

AUDIT DOCUMENTATION AND AUDIT EVIDENCE

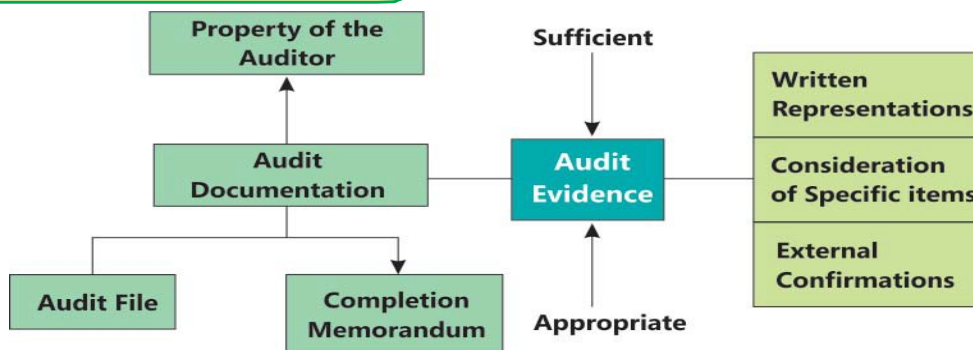


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ☐ Understand the concepts of audit documentation, nature and purpose of audit documentation, Form, content and extent of audit documentation, audit documentation summary, audit file, assembly of the final audit file, ownership of audit documentation, nature of related party relationships and transactions.
- ☐ Gain the knowledge of written representations and the objectives of the auditor regarding written representation.
- ☐ Identify Audit Evidence—Specific Considerations For Selected Items, External confirmation.
- ☐ Learn objective of Auditor with respect to Opening balances – in conducting an initial audit engagement.
- ☐ Explain audit evidence, sufficiency and appropriateness of audit evidence, types of audit evidence, relevance and reliability of audit evidence, and also methods to obtain audit evidence.
- ☐ Understand materiality, its definition and judge the materiality of the item in different circumstances.
- ☐ Explain concepts of true and fair and disclosure of accounting policies.
- ☐ Understand the Fundamental Accounting Assumptions.

CHAPTER OVERVIEW



1. AUDIT DOCUMENTATION

Audit documentation: SA 230 on “Audit Documentation”, audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as “working papers” or “work papers” are also sometimes used.)

1.1 Nature of Audit Documentation

Audit documentation provides:

- evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and
- evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

1.2 Purpose of Audit Documentation

The following are the purpose of Audit documentation:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

1.3 Form, Content and Extent of Audit Documentation

The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

1.4 Examples of Audit Documentation

Audit documentation may be recorded on paper or on electronic or other media.

Example

Audit Documentation include:

- ♦ Audit programmes.
- ♦ Analyses.
- ♦ Issues memoranda.
- ♦ Summaries of significant matters.
- ♦ Letters of confirmation and representation.
- ♦ Checklists.
- ♦ Correspondence (including e-mail) concerning significant matters.

The auditor may include copies of the entity's records (**for example**, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.

1.5 Audit File

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

1.6 Assembly of the Final Audit File

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- ◆ Deleting or discarding superseded documentation.
- ◆ Sorting, collating and cross referencing working papers.
- ◆ Signing off on completion checklists relating to the file assembly process.
- ◆ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

1.7 Documentation of Significant Matters and Related Significant Professional Judgments

Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- ◆ Matters that give rise to significant risks.
- ◆ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- ◆ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- ◆ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ◆ The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- ◆ The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- ◆ The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

1.8 Completion Memorandum or Audit Documentation Summary

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- ◆ the significant matters identified during the audit and
- ◆ how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

1.9 Ownership of Audit Documentation

Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

2. AUDIT EVIDENCE

2.1 Introduction

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

- (1) Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

2.2 Sufficiency and Appropriateness of Audit Evidence

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 such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and

analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

Sufficiency of Audit Evidence: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor's judgment as to sufficiency may be affected by the factors such as:**

- (i) **Materiality**
 - (ii) **Risk of material misstatement**
 - (iii) **Size and characteristics of the population.**
- (a) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.
- (2) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have

a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

- (c) **Size of a population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Appropriateness of Audit Evidence: Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330, "The Auditor's Responses to Assessed Risks" requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. 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 judgement. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgement regarding whether sufficient appropriate audit evidence has been obtained.

In order to obtain reliable audit evidence, information produced by the entity ("IPE") that is used for performing audit procedures needs to be sufficiently complete and accurate.

2.3 Sources of Audit Evidence

Some audit evidence is obtained by performing audit procedures to test the accounting records.

Example

- ◆ through analysis and review,
- ◆ reperforming procedures followed in the financial reporting process,
- ◆ and reconciling related types and applications of the same information.

Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.

Example

Corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors.

2.4 Audit Procedures to Obtain Audit Evidence

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

- (a) Risk assessment procedures; and
- (b) Further audit procedures, which comprise:
 - (i) Test of controls, when required by the SAs or when the auditor has chosen to do so; and
 - (ii) Substantive procedures, including tests of details and substantive analytical procedures.

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry described below may be used as risk assessment procedures, test of controls or substantive procedures, depending on the context in which they are applied by the auditor

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

Nature and Timing of the Audit Procedures

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source

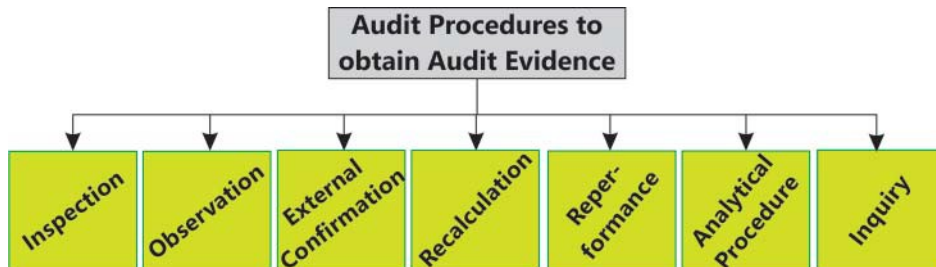
documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Audit Procedures

Audit procedures to obtain audit evidence can include:

- (i) Inspection
- (ii) Observation
- (iii) External Confirmation
- (iv) Recalculation
- (v) Reperformance
- (vi) Analytical Procedures
- (vii) Inquiry



Inspection: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example

Example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation: Observation consists of looking at a process or procedure being performed by others.

Example

The auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

External Confirmation: An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.

Example

The auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are.

External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.

Example

The absence of a "side agreement" that may influence revenue recognition.

Recalculation: Recalculation consists of checking the mathematical accuracy of

documents or records. Recalculation may be performed manually or electronically.

Re-performance: Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Example

Re-performing the reconciliation of bank statement, re-performing the aging of accounts receivable.

Analytical Procedures: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non- financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(Note : Students are advised to refer Chapter 8 Analytical Procedures for detailed understanding of the concept)

Inquiry: Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.

Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

At this stage, it would be pertinent to discuss further audit procedures, which comprise:

- (i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and
- (ii) Substantive procedures, including tests of details and substantive analytical procedures.

Test of controls: Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Test of Controls

In designing and performing test of controls, the auditor shall:

- (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:
 - (i) How the controls were applied at relevant times during the period under audit.
 - (ii) The consistency with which they were applied.
 - (iii) By whom or by what means they were applied.
- (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness.

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:

- ◆ The frequency of the performance of the control by the entity during the period.
- ◆ The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- ◆ The expected rate of deviation from a control.
- ◆ The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- ◆ The extent to which audit evidence is obtained from tests of other controls related to the assertion.

Timing of Test of Controls

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls in order to provide an appropriate basis for the auditor's intended reliance.

Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using Audit Evidence Obtained in Previous Audits

In determining whether it is appropriate to use audit evidence about the operating

effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
- (c) The effectiveness of general IT-controls;
- (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- (f) The risks of material misstatement and the extent of reliance on the control.

If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

Evaluating the Operating Effectiveness of Controls

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Specific inquiries by auditor when deviations from controls are detected.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

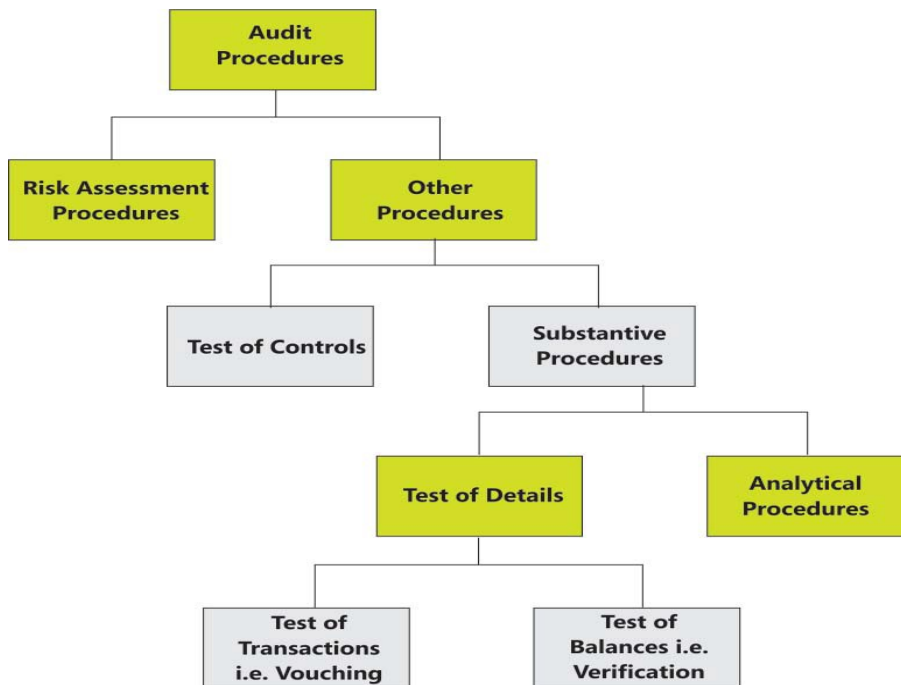
- (a) The test of controls that have been performed provide an appropriate basis for reliance on the controls;
- (b) Additional test of controls are necessary; or
- (c) The potential risks of misstatement need to be addressed using substantive procedures.

Substantive Procedures

Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (i) Tests of details (of classes of transactions, account balances, and disclosures), and
- (ii) Substantive analytical procedures.

The following chart illustrates different audit procedures:



Designing and Performing Substantive Procedures

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:

- (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and
 - (ii) there are inherent limitations to internal control, including management override.
2. Depending on the circumstances, the auditor may determine that:
- (i) Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from test of controls.
 - (ii) Only tests of details are appropriate.
 - (iii) A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.
4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

External Confirmation as Substantive Procedures

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

1. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not

be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- (i) Bank balances and other information relevant to banking relationships.
 - (ii) Accounts receivable balances and terms.
 - (iii) Inventories held by third parties at bonded warehouses for processing or on consignment.
 - (iv) Property title deeds held by lawyers or financiers for safe custody or as security.
 - (v) Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
 - (vi) Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
 - (vii) Accounts payable balances and terms.
2. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence.

Example

External confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence

3. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters.

Example

For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions.

Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

4. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:
 - (i) The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
 - (ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:
 - may not accept responsibility for responding to a confirmation request;
 - may consider responding too costly or time consuming;
 - may have concerns about the potential legal liability resulting from responding;
 - may account for transactions in different currencies; or
 - may operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

- (iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process

The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- (a) Agreeing or reconciling the financial statements with the underlying accounting records; and
- (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature, and also the extent, of the auditor's examination of journal entries and

other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks: When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

The above paragraph requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error.

Example

If the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

The Use of Assertions

1. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

2. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:
- (a) Assertions about classes of transactions and events for the period under audit:
 - (i) **Occurrence** – transactions and events that have been recorded have occurred and pertain to the entity.
 - (ii) **Completeness** – all transactions and events that should have been recorded have been recorded.
 - (iii) **Accuracy** – amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (iv) **Cut-off** – transactions and events have been recorded in the correct accounting period.
 - (v) **Classification** – transactions and events have been recorded in the proper accounts.
 - (b) Assertions about account balances at the period end:
 - (i) **Existence** – assets, liabilities, and equity interests exist.
 - (ii) **Rights and obligations** – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (iii) **Completeness** – all assets, liabilities and equity interests that should have been recorded have been recorded.
 - (iv) **Valuation and allocation** – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
 - (c) Assertions about presentation and disclosure:
 - (i) **Occurrence and rights and obligations** – disclosed events, transactions, and other matters have occurred and pertain to the entity.
 - (ii) **Completeness** – all disclosures that should have been included in the financial statements have been included.

- (iii) **Classification and understandability** – financial information is appropriately presented and described, and disclosures are clearly expressed.
 - (iv) **Accuracy and valuation** – financial and other information are disclosed fairly and at appropriate amounts.
3. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.
 4. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph 2, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed.

Example 1: When we find in the balance sheet, an item under current assets reading as “cash in hand - ₹ 8,000” the obvious assertions that would strike the mind are the following:

- (i) The firm concerned had ₹ 8,000 in hand in valid notes and coins on the balance sheet day;
- (ii) That the cash was free and available for expenditure to the firm; and
- (iii) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

Example 2:

Particulars		₹
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,00	
Depreciation for the year	13,00	83,000
		1,17,000

The assertions are as follows:

- (i) the firm owns the plant and machinery;
- (ii) the historical cost of plant and machinery is ₹ 2 lacs;
- (iii) the plant and machinery physically exists;
- (iv) the asset is being utilised in the business of the company productively;
- (v) total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and
- (vi) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements. Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading.

An example of the former category may be found in the following items appearing in the liability side of the balance sheet:

Secured Loans ₹ 4,00,000

The description does not give us a complete picture. We do not know:

- (i) the name of the lender, if it is relevant;
- (ii) the nature of security provided; and
- (iii) the rate at which interest is payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position. Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present "the results of operations" a balance sheet purports to present "financial position". The auditor's opinion is typically directed to these

overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that makes up each of these statements. Out of his individual judgments of these specific assertions he arrives at a judgement on the financial statement as a whole.

Some observations about audit evidence may be of help in deciding upon the techniques to be adopted for obtaining them. First, there is nothing mysterious about the evidence which an auditor can obtain and on which he relies; it is straight forward information, some of it is obtained only by diligent effort but all of it is of the common sense variety. Second, evidence varies in reliability. When the auditor recalculates certain figures, like depreciation or inventory valuation, he may be completely convinced about the reliability of the company's figure. However, information supplied by an employee may not be that reliable because he may have an interest in concealing rather than revealing the truth. This suggests that we must always be alert to the relative reliability of different kinds of evidence. Third, some evidence may be more difficult to obtain than other. It is relatively easy to put questions to employees who are present inside the company. It is easy to examine inventory on hand; it is more difficult to verify inventory stored elsewhere. Fourth, it must be recognised that the available evidence be persuasive and that the evidence may not be conclusive. In giving the opinion, the auditor necessarily takes a calculated risk. He gets the best evidence reasonably available and forms his judgment accordingly. In fact, in auditing it is very difficult and at times impracticable to obtain conclusive evidence both on account of time and cost constraints. This explains why an auditor gives an opinion rather than some kind of guarantee or certificate. All he can state is that he has carefully examined the various assertions in the financial statements, obtained evidence what he, in his professional judgement, thought adequate or the best available; and that he has considered that evidence judiciously in forming an opinion as to the reliability of the financial statements. Fifth, the auditor may gain increased assurance when audit evidence obtained from different sources of a different nature is consistent. In the 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 procedure may have to be performed to resolve the inconsistency. Sixth, the auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation. In selecting procedures to obtain evidence, he should recognize the possibility that the financial information may be materially misstated. Seventh, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the

matter of difficulty and expenses involved in testing a particular item is not in itself a valid basis for omitting a procedure. Eight, when the auditor is in reasonable doubt as to any assertion he should 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.

2.5 Types of Audit Evidence

Internal evidence and external evidence: Evidence which originates within the organisation being audited is internal evidence.

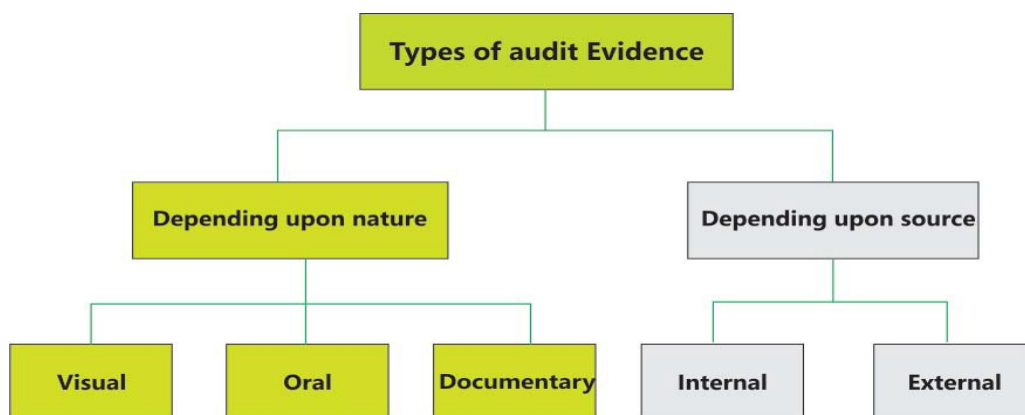
Example

Sales invoice, Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization.

Example

Purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.



In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties

who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g. an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see as to what extent the various internal evidence corroborate each other.

2.6 Relevance and Reliability

While audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources.

Example

Previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance: Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing.

Example

If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to

the same assertion.

Test of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing test of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation in conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

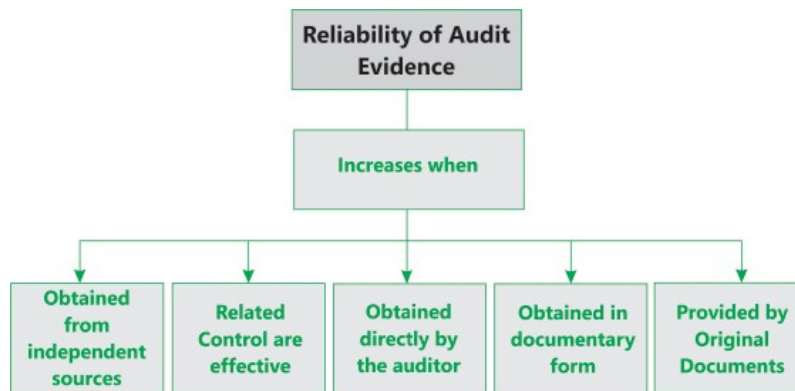
Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- ◆ The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- ◆ The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- ◆ Audit evidence obtained directly by the auditor (for **example**, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for **example**, inquiry about the application of a control).
- ◆ Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for **example**, a

contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

- ♦ Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.



3. WRITTEN REPRESENTATIONS

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

3.1 Written Representations as Audit Evidence

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or

about specific assertions.

ILLUSTRATION

The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of Kapur Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter.

Required

Discuss how would you deal as an auditor.

SOLUTION

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

3.2 The objectives of the auditor regarding written representation

The objectives of the auditor are:

(a) To obtain written representations

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other evidence

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(c) To respond appropriately

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

3.3 Management from Whom Written Representations Requested

The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation. However, management (rather than those charged with governance) is often the responsible party.

Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

- ◆ An actuary responsible for actuarially determined accounting measurements.
- ◆ Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
- ◆ Internal counsel who may provide information essential to provisions for legal claims.

In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

3.4 Written Representations about Management's Responsibilities

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements.

Audit evidence obtained during the audit that management has fulfilled the responsibilities is not sufficient without obtaining confirmation from management about the same. This is because the auditor is not able to judge solely on other audit evidence.

For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

- ◆ Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- ◆ The terms of the audit engagement were prepared in a previous year;
- ◆ There is any indication that management misunderstands those responsibilities; or
- ◆ Changes in circumstances make it appropriate to do so.



4. AUDIT EVIDENCE — SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

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

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

4.1 Inventory

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

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

4.2 Attendance at Physical Inventory Counting

Attendance at Physical Inventory Counting Involves:

- (a) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- (b) Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- (c) Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

4.3 Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include, for example:

- (a) Nature of inventory.
- (b) Stages of completion of work in progress.
- (c) The risks of material misstatement related to inventory.

- (d) The nature of the internal control related to inventory.
- (e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- (f) The timing of physical inventory counting.
- (g) Whether the entity maintains a perpetual inventory system.
- (h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- (i) Whether the assistance of an auditor's expert is needed.

4.4 Physical Inventory Counting Conducted Other than at the Date of the Financial Statements

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

4.5 If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

4.6 Attendance at Physical Inventory Counting Is Impracticable

If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, **for example**, where inventory is held in a location that may pose threats to the safety of the auditor.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as

explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

In some cases where attendance is impracticable, alternative audit procedures, for **example** inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

ILLUSTRATION

Paramount Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of Paramount Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

Required

Suggest the audit procedures in the given case.

SOLUTION

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

- (b) Perform inspection or other audit procedures appropriate in the circumstances.

4.7 Litigation and Claims

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

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

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

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, for example, where:

- ◆ The auditor determines that the matter is a significant risk.
- ◆ The matter is complex.
- ◆ There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

ILLUSTRATION

Pride India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

Required

Suggest the auditor with reference to SAs.

SOLUTION

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

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

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

**5. EXTERNAL CONFIRMATION**

External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

5.1 Definition of other Important Terms

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

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

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

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

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

5.2 External Confirmation Procedures

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested;
- (b) Selecting the appropriate confirming party;
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

5.3 Determining the Information to be Confirmed or Requested

External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

5.4 Designing Confirmation Requests

The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

Factors to consider when designing confirmation requests include:

- ◆ Specific identified risks of material misstatement, including fraud risks.
- ◆ The layout and presentation of the confirmation request.
- ◆ Prior experience on the audit or similar engagements.
- ◆ The assertions being addressed.

- ◆ The method of communication [for **example**, in paper form, or by electronic mode (like e-mail) or other medium].
- ◆ Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- ◆ The ability of the intended confirming party to confirm or provide the requested information (for **example**, individual invoice amount versus total balance).

5.5 Management's Refusal to Allow the Auditor to Send a Confirmation Request

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

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

ILLUSTRATION

While conducting the audit of Jay Kay Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables but the management refused the auditor to send confirmation request.

Required

How would the auditor proceed?

SOLUTION

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

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

**6. INITIAL AUDIT ENGAGEMENT**

An engagement in which either:

- (i) The financial statements for the prior period were not audited; or
- (ii) The financial statements for the prior period were audited by a predecessor auditor.

6.1 Objective of Auditor with respect to Opening Balances – in conducting an Initial Audit Engagement

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

6.2 Audit Procedures regarding Opening Balances

The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following:
 - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with SA 450.

6.3 Consistency of Accounting Policies relating to opening balances

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the

accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

6.4 Audit Conclusions and Reporting in relation to Opening Balances

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.



7. MEANING OF RELATED PARTY

A party that is either:

- (i) A related party as defined in the applicable financial reporting framework ; or
- (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - (a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - (b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - (c) Another entity that is under common control with the reporting entity through having:
 - Common controlling ownership;
 - Owners who are close family members; or
 - Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

7.1 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

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

7.2 Responsibilities of the Auditor

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

- (a) Achieve a true and fair presentation ; or
- (b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.

Owing to 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 the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- ◆ Management may be unaware of the existence of all related party relationships.
- ◆ Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.



8. CONCEPT OF TRUE AND FAIR

The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with Accounting Standards.

What constitutes a 'true and fair' view is a matter of an auditor's judgment in the

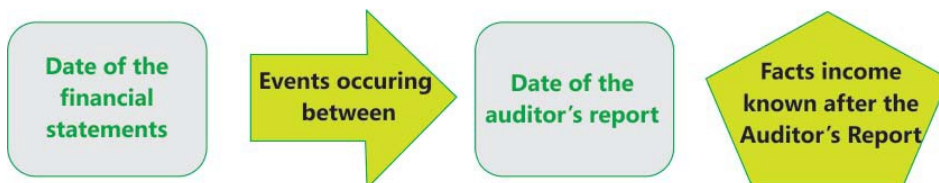
particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

- (i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
- (ii) no material asset is omitted;
- (iii) the charge, if any, on assets are disclosed;
- (iv) material liabilities should not be omitted;
- (v) the profit and loss account and balance sheet discloses all the matters required to be disclosed;
- (vi) accounting policies have been followed consistently; and
- (vii) all unusual, exceptional or non-recurring items have been disclosed separately.

9. AUDITOR AND THE SUBSEQUENT EVENTS

Meaning of Subsequent Events

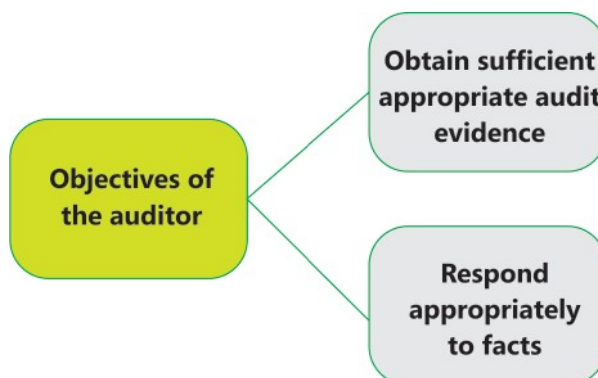
Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.



Objectives

The objectives of the auditor are to:

- (a) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and
- (b) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

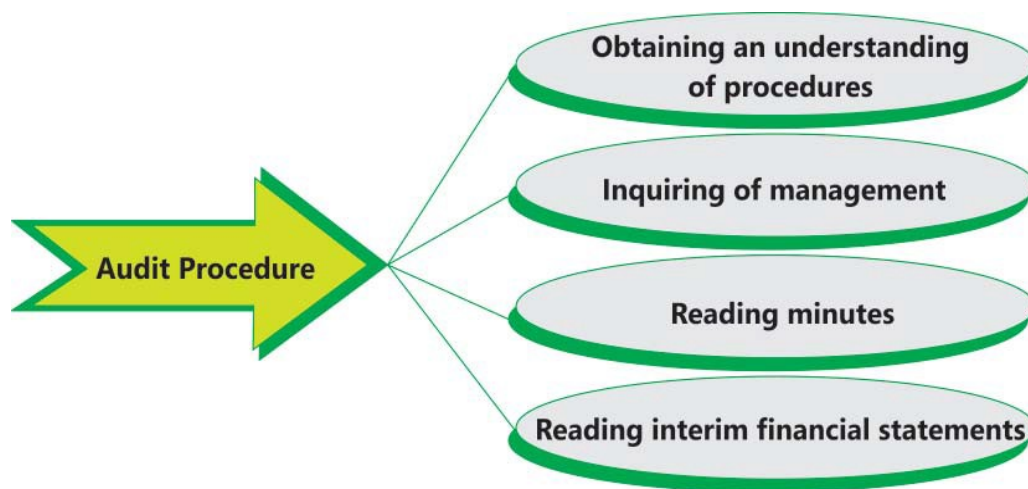


Audit Procedure Regarding Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment which shall include the following:



- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity's latest subsequent interim financial statements, if any.

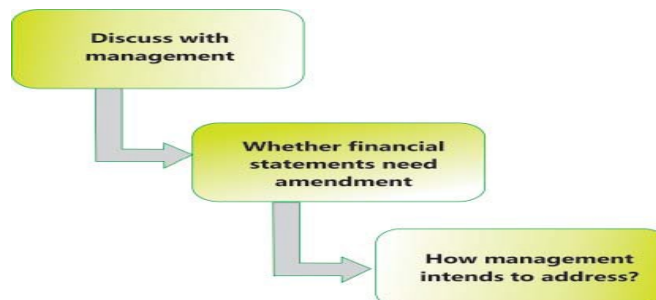
When, as a result of the procedures performed as required above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Auditor's Obligations Regarding Subsequent Events

(I) Facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.



(II) Facts Which Become Known to the Auditor After the Financial Statements have been Issued

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.

10. AUDITOR AND THE GOING CONCERN ASSUMPTION

Going Concern Basis of Accounting

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is



appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern

The objectives of the auditor are:

- (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Responsibilities of the Auditor

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Events or Conditions That May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern

The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

Financial

- ◆ Net liability or net current liability position.
- ◆ Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- ◆ Indications of withdrawal of financial support by creditors.
- ◆ Negative operating cash flows indicated by historical or prospective financial statements.
- ◆ Adverse key financial ratios.

Operating

- ◆ Management intentions to liquidate the entity or to cease operations.
- ◆ Loss of key management without replacement.
- ◆ Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- ◆ Labor difficulties.
- ◆ Shortages of important supplies.
- ◆ Emergence of a highly successful competitor.

Other

- ◆ Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- ◆ Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- ◆ Changes in law or regulation or government policy expected to adversely affect the entity.
- ◆ Uninsured or underinsured catastrophes when they occur.

Additional Audit Procedures When Events or Conditions Are Identified

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (hereinafter referred to as "material

uncertainty”) through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

- (a) Where management has not yet performed an assessment of the entity’s ability to continue as a going concern, requesting management to make its assessment.
- (b) Evaluating management’s plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management’s plans are feasible in the circumstances.
- (c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management’s plans for future actions:
 - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
 - (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
- (d) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- (e) Requesting written representations from management regarding their future action plans and the feasibility of these plans.

Audit procedures that are relevant to the requirement as stated above may include the following:

- ◆ Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- ◆ Analyzing and discussing the entity’s latest available interim financial statements.
- ◆ Reading the terms of debentures and loan agreements and determining whether any have been breached.
- ◆ Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- ◆ Inquiring of the entity’s legal counsel regarding the existence of litigation and claims and the reasonableness of management’s assessments of their outcome and the estimate of their financial implications.

- ◆ Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- ◆ Evaluating the entity's plans to deal with unfilled customer orders.
- ◆ Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- ◆ Confirming the existence, terms and adequacy of borrowing facilities.
- ◆ Obtaining and reviewing reports of regulatory actions.
- ◆ Determining the adequacy of support for any planned disposals of assets.

SUMMARY

Audit documentation (SA 230) refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation provides evidence of the auditor's basis for a conclusion and evidence that the audit was planned and performed in accordance with SAs. Audit file refers to one or more folders or other storage media containing the records that comprise the audit documentation for a specific engagement.

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

Risk assessment procedures refer to the audit procedures performed to obtain an

understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Written representations may be defined as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

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

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

External confirmation may be defined as an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the

auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

TEST YOUR KNOWLEDGE

MCQs

1. _____ refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.
 - (a) Audit Techniques
 - (b) Audit evidence
 - (c) Audit Documentation
 - (d) None of the above
2. _____ may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
 - (a) Audit File
 - (b) Audit evidence
 - (c) Completion Memorandum
 - (d) both (a) and (b) above
3. As per SQC-1 "An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than ____ days after the date of the auditor's report".
 - (a) 30
 - (b) 60
 - (c) 90
 - (d) 45
4. A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
 - (a) ... Positive confirmation request

- ... (b) Non Response
 - (c) Negative Confirmation request
 - (d) Exception
5. Auditor's judgment as to sufficiency may be affected by which factor:
- (a) Materiality
 - (b) Risk of material misstatement
 - (c) Size and characteristics of the population.
 - (d) All of the above
6. Which of the following is not an Audit procedures to obtain audit evidence :
- (a) Inspection
 - (b) Observation
 - (c) External Confirmation
 - (d) None of the above
7. Which of the following is not an assertion about presentation and disclosure:
- (a) Occurrence and rights and obligations
 - (b) Completeness
 - (c) Classification and understandability
 - (d) Existence

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

- (i) As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor.
- (ii) Purchase invoice is an example of internal evidence.
- (iii) Sufficiency is the measure of the quality of audit evidence.

Theoretical Questions

- 1. Define audit documentation. Also give some examples.
- 2. "Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.

3. "Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal". Discuss.
4. Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.
5. Define Risk of material misstatement. Explain its components also.
6. "When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences" Explain.

ANSWERS/SOLUTIONS

Answers to MCQs

- | | | | | | | | | | | | |
|----|-----|----|-----|----|-----|----|-----|----|-----|----|-----|
| 1. | (c) | 2. | (a) | 3. | (b) | 4. | (c) | 5. | (d) | 6. | (d) |
| 7. | (d) | | | | | | | | | | |

Answers to Correct/Incorrect

- (i) **Incorrect:** As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.
- (ii) **Incorrect:** Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.
- (iii) **Incorrect:** Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

Answers to Theoretical Questions

1. Refer Para 1.4
2. Refer Para 1.8
3. Refer Para 3.1
4. Refer Para 6.1
5. Refer Para 2.2
6. Refer Para 2.4