



CA-Intermediate



Auditing & Ethics

Key Highlights:

- Suitable for independent preparation for class syllabus
- Updated with all relevant amendments in regard to Indian Companies Act, 2013, Companies Act, 1956, Companies (Accounts) Regulations, 2011, etc. (upto 31.03.2013)
- Tabular Presentation of Subject Matter



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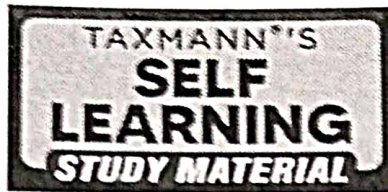
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CA Pankaj Garg

13th Edition

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Nature, Objective and Scope of Audit

1.1 - Meaning and Nature of Auditing

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| <p>Meaning of Audit</p> | <p>An Audit is independent examination of Financial Information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.</p> <p>This definition has the following implications:</p> <ol style="list-style-type: none"> Audit is independent examination of financial information. Requirement of audit applies in case of every entity, whether profit oriented or not (NGO or a Charitable Trust), whatever is business size of entity (Small Size entity or large size entity), whatever is the legal form of the entity (proprietor, partnership, LLP or company). Purpose of audit is to express an opinion on the F.S. by means of written audit report. <p style="text-align: center;">Points to remember</p> <ul style="list-style-type: none"> Independence implies that judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. Auditor should be independent of entity whose F.S. are subject to audit so that he can form an opinion without being affected by any influence. Independence increases auditor's ability to act objectively. |
| <p>Points to be ensured that F.S. not misled anybody</p> | <p>Auditor engaged to perform task of performing audit need to ensure the following:</p> <ol style="list-style-type: none"> Accounts have been drawn up with reference to entries in books of account; Entries in books of account are adequately supported by sufficient and appropriate evidence; None of the entries in books of account has been omitted in the process of compilation; Information contained in the F.S. is clear and unambiguous. Amounts shown in F.S. are properly classified, described and disclosures are made in conformity with applicable ASs. F.S. reflect true and fair view of financial results and financial position. |
| <p>Inter-Disciplinary Nature of Auditing</p> | <p>Auditing is interdisciplinary in nature. It draws from diverse subjects including accountancy, law, behavioural science, statistics, economics and financial management and makes use of these subjects.</p> <ol style="list-style-type: none"> Auditing and Accounting: Since audit of F.S. is concerned with financial information, a sound knowledge of accounting principles is a fundamental requirement for an auditor of F.S. to conduct audit and express an opinion. |

Nature, Objective and Scope of Audit

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| | <p>(b) Auditing and Law: Good knowledge of business laws and various taxation laws helps auditor to understand F.S. in a better way in accordance with applicable laws.</p> <p>(c) Auditing and Behavioral Sciences: During course of audit, auditor has to interact with lot of persons for seeking information and making inquiries. This can be done only if one has knowledge of human behaviour.</p> <p>(d) Auditing and Statistics: Auditors use statistical methods to draw samples in a scientific manner. It is not possible for an auditor to check each and every transaction.</p> <p>(e) Auditing and Economics: Knowledge of economics helps auditor to be familiar with overall economic environment in which specific business is operating.</p> <p>(f) Auditing and Financial Management: Financial management deals with issues such as funds flow, working capital management, ratio analysis etc. and an auditor is expected to have knowledge about these for applying some of audit procedures and carrying out audit effectively.</p> <p>Besides, knowledge of financial markets comprised in study of financial management is expected from a professional auditor.</p> |
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| Objectives of Audit | <p>As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", in conducting an audit of F.S., the overall objectives of the auditor are:</p> <p>(a) To obtain reasonable assurance about whether the F. S. as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the F.S. are prepared, in all material respects, in accordance with an applicable FRF, and</p> <p>(b) To report on the F.S. and communicate as required by the SAs, in accordance with the auditor's findings.</p> |
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Points to remember – Reasonable Assurance vs Absolute Assurance

Absolute assurance is a complete assurance or a guarantee that F.S. are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

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| Scope of Audit | <p>Elements included in Scope of Audit</p> <p>(1) Coverage of all aspects of entity: Audit of F.S. should be organized adequately to cover all aspects of the entity relevant to the F.S.</p> <p>(2) Reliability and sufficiency of financial information: Auditor should be reasonably satisfied that information contained in accounting records and other source data (like bills, vouchers, documents etc.) is reliable and provide sufficient basis for preparation of F.S.</p> <p>For this purpose, auditor is required to study and assess accounting systems and internal controls.</p> <p>(3) Proper disclosure of financial information: Auditor should decide whether relevant information is properly disclosed in F.S. in compliance with applicable statutory requirements. For this purpose, auditor is required to study and assess accounting systems and internal controls.</p> |
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| | | <p>Ensuring that F.S. properly summarize transactions and events recorded therein and considering judgments made by management in preparation of F.S.</p> <p>Auditor should also evaluate whether accounting policies selected by management are proper and whether chosen policy has been applied consistently on a period-to-period basis.</p> |
| | <p>Elements not included in Scope of Audit</p> | <ul style="list-style-type: none"> • Auditor is not expected to perform duties which fall outside domain of his competence. • An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field. <p>Audit vs. Investigation</p> <ul style="list-style-type: none"> • Audit is not an official investigation into alleged wrong doing. Auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation. • Investigation is a critical examination of accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation. • Objective of audit is to obtain reasonable assurance about whether the F.S. as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion. • Scope of audit is general and broad whereas scope of investigation is specific and narrow. |
| <p>Benefits of Audit</p> | | <ul style="list-style-type: none"> (a) Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally. (b) In case of companies, shareholders may or may not be involved in daily affairs of the company. F.S. are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit. (c) Audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit. (d) Audited F.S. are helpful to government authorities for determining tax liabilities. (e) Audited F.S. can be relied upon by lenders, bankers for making their credit decisions i.e., whether to lend or not to lend to a particular entity. (f) Audit may also detect fraud or error or both. (g) Audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies. |

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| <p>Mandatory Audit vs. Voluntary Audit</p> | <ul style="list-style-type: none"> • Audit is not always legally mandatory. Entities like companies are compulsorily required to get their accounts audited under law. Non-corporate entities may be compulsorily required to audit of their accounts under tax laws, if turnover crosses certain threshold limit. • Entities like schools may also be required to get their accounts audited for the purpose of obtaining grant or assistance from the Government. • Many entities may get their accounts audited voluntarily because of benefits from the process of audit. |
| <p>Who Appoints Auditor</p> | <ul style="list-style-type: none"> • In case of companies, auditor is appointed by members (shareholders) in AGM. • In case of government companies, auditor is appointed by C&AG of India. • In case of a firm, auditor is appointed by partners of firm. |
| <p>To whom Audit Report is submitted</p> | <ul style="list-style-type: none"> • The report is submitted to person making the appointment. • In case of companies, these are shareholders; in case of a firm, to partners who have engaged him. |

1.2 – Inherent Limitations of Audit

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the F.S. are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit which arises due to following factors:

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| <p>(1) The Nature of Financial Reporting</p> | <ul style="list-style-type: none"> • Preparation of F.S. involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors. • One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of F.S. in accordance with applicable FRF and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations. |
| <p>(2) Nature of Audit Procedures</p> | <p>There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:</p> <p>(1) Auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.</p> <p>(2) Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as requested. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.</p> |
| <p>(3) Not in Nature of Investigation</p> | <p>Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors.</p> |

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| (4) Timeliness of Financial Reporting & decrease in relevance of information over time | The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it. |
| (5) Future Events | Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events. |

1.3 - Meaning, Nature and Types of Engagements

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| Engagement | <ul style="list-style-type: none"> • An arrangement to do something. • In context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. • It takes the shape of engagement letter. |
| External audit engagements | Purpose of external audit engagements is to enhance the degree of confidence of intended users of F.S. Such engagements are also reasonable assurance engagements. |
| Assurance Engagement | An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. |
| Elements of an Assurance Engagement | |
| <p>(a) Three Party relationship: An assurance engagement involves three parties - a practitioner, a responsible party, and intended users.</p> <ul style="list-style-type: none"> • Practitioner: Person who provides the assurance. Practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information. • Responsible party: Party responsible for preparation of subject matter. • Intended users: Persons for whom an assurance report is prepared. These persons may use the report in making decisions. <p>(b) Subject matter: Information to be examined by practitioner. For example: Financial information contained in F.S. while conducting audit of F.S.</p> <p>(c) Suitable Criteria: Benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.</p> <p>(d) Sufficient appropriate evidence: Practitioner performs an assurance engagement to obtain sufficient appropriate evidence. Conclusions are arrived and an opinion is formed on the basis of evidences. "Sufficiency" relates to quantity of evidence obtained; whereas "Appropriateness" relates to quality of evidence obtained.</p> <p>(e) Written assurance report: Outcome of an assurance engagement and contains conclusion that conveys the assurance about the subject matter.</p> | |

Nature, Objective and Scope of Audit

| Types of Assurance Engagements | Reasonable Assurance Engagement | Limited Assurance Engagement |
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| Level of Assurance | High, but not absolute | Lower than reasonable |
| Nature of Procedures to obtain evidences | Elaborate and extensive procedures | limited procedures (Inquiry and Analytical Procedures) |
| Conclusion Obtained | Reasonable conclusions. | Limited conclusions. |
| Example | Audit engagement. | <ul style="list-style-type: none"> Review engagement; Examination of Prospective Financial Information (PFI); Examine Internal Controls. |

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| Examples of Assurance Engagements | <ul style="list-style-type: none"> Audit of F.S. - Reasonable assurance engagement Review of F.S. - Limited assurance engagement Examination of PFI - Provides assurance regarding reasonability of assumptions forming basis of projections and related matters. Report on controls operating at an organization - Provides assurance regarding design and operation of controls. |
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| Audit Vs. Review | <ul style="list-style-type: none"> Both "audit" and "review" are related to F.S. prepared on the basis of historical financial information. Audit is a reasonable assurance engagement; review is a limited assurance engagement. Review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up. |
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| Prospective Financial Information (PFI) | <ul style="list-style-type: none"> Financial information based on assumptions about events that may occur in the future and possible actions by an entity. It can be in the form of a forecast or projection or combination of both. In assurance reports involving PFI, practitioner obtains sufficient appropriate evidence to the effect that <ol style="list-style-type: none"> Management's assumptions on which PFI is based are not unreasonable, PFI is properly prepared on the basis of assumptions and PFI is properly presented & all material assumptions are adequately disclosed. As PFI is related to future events; evidences are available to support the assumptions on which the PFI is based, such evidences are also future- oriented. Practitioner is, therefore, not in a position to express an opinion as to whether the results shown in PFI will be achieved. |
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| | | <ul style="list-style-type: none"> • Therefore, practitioner provides a report assuring that nothing has come to his attention to suggest that these assumptions do not provide a reasonable basis for the projection. • Such type of assurance engagement provides only a "moderate" level of assurance. <p>"Historical Financial Information" & "Prospective Financial Information."</p> <p>Historical Financial Information (HFI): Information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods.</p> <p>Prospective Financial Information (PFI): Financial information based on assumptions about occurrence of future events and possible actions by an entity.</p> <p>HFI is rooted in past events which have already occurred whereas PFI is related to future events.</p> |
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1.4 - Qualities of Auditor

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| <p>Qualities</p> | <ul style="list-style-type: none"> • Auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. • The qualities required are tact, caution, firmness, good temper, integrity, discretion, industry knowledge, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. • In addition, auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. • Auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review F.S. and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. • An exhaustive knowledge of accounting in all its branches is the <i>sine qua non</i> of the practice of auditing. He must know thoroughly all accounting principles and techniques. |
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1.5 - Quality Control and Engagement Standards

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| <p>Need for Standards</p> | <ul style="list-style-type: none"> • Standards ensure carrying out of audit against established benchmarks at par with global practices. • Standards improve quality of financial reporting thereby helping users to make diligent decisions. • Standards promote uniformity as audit of F.S. is carried out following these Standards. • Standards equip professional accountants with professional knowledge and skill. • Standards ensure audit quality. |
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Nature, Objective and Scope of Audit

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| Standards on Quality Control (SQC) | <ul style="list-style-type: none"> Establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for the conduct of audit and review of historical financial information and for other assurance and related service engagements. SQC 1 has been issued and it requires auditors/practitioners to establish system of quality control so that: <ol style="list-style-type: none"> firm and its personnel comply with professional standards and regulatory & legal requirements and reports issued are appropriate. SQC 1 applied for all services covered by Engagement Standards. | |
| Engagement Standards | <p>"Engagement Standards" comprises the following Standards:</p> <ol style="list-style-type: none"> Standards on Auditing (SAs): to be applied in the audit of historical financial information. Standards on Review Engagements (SREs): to be applied in the review of historical financial information. Standards on Assurance Engagements (SAEs): to be applied in assurance engagements, engagements dealing with subject matter other than historical financial information. Standards on Related Services (SRRs): to be applied to engagements involving application of agreed upon procedures to information and other related services such as compilation engagements. | |
| Numbering of Standards | Standards on Quality Control (SQC) | 01-99 |
| | Standards on Auditing (SA) | 100-899 |
| | Standards on Review Engagements (SRE) | 2000-2699 |
| | Standards on Assurance Engagements (SAE) | 3000-3699 |
| | Standards on Related Services (SRS) | 4000-4699 |
| Classification of SAs | Introductory matters | 100-199 |
| | General Principles and Responsibilities | 200-299 |
| | Risk Assessments & Response to Assessed Risk | 300-499 |
| | Audit Evidence | 500-599 |
| | Using work of Others | 600-699 |
| | Audit conclusions and Reporting | 700-799 |
| | Specialised Areas | 800-899 |
| Standards on Auditing (SAs) | <ul style="list-style-type: none"> SAs apply in the context of an audit of F.S. by an independent auditor. These Standards establish high quality benchmarks and are followed by auditors in conducting audit of Historical Financial Information contained in F.S. SAs have been issued on various issues in the field of auditing ranging from overall objectives of independent auditor, audit documentation, planning an audit, identifying and assessing risk of material misstatement, audit sampling, audit evidence and forming an opinion and reporting on F.S. | |

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| | <ul style="list-style-type: none"> • Examples of SAs are: <ul style="list-style-type: none"> (a) SA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing. (b) SA 230: Audit Documentation. (c) SA 315: Identifying & Assessing Risks of Material Misstatement through Understanding the Entity and its Environment. (d) SA 500: Audit Evidence. (e) SA 700: Forming an Opinion and Reporting on Financial Statements |
| <p>Standards on Review Engagements (SRE)</p> | <ul style="list-style-type: none"> • SRE apply in the context of review of F.S. • Review is a limited assurance engagement and it provides assurance which is lower than that assurance provided by audit as review involves fewer procedures as compared to audit. • Since a review also provides assurance to users, it also involves obtaining sufficient appropriate evidence. • Examples of SREs are: <ul style="list-style-type: none"> (a) SRE 2400: Engagements to Review Historical Financial Statements. (b) SRE 2410: Review of Interim Financial Information Performed by Independent Auditor of the Entity <p>Note: Both SAs and SREs apply to engagements involving historical financial information.</p> |
| <p>Standards on Assurance Engagements (SAE)</p> | <ul style="list-style-type: none"> • SAEs deal with subject matters other than historical financial information. For example, an assurance engagement relating to examination of PFI. • In such type of assurance engagements, examination is not of historical financial information or engagement may relate to providing assurance regarding non-financial matters like design and operation of internal control in an entity. • Examples of SAEs are: <ul style="list-style-type: none"> (a) SAE 3400: The Examination of Prospective Financial Information. (b) SAE 3402: Assurance Reports on Controls at a Service Organisation. (c) SAE 3420: Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus. |
| <p>Standards on Related Services (SRS)</p> | <ul style="list-style-type: none"> • SRSs apply in case of Non-Assurance Engagements. Examples of such related services include engagements to perform agreed-upon procedures and Compilation Engagement. • Engagement to perform agreed-upon procedures require auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties etc. or a financial statement, say, a balance sheet or even a complete set of financial statements. • In Compilation engagement, practitioner is required to assist management with the preparation and presentation of historical financial information without obtaining assurance on that information. In such engagements, practitioner issues a report clearly stating that it is not an assurance engagement and no opinion is being expressed. |

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| | <ul style="list-style-type: none"> • Examples of Standards on related services are: <ol style="list-style-type: none"> (a) SEC Rule: Engagements to perform agreed-upon procedures regarding financial information. (b) SEC Rule: Compliance engagements. |
| <p>Issues in relation to Engagements and Quality Control Standards</p> | <ul style="list-style-type: none"> • It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. • However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, professional accountants are required to ensure the following: <ol style="list-style-type: none"> (a) Document how alternative procedures performed to achieve the purpose of required procedure; (b) Reason for departure has also to be documented; (c) Report should draw attention to such departures. <p>Note: A mere disclosure in report does not absolve a professional accountant from complying with applicable Standards.</p> |

NOTES

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Audit Strategy, Audit Planning & Audit Programme

2.1 – Auditor's Responsibility to Plan an Audit of F.S.

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| <p>Meaning</p> | <ul style="list-style-type: none"> • Planning in auditing encompasses developing an overall plan for the <i>expected scope and conduct of the audit and developing an audit programme showing the nature, timing and extent (NTE) of audit procedures.</i> • SA 300 "Planning an Audit of Financial Statements" deals with the auditor's responsibility to plan an audit of F.S. It states that objective of auditor is to plan the audit so that it will be performed in an effective manner. |
| <p>Benefits of Planning</p> | <p>Adequate planning benefits the audit of financial statements in several ways, including the following:</p> <ol style="list-style-type: none"> (a) Planning helps the auditor to devote appropriate attention to important areas of the audit. (b) Planning helps the auditor identify and resolve potential problems on a timely basis. (c) Adequate planning helps the auditor in properly organizing and managing the audit engagement so that it is performed in an effective and efficient manner. (d) Planning assists the auditor in the selection of engagement team members with appropriate levels of capabilities and competence. (e) Planning facilitates the direction and supervision of engagement team members and the review of their work. (f) Planning helps the auditor in coordination of work done by auditors of components and experts. <p>When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.</p> |
| <p>Planning – a continuous process</p> | <p>Planning is not a discrete phase of an audit but rather a continuous process. It often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.</p> <p>Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:</p> <ul style="list-style-type: none"> • The analytical procedures to be applied as risk assessment procedures. • Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework. • The determination of materiality. • The involvement of experts. • The performance of other risk assessment procedures. |

Audit Strategy, Audit Planning & Audit Programme

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| Involvement of Key ET Members | <p>For the following purposes:</p> <ul style="list-style-type: none"> (a) Their participation in discussion with audit team. (b) To get the benefit of their experience and insight. (c) To increase effectiveness and Efficiency of Planning. |
| Discussion of elements of planning with management | <ul style="list-style-type: none"> • Auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. • When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit |
| Elements of Planning | <ul style="list-style-type: none"> (I) Preliminary engagement activities; and (II) Planning activities |
| Preliminary Engagement Activities | <ul style="list-style-type: none"> (a) Performing procedures regarding the continuance of the client relationship. (b) Evaluating compliance with ethical requirements, including independence. (c) Establishing an understanding of terms of engagement. |
| Performing procedures regarding the continuance of the client relationship | <ul style="list-style-type: none"> • Ensure that appropriate procedures regarding acceptance and continuance of client relationships and audit engagements have been followed and conclusions reached are appropriate. • Obtain necessary information before <ul style="list-style-type: none"> (a) accepting an engagement with a new client, (b) deciding whether to continue an existing engagement, and (c) considering acceptance of new engagement from existing client. • Matters such as integrity of principal owners and key management, competence of ET to perform the audit engagement and implications of matters that have arisen during current and previous audit engagement may need to be considered. |
| Evaluating compliance with ethical requirements, including independence | <p>EP shall form a conclusion on compliance with independence requirements. In doing so, he shall:</p> <ul style="list-style-type: none"> (i) Obtain relevant information from the firm to identify and evaluate circumstances & relationships that create threats to independence. (ii) Evaluate information on identified breaches, if any, to determine whether they create a threat to independence for audit engagement. (iii) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement. (iv) EP shall promptly report to the firm any inability to resolve the matter for appropriate action. |
| Establishing an understanding of terms | <p>It is in interests of entity & auditor that auditor sends an engagement letter before commencement of audit to help avoid misunderstandings with respect to the audit.</p> |
| Planning Activities | <ul style="list-style-type: none"> (a) Establishing the overall audit strategy; and (b) Developing an audit plan. |

2.2 - Audit Strategy

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| Meaning | Audit strategy is concerned with designing optimised audit approaches that seek to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. | |
| Benefits of Audit Strategy | Employment of Qualitative Resources | Audit strategy helps in deploying the appropriate resources for specific audit areas, such as the use of experienced team members for high risk areas or the involvement of experts on complex matters. |
| | Allocation of Quantity of Resources | Audit strategy helps in allocating appropriate number of resources to specific audit areas, such as number of team members assigned to observe the inventory count at material locations, extent of review of other auditors' work in case of group audits, or the audit budget in hours to allocate to high risk areas. |
| | Timing of Deployment of Resources | Audit strategy helps in determining the timing of deploying the resources, such as whether at an interim audit stage or at key cut-off dates. |
| | Management of Resources | Audit strategy helps in managing, directing, supervising the resources, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place and whether to complete engagement quality control reviews. |
| Establishment of Overall Audit Strategy | As per SA 300 "Planning an Audit of F.S." auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and guides the development of the audit plan. In establishing the overall audit strategy, the auditor shall: (i) Identify the characteristics of the engagement that define its scope; (ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required; (iii) Consider the factors that are significant in directing the engagement team's efforts; (iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and (v) Ascertain the NTE of resources necessary to perform the engagement. | |
| | Considerations of Characteristics of Engagement | It is important for auditor to identify scope of engagement. Only a well identified scope can lead to establishment of a sound audit strategy. There are many characteristics of engagement defining its scope, including: (a) FRF applicable to the entity. (b) Nature of business segments to be audited including need for specialized knowledge. (c) Industry specific reporting requirements required by industry regulators. (d) Expected use of audit evidence obtained in previous audits. |
| | Considerations of Reporting Objectives | Ascertaining reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances to be considered are: |

Audit Strategy, Audit Planning & Audit Programme

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| | <ul style="list-style-type: none"> Entity's timetable for reporting, such as at interim and final stages. Organization of meetings with management and TCWG to discuss the NTE of the audit work. Discussion with management regarding expected type and timing of reports to be issued. Expected nature and timing of communications among ET members, including the nature and timing of team meetings and timing of the review of work performed. |
| Consideration of factors significant in directing the ET efforts | <p>Auditor needs to direct efforts of ET towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under:</p> <ul style="list-style-type: none"> Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control. Significant industry developments such as changes in industry regulations and new reporting requirements. Significant changes in the financial reporting framework, such as changes in accounting standards. Other significant relevant developments, such as changes in the legal environment affecting the entity |
| Considerations of preliminary engagement activities | <p>Considering results of preliminary engagement activities and knowledge gained from similar engagements helps in establishing sound audit strategy. For example:</p> <ul style="list-style-type: none"> Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them. Manner in which the auditor emphasizes to ET members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence. |
| Considerations of NTE of resources | <ul style="list-style-type: none"> Selection of ET and assignment of audit work to team members is a significant factor in establishing overall audit strategy. Experienced team members may be assigned in areas where there is higher RMM. |

2.3 – Audit Planning

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| Development of Audit Plan | <ul style="list-style-type: none"> Once overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. Understanding client's business is one of the important principles in developing an audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible. |
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| | <ul style="list-style-type: none"> SA-300 states that auditor shall develop an audit plan that shall include description of: <ol style="list-style-type: none"> Nature, timing and extent of planned risk assessment procedures; Nature, timing and extent of planned further audit procedures at assertion level; an Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. |
| Relationship between the Audit Strategy and Audit Plan | <ul style="list-style-type: none"> Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy. Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented. The audit plan is more detailed than the overall audit strategy that includes the NTE of audit procedures to be performed by ET members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy. Establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other. |
| Overall Audit Strategy & Audit Plan - Auditor's Responsibility | <ul style="list-style-type: none"> Overall audit strategy and audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit. |
| Changes to Planning decisions | <ul style="list-style-type: none"> The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. The auditor may need to modify the overall audit strategy and audit plan as a result of: <ol style="list-style-type: none"> unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures. Based on the revised consideration of assessed risks, auditor need to modify the NTE of further audit procedures. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict audit evidence obtained through tests of controls. |
| Planning the Direction and Supervision of Engagement Team | <ul style="list-style-type: none"> As per SA 300 "Planning an Audit of F.S." auditor shall plan the NTE of direction and supervision of ET members and the review of their work. NTE of direction and supervision of ET members and review of their work vary depending on many factors, including: <ol style="list-style-type: none"> Size and complexity of the entity. Area of the audit. Assessed risks of material misstatement. Capabilities & competence of individual team members performing the audit work. |

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| <p>Documentation of Audit Plan</p> | <p>The auditor shall document:</p> <ul style="list-style-type: none"> (a) The overall audit strategy; (b) The audit plan; and (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. <p style="text-align: center;">Points to remember</p> <ul style="list-style-type: none"> • Documentation of overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to ET. • Documentation of the audit plan is a record of the planned NTE of RAPs and FAPs at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. • Record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned NTE of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. |
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2.4 - Audit Programme

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| <p>Meaning and Nature</p> | <ul style="list-style-type: none"> • An audit programme consists of a series of verification procedures to be applied for the purpose of obtaining evidences to enable auditor to express an informed opinion on F.S. • Audit programme is a list of examination and verification steps to be applied and set out in such a way that the interrelationship of one step to another is clearly shown and designed. • In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. |
| <p>Evolving Audit Programme for different audits</p> | <ul style="list-style-type: none"> • Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary. • On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. • However, it becomes a necessity to specify in detail in audit programme, nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of. |
| <p>Assistant to keep an open mind</p> | <ul style="list-style-type: none"> • To start with, an auditor having regard to nature, size and composition of the business and dependability of internal control and given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. • As experience is gained by actually carrying out work, programme may be altered to take care of situations which were left out originally, but are found relevant. • Similarly, if any work originally provided for proves beyond doubt to be unnecessary, it may be dropped. |

Chapter 2

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| | <ul style="list-style-type: none"> • Assistants engaged should be encouraged to keep an open mind beyond the programme given to him. They should be instructed to note and report significant matters coming to their notice, to seniors or partners or proprietor of the firm. | | | | | | | | | | |
| Periodic Review of Audit Programme | <ul style="list-style-type: none"> • There should be periodic review of audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. • Unless this is done, any change in the business policy of the client may not be adequately known, & consequently, audit work may be carried on, on basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences. • Utility of audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. | | | | | | | | | | |
| Points to be considered in constructing Audit Programme | <p>For the purpose of programme construction, the following points should be kept in mind:</p> <ol style="list-style-type: none"> (1) Stay within the scope and limitation of the assignment. (2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. (3) Determine evidence reasonably available and identify best evidence for deriving the necessary satisfaction. (4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation. (5) Include audit objectives for each area and sufficient details which serve as a set of instructions for assistants involved in audit and help in controlling the proper execution of the work. (6) Consider all possibilities of error. (7) Coordinate the procedures to be applied to related items. | | | | | | | | | | |
| Audit Programme - Designed to provide Audit Evidence | <ul style="list-style-type: none"> • Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. • What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. • Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction. • Auditor picks up evidence from a variety of fields and generally of following broad types: <table border="1" style="width: 100%; border-collapse: collapse; margin-top: 10px;"> <tr> <td style="width: 50%; padding: 5px;">(i) Documentary examination</td> <td style="width: 50%; padding: 5px;">(ii) Physical examination</td> </tr> <tr> <td style="padding: 5px;">(iii) Statements and explanation of management, officials and employees</td> <td style="padding: 5px;">(iv) Statements and explanations of third parties</td> </tr> <tr> <td style="padding: 5px;">(v) Arithmetical calculations by auditor</td> <td style="padding: 5px;">(vi) State of internal controls</td> </tr> <tr> <td style="padding: 5px;">(vii) Inter-relationship of accounting data</td> <td style="padding: 5px;">(viii) Subsidiary & memorandum records</td> </tr> <tr> <td style="padding: 5px;">(ix) Minutes</td> <td style="padding: 5px;">(x) Subsequent action by client & others.</td> </tr> </table> | (i) Documentary examination | (ii) Physical examination | (iii) Statements and explanation of management, officials and employees | (iv) Statements and explanations of third parties | (v) Arithmetical calculations by auditor | (vi) State of internal controls | (vii) Inter-relationship of accounting data | (viii) Subsidiary & memorandum records | (ix) Minutes | (x) Subsequent action by client & others. |
| (i) Documentary examination | (ii) Physical examination | | | | | | | | | | |
| (iii) Statements and explanation of management, officials and employees | (iv) Statements and explanations of third parties | | | | | | | | | | |
| (v) Arithmetical calculations by auditor | (vi) State of internal controls | | | | | | | | | | |
| (vii) Inter-relationship of accounting data | (viii) Subsidiary & memorandum records | | | | | | | | | | |
| (ix) Minutes | (x) Subsequent action by client & others. | | | | | | | | | | |

• **Examples:**

- (i) For cash in hand, the best evidence is 'count'.
- (ii) For investment pledged with a bank, the banker's certificate.
- (iii) For verifying assertions about book debts, client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction.

Advantages

- (a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- (b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- (c) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- (d) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records.
- (e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- (f) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- (g) It serves as a guide for audits to be carried out in the succeeding year.
- (h) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor.

Disadvantages

- (a) Work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (b) Programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on.
- (c) Inefficient assistants may take shelter behind the programme *i.e.* defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (d) Hard & fast audit programme may kill initiative of efficient and enterprising assistants.

Points to remember

Disadvantages of an Audit programme may be eliminated by:

- **imaginative supervision of the work carried on by the assistants;**
- **receptive attitude of auditor as regards the assistants;**
- **encouraging assistants to observe matters objectively and bring significant matters to the notice of supervisor/principal.**

3

Risk Assessment and Internal Control

3.1 - Audit Risk (SA 315)

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| <p>Meaning</p> | <ul style="list-style-type: none"> • Risk that auditor gives an inappropriate audit opinion when F.S. are materially misstated. It is the possibility that auditor expresses an unmodified opinion even when F.S. are materially misstated. • Auditor is required to plan and perform audit in such a way that audit risk is reduced to an acceptably low level. SA 200 states that auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. • Audit risk is a function of the risks of material misstatement and detection risk. <p>Audit Risk - what is not included</p> <ul style="list-style-type: none"> • Audit risk is a technical term related to process of auditing; it does not refer to auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of F.S. • Audit risk does not include risk that auditor might express an opinion that the F.S. are materially misstated when they are not. This risk is ordinarily insignificant. |
| <p>Risk of Material Misstatement (ROMM)</p> | <ul style="list-style-type: none"> • SA 200 states that ROMM is the risk that the F.S. are materially misstated prior to audit, i.e., there is a probability of frauds or errors in F.S. before audit. • ROMM may exist at two levels: <ul style="list-style-type: none"> (a) Overall F.S. level; and (b) Assertion level for classes of transactions, account balances, and disclosures. • ROMM at overall financial statement level refer to ROMM that relate pervasively to the F.S. as a whole and potentially affect many assertions. • ROMM at assertion level are assessed in order to determine NTE of further audit procedures necessary to obtain sufficient appropriate audit evidence. ROMM at assertion level consist of two components: <ul style="list-style-type: none"> (a) Inherent risk; and (b) Control risk. • Both inherent and control risk are entity's risks and they exist independently of audit of F.S. Inherent and control risk are influenced by the client; not influenced by the auditor. |
| | <p>Misstatement - Meaning and Examples</p> <ul style="list-style-type: none"> • Meaning: A difference between amount, classification, presentation or disclosure of a reported F.S. item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable FRF. |

- **Examples:**
 - (a) Charging of an item of capital expenditure to revenue or vice-versa.
 - (b) Difference in disclosure of a F.S. item vis-à-vis its requirement in applicable FRF.
 - (c) Selection or application of inappropriate accounting policies.
 - (d) Difference in accounting estimate vis-à-vis its appropriateness in applicable FRF.
 - (e) Intentional booking of fake expenses in statement of profit and loss.
 - (f) Overstating of receivables by not writing off irrecoverable debts.
 - (g) Overstating or understating inventories

Components of Risk of Material Misstatement

Inherent Risk

- Susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, assuming that there were no related internal controls.
- Inherent risk is higher for some assertions & related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.
- It is important to consider reason for each identified inherent risk even if risk is lower, when auditor designs TOCs & substantive procedures

Examples of Inherent Risk

- (a) AS providing guidance on complex issue which might not be understood by management; recording of this issue carries inherent risk of being misstated.
- (b) Due to business failures in an industry, assertions in F.S. of an entity operating in such an industry carry an inherent risk of being misstated.

Control Risk

- Risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- Control Risk is the risk that material misstatement will not be prevented or detected and corrected on a timely basis by the internal control system.
- There exists an inverse relation between control risk and efficiency of internal control of an entity. When efficiency of internal control is high, control risk is low and when efficiency of internal control is low, control risk is high.

Examples of Control Risk

- (a) A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.