due Professional Care - hen 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 this Poser Mr. Y should review the work performed by the assistants.

Q.22. What will be position of the Auditor in the following cases: Y is the Auditor of X Pvt.

Ltd. in which there are four shareholders only, who are also the directors of the company. On account of bad trade and for reducing the expenses in all directions, the Directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full Audit as he has done in the past. Y accepted the suggestions of the directors.

As per SA-200 Overall objectives of Independent Auditor and the conduct in accordance with standard on Auditing

- 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. In the given question terms of Engagement on reduced fee are limiting the scope of the Audit as determined by pronouncement of the institute and section 143 of the Companies Act, 2013.

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