

Audit Strategy, Planning and Programming

2.1 Commencing an Audit

Auditing has been conceived of to provide a highly useful technical service to the economy to know performances in financial and other appropriate terms in a reliable manner. It is needless to say that multitudes of significant decisions in the economic society are taken based on the financial information and, therefore, ensuring reliability of such information is an imperative necessity. Any such important technical function as auditing requires a thorough planning to avoid slips and omissions which may take place because of the complexity, volume and technicality of the economic operations. The audit planning is also necessary to conduct an effective audit in an efficient and timely manner. It has been stated that the audit plans should be based on knowledge of client's business. Further, plans should be made to cover, among other things:

- (a) acquiring knowledge of the client's accounting system, policies, and internal control procedures;
- (b) establishing the expected degree of reliance on internal control;
- (c) determining and programming the nature, timing and extent of the audit of procedures to be performed; and
- (c) coordinating the work to be performed.

Planning in auditing encompasses developing an overall plan for the expected scope and conduct of the audit and developing an audit programme showing the nature, timing and extent of audit procedures. Planning is a continuous process and changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan as well as the detailed audit programme. It is necessary to document reasons of significant changes in audit planning. Careful and adequate audit planning is helpful in: (i) ensuring devotion of appropriate attention to important areas of the audit, (ii) promptly identifying potential problems, (iii) completing the work expeditiously, (iv) proper utilisation of assistants, and (v) co-ordination of work done by other auditors and experts.

2.1.1 Before Engagement: Before an auditor accepts a new appointment, he should communicate by a letter with the retiring auditor to see if there is any professional reason why the appointment should be refused. Such communication is an ethical requirement as opposed to a legal requirement, and it can also be seen as a matter of professional courtesy to the previous holder of the post. The duty to communicate should be explained to the potential client, from whom authority must be obtained before writing. If such authority is not forthcoming or if the existing auditor is prevented from revealing anything of the client's affairs,

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then the appointment should not be accepted; for such would be a strong indication that something is amiss. Normally the communication will be a routine matter, but occasionally circumstances may reveal which could affect an acceptance decision. Such circumstances may range from failure to pay fees, to dubious trading practices, and even to undue pressure being placed upon auditors to comply with directors' wishes concerning the accounts. The requirement to communicate may be seen as one of the ways in which the profession seeks to protect itself against this latter ever-present risk.

If the audit is that of a limited company, the scope of the work is defined by statute. But if the client is a partnership or sole trader, then it will be very necessary to discuss the precise scope of the work that is required, carefully distinguishing between audit and accountancy work and any other services. The extent of any audit work must be precisely defined to ensure that there are no misunderstandings as to the scope of work. And whatever may be the type of audit, at this stage it will also be appropriate to discuss the basis for charging the fee. These and other matters must be put in writing to safeguard the auditor in case of future legal disputes, and this is the best achieved by an engagement letter as discussed below.

2.1.2 Audit Engagement Letter: *As per SA 210 "Agreeing the Terms of Audit Engagements"*, the form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on SA 200 (Revised). Paragraphs 6(b) and 12 of this SA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, SAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations (see also paragraph A13).
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.

- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

Many audit firms have standard engagement letters to cover different circumstances. Two copies of the letter should be sent, one to be signed and returned by the client as acknowledgement of and agreement to the terms contained therein.

2.1.3 Commencement procedures: Once a satisfactory reply has been received from the retiring auditor, and the engagement has been documented in the form of an engagement letter, the auditor can begin collecting the information necessary to commence his detailed work. This will include:

- ◆ A copy of the regulations (if any) of the client, e.g., Memorandum and Articles of Association, or partnership agreement, or club rules, etc.
- ◆ Details as to the nature of the business.
- ◆ Details of physical location of factories, offices, shops, etc.
- ◆ An organisation chart of the client's staff, with special emphasis on those employees with whom the auditor is likely to have regular contact.
- ◆ An accounts manual, or other details as to the accounting system and the accounting records of which it is composed.
- ◆ Copies of previous annual accounts.
- ◆ Details of the financial history of the company, noting whether it is listed or unlisted, and whether it is director controlled.
- ◆ Names and addresses of the client's advisers, including solicitors, stockbrokers, bankers and management consultants.
- ◆ Copies of important documents, such as leases, debenture deeds and major contracts.

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During the course of acquiring the information it can be extremely valuable to visit the client's various locations, and to meet the employees with whom the auditor is likely to have frequent dealings. In this way a very valuable initial impression can be gained of the efficiency of the company and of the sort of problems that may be encountered during the course of the audit.

2.1.4 Knowledge of the client's business: The knowledge of the client's business is one of the critical elements in formulating the audit programme. The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment.

As per SA 315 the auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgement, may have a significant effect on the financial information. Among other things, the auditor can obtain such knowledge from:

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

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

Discussions with the client might include such subjects as:

- ◆ Changes in management, organisation structure and activities of the client.
- ◆ Current Government legislation, rules, regulations and directives affecting the client.
- ◆ Current business developments affecting the client.
- ◆ Existence of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.

- ◆ New or old premises and plant facilities.
- ◆ Recent or impending changes in technology, type of products or services and production or distribution methods.
- ◆ Significant matters arising from previous year's financial statements, audit report and management letters, if any.
- ◆ Changes in accounting practices and procedures and in the system of internal control.
- ◆ Scope and timing of the examination.
- ◆ Assistance of client's personnel in data preparation.
- ◆ Relevance of any work to be carried out by the client's internal auditors.

2.2 Formulating an Audit Programme

In PCC/IPCC study material, we have discussed audit programme generally so as to enable the students to know the utility and nature of audit programmes. It is useful for students to know how to plan an audit programme. The next step in planning is to prepare a written audit programme setting forth the procedures that are needed to implement the overall plan of audit. The programme, in addition, may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of work. It may be emphasised that a clear spelling out of audit objectives for each area is important to link up the procedures with audit objectives and to ensure a purposeful audit. For example, in the area of fixed assets, audit objectives can be the following:

- (i) Ascertaining their existence on the balance sheet date;
- (ii) Confirming ownership;
- (iii) Finding out encumbrances attaching the assets, if any;
- (iv) Determining the valuations;
- (v) Presentation of relevant information for a proper understanding of their nature value and usefulness;
- (vi) Proper categorisation of assets;
- (vii) Generally ascertaining whether the assets are in good working order.

Procedures of verification for this purpose may include physical verification, review of working papers, document verification including verification of loan documents, checking of provisions for depreciation, review of accounting policy on fixed assets, verification of compliance with legal requirements about disclosure and verification of jobs work performed by the assets. This linkage in the mind of the assistants on job is imperative and without this the audit would be just a mechanical performance. They should be able to identify the assertions made in the Balance Sheet and Profit and Loss Account because that provides key to the auditor's selection of the procedures. The important matters which need to be considered in this regard are:

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- (a) Nature of business in which the organisation is engaged.
- (b) Overall plan prepared for the audit.
- (c) System of internal control and accounting procedures.
- (d) Size of the organisation and structure of its management.
- (e) Information regarding the organisation of business.
- (f) Accounting policies followed by the client.

(a) Nature of business in which the organisation is engaged: On his first appointment, the auditor should examine in detail the financial and accounting organisation of the business by visiting the client's office; by observing different stages through which papers pass before each transaction is authorised and recorded; the record that is kept and the titles of books in which it is kept. In the case of an industrial concern, he must also visit the factory to acquaint himself with the different processes of manufacture, the quantitative records maintained and the manner in which statistics are compiled in respect of losses in process. He also must find out the technical details of manufacture so that he can test check that the quantities of materials shown to have been issued for various processes of manufacture are in consonance with the technical formulae reported to him, and that losses in different processes are not larger than those anticipated.

The nature of business carried on by the concern has a great relevance to different audit procedures. The auditor, therefore, should draw up the programme of audit on a consideration of the technical, financial and accounting set-up of the company. In addition, for his general guidance, he must study the audit programme of different types of business to find out audit procedures that are considered suitable under different conditions and circumstances. The Institute of Chartered Accountants of India has brought out Technical Guides concerning audit of specified industries, for example; sugar, textiles, type, advertising, etc. Students will do well to read them to understand the several technical aspects to be gone into while undertaking the audit of such industries. The nature and size of the business is a basic fact to be reckoned in devising the audit procedures and in assessing the adequacy of the internal control in recognition of this, the auditors are required to give their assessment of the internal controls in relation to the nature and size of the company under the Companies (Auditor's Report) Order, 2003.

(b) Overall plan: Overall plan for the audit programme should be drawn up to ensure a systematic approach to the work. If in drawing the audit programme, any divergence from the overall plan becomes necessary, first the overall plan should be modified after due consideration and thereafter only the matter may be taken in the audit programme. The frame provided by the overall plan should be strictly adhered to.

(c) System of internal control and accounting procedures: The existence of a system of internal control is essential for every business organisation. It ensures that both financial and statistical records are checked continuously; it also unearths errors, both of omission and of commission. The auditor, in framing his opinion on financial statements needs reasonable assurance that transactions are properly authorised and recorded in the accounting records

and that transactions have not been omitted. Internal control may contribute to the reasonable assurance the auditor seeks. Therefore it has become an accepted audit practice to study and evaluate internal control. The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal control in determining the nature, timing and extent of his substantive auditing procedures. The auditor also obtains an understanding of the accounting system to identify points in processing of transaction and handling of assets where errors or fraud may occur. When the auditor relies on internal control, it is at these points that he must be satisfied that internal control procedures applied by the entity are effective for his purpose.

In the context of our country, the study and evaluation of internal control has become a standard audit procedure for the contribution it can make towards satisfactory discharge of auditing responsibilities and also for the very nature of statutory duty cast on company auditors. Maintenance of accurate and complete accounting records constitutes an integral part of internal control. Under Section 227(3) of the Companies Act, an auditor has to report, *inter alia*, whether proper books of account required by law have been maintained by the company. Maintenance implies maintenance in a complete and accurate manner and it requires a study and evaluation by the auditor. It amounts to a statutory requirement to study and evaluate this aspect of internal control. Further, the CARO, 2003 issued under Section 227(4A) of the Companies Act directly requires the auditor to study and evaluate internal control in specific areas.

Before commencing an audit, it is essential that the auditor should verify that proper records of transactions entered into by the entity have been maintained and that accounting data collected has been duly analysed. For the purpose, he should examine the procedures followed for recording transactions. He should also verify that there exists a system of internal control which guards against occurrence of mistakes and frauds. The verification of the system of the internal control obtaining in the client's office is thus the primary duty of the auditor. He carries it out by examining the manner in which it operates and by application of procedural checks and test checks to a number of transactions of different kinds recorded in the books. The auditor's examination of the system of internal control should have three features: review and preliminary evaluation, testing of compliance and evaluation.

- (i) **Review and preliminary evaluation** - The auditor should review the accounting system and related internal control to gain an understanding of the flow of transactions and the specific control procedures to be able to make a preliminary evaluation and identification of these aspects of internal control on which it might be efficient and effective to rely in conducting his audit. He should enquire whether the internal controls intended to be relied upon were in use throughout the period for which accounts were made up. If substantially different controls were in use at different times during the period, the auditor should consider each of them separately. A break-down in internal controls for specific portions of the period would necessitate a separate consideration of the nature, timing and extent of audit procedures to be applied for that period. The review is made by reference to documents i.e., manuals, job descriptions and flow charts and discussions with related personnel of the client. It may be useful to trace a transaction through the accounting system to assist in understanding that system and its related internal controls.

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Different techniques such as narrative description, questionnaire and flow-chart are available to the auditor to record information relating to internal control. Selection of the particular technique is a matter of auditor's own judgement the purpose of preliminary evaluation is to identify the particular controls on which the auditor still intends to rely and to test them through compliance procedures. The auditor may also decide not to rely on any particular internal control.

(ii) **Test of compliance** - Compliance tests should be conducted by the auditor to gain evidence that those internal controls on which he intends to rely operate generally as identified by him and that they function effectively throughout the period of intended reliance. Based on the results of his compliance procedure including observed deviations, the auditor should evaluate whether the internal controls are adequate for his purposes. If based on the results of compliance procedure, the auditor concludes that a particular control cannot be substantially relied upon; he should ascertain whether there exists another control that may satisfy his purpose. For example, if he finds that materials are not regularly checked for quantity when received at the Receiving Section but Stock Section carries out a quantity check before accepting the materials in stock, he may prefer to rely on Stock Section checking for receipt of the materials as correct quantity, provided further that the Stock Section records are properly and regularly maintained. If he cannot find another supportive control procedure, he may have to modify the nature, timing and extent of his substantive audit procedure. The compliance procedure normally should be applied to transactions selected from those of the whole period under examination. Compliance procedure is essentially a testing procedure. It demands that important sections of the record of the concern or selected items of income and expenditure of transactions should be examined "in depth" and by the application of procedural tests to ensure that the transactions have been properly authorised, evidenced and recorded. In certain cases, for purpose of verification, it is necessary to observe the operation of the system by actual attendance, e.g., in the case of stock-taking, payment of wages, etc. The examination in depth is a method whereby a few selected transactions are traced through various stages from the origin to the conclusion: at each stage, the record and the authority are examined and the operation of internal check and delegation of authority considered. For example, to verify in depth a payment to a creditor in respect of goods supplied, it will be necessary to examine the following documents:

- ◆ The invoice and the statement of account received from the supplier.
- ◆ The evidence that goods have been entered in stock records.
- ◆ The goods received note and inspection certificate.
- ◆ A copy of the original order and the authority therefore.

The number of transactions selected for examination in depth, generally, can be reduced as the intricacy of examination increases. For example, while examining payments to creditors for goods supplied, the auditor, after he has verified all the acknowledgements for payments, need examine only a proportion of these cases with the suppliers' invoices

and statements and a still smaller proportions of the evidence that goods have been recorded in the stock records and so on until a comparatively small proportion is verified completely in depth. In addition, there are several other audit tests which can be applied to strengthen the effectiveness of the system of internal control, e.g., procedural test. In the case of a small concern, a large proportion of transactions should be selected for examination in depth or application of procedural tests than is necessary in the case of a large concern since the latter would normally have a more comprehensive system of internal control. Further, in selecting items for examination as well as for deciding the scope of tests, the auditor should consider to what extent the transactions under review are material in relation to the affairs of the company as a whole. In addition to the annual review of all procedures, it is desirable that each year the auditor makes an intensive review of the accounting procedures relative to one main aspect of the activities of the business, e.g., purchases, sales, payment of wages and salaries. In this way, it would be possible for him to review the main aspects of the system of internal control over a period of years.

- (iii) **Evaluation** - It is essentially an objective process of application of auditor's judgement to determine whether all or any of the internal controls in the client's organisation can be relied upon in carrying out the audit. Based on the degree of reliance which may be full, partial or none, the auditor will programme for the substantive verification of transactions for expression of audit opinion. The results of compliance procedure directly provide the basis for this evaluation and, in turn, basis to determine the nature, timing and extent of the substantive audit procedure. In evaluating the auditor recognises that some deviations from compliance may have occurred.

If the tests applied by the auditor reveal certain mistakes in accounting due to which either some transactions have not been recorded or have been wrongly recorded, the auditor should ascertain the nature and causes thereof. In case they are the result of some inherent defect in the system of recording, their impact on the true and fair position of the records should be assessed by extending the area selected for examination. For example, if it is the duty of the sales manager to verify that various items of goods have been correctly billed to customers and the examination of sales invoices that reveals wrong rates have been applied in the case of one or two invoices, it should be assessed whether the mistake are accidental or otherwise. If, however, there are many such instances, the presumption would be that the sales manager had failed to discharge his duty. If despite this, the auditor is satisfied that the magnitude of discrepancies or irregularities is not sufficiently large to affect the true and fair character of the accounts of the concern, he may decide to rely upon the control. In such a case, he needs only report the result of his findings to the management with a recommendation that the system of internal control be strengthened in such ways as he considers appropriate. If, however, the auditor considers that the internal control is inadequate to such an extent that reliance cannot be placed, he may have to extend his substantive audit procedure significantly. If he is still not satisfied that the records are sufficiently reliable, he should state in his report that books of account have not been properly kept.

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In the end, the auditor should prepare a memorandum as regards the system of internal control in operation, the test checks applied and matters observed on their application as a general guide for drawing up the programme of audit. In specific terms he will identify the controls which he has decided to rely upon, the controls which may be relied upon only in conjunction with another control and the controls which cannot be relied upon together with appropriate basis.

(d) Size of the organisation and structure of its management: An increase in the size of the organisation enhances the complexity of the examination of its accounting records specially when it has a number of branches, deals in several products or has a very large turnover. With the increase in the size ordinarily the scope and extent of the system of internal control also should increase but it may not be so in every case. It has been the experience that while many small businesses have excellent controls, some of the large enterprises are deficient in their operational controls. For example, the reports of the Comptroller and Auditor General on audit of accounts of Public Enterprises show that some of them have a very poor system of internal control. In such cases, the magnitude of the tasks of the auditor increases considerably.

The structure of management of a concern is governed by law as well as its status in the industry. For instance, management structure of a company is one contemplated by the Companies Act. It is simple or elaborate, depending upon the position the company occupies in the trade or industry in which it is engaged. For example, a company which is big and is engaged in diverse trade or business would have a large Board of Directors, a number of whole-time directors and a team of qualified managers to attend to different aspects of the business activity-technical, financial accounting, commercial, etc. On the other hand, a small company may only have a managing director who attends to all the affairs of the company and a small board of directors to guide its operations.

The structure of management of a co-operative society is the one contemplated by the Co-operative Societies Act. Usually, its affairs are managed by persons who neither have had formal training nor any commercial or administrative experience. Moreover, on account of the limitation on shareholdings, no member of the managing committee has a sizeable investment. Thus, self-interest which is an incentive to efficient management, is absent in a co-operative enterprise. On that account the Co-operative Societies Act provides a detailed control over the working of co-operative institutions by a Governmental agency (the Registrar).

It is also important for the auditor to examine the character of management for determining the seat of power. If he is satisfied, it would not be necessary for him to examine each and every decision taken by the management in so far as it affects the finances of the company. In the alternative, it would be his duty to examine these matters in greater detail. For instance, in the case of a concern in which powers and duties of the management are distributed among a large number of persons and the work of each person is being effectively supervised by the top management, by obtaining reports, etc., it may be sufficient for the auditor to carry out only a balance sheet audit, provided the application of procedural tests shows that accounts are properly maintained. On the other hand, in the case of a co-operative society or a proprietary

or partnership concern, it would be necessary for the auditor to examine the correctness and validity of a large number of transactions entered into by them.

(e) **Information as regards organisation of the business:** To plan audit programme, it is necessary that the auditor should obtain from his client information as regards the under mentioned matters:

- ◆ Client's history and business.
- ◆ Purpose and nature of engagement.
- ◆ Time schedule for the completion of audit.

Before accepting a new audit, the auditor should satisfy himself as to the desirability of being associated with the job. If the concern is not known to him, he should enquire into its standing, financial background, nature of business and other similar matters. As far as practicable, he should also try to ascertain the reputation of the concern as also the honesty and integrity of principal executive. On the basis of the enquiries made he should gather information on the following points:

- ◆ Date of incorporation and commencement of business.
- ◆ The name of subsidiary companies or affiliates as well as the nature of business carried on by each of them. The auditor should have information as regards work of all the companies associated with the client through common ownership of capital or the management.
- ◆ Details of products manufactured or services rendered and methods of their distribution.
- ◆ The status in the industry or in the geographical areas or among similar concerns operating within the State.
- ◆ Location of plants and offices together with a description of activities at each location.
- ◆ The names of financial, technical and tax consultants working for the company.
- ◆ Names and designations of officers holding important positions in the administration of the company, the duties of each officer being demarcated separately.
- ◆ The objective for which the audit is being conducted so that where necessary the auditor may take the necessary precautions to see that he may not incur any liability for negligence to a person or persons to whom these reports might be presented. This matter has become of special importance since the decision in the case of *Hedley Byrne & Co. Ltd. vs. Heller and Partners Limited* (an English case) and the case of *Equity Funding* in the United States. If the engagement is in the nature of a tax audit, he must plan to have all the pertinent facts recorded in his working paper. This he should do in all other cases as well.

It is desirable that the auditor should know the date when the audit report shall be required. This would depend on the purpose for which the auditor has been engaged. In case it is for filing the income-tax return, the date by which the same is ordinarily required to be filed should be ascertained. On the other hand, if the audit is for release of financial statements to the

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shareholders for the annual meeting, the last date by which the notice should be issued should be ascertained. This would indicate to him the last date by which the audit report should be submitted. This information would be helpful to him in preparing a time schedule of his work and that of his assistants so that the audit can be completed by the date the audit report would be required. In drawing up the time schedule adequate provision should be made for unforeseen complications and other delays. This time-schedule should separately show time that a partner would be required to spend and that which the supervisor and senior assistants and junior assistants would be required to spend. These, in turn must be coordinated with the demands on them of other clients to attain an economical staff utilisation.

(f) Accounting and management policies: In view of the provisions under Clause (3) (xv) of Part II of erstwhile Schedule VI to the Companies Act, it is necessary for an auditor to know whether there has been any change in the basis of accounting in order that he may report its effect to the shareholders; also, the accounting principles require a disclosure of change in the basis of accounting. The revised Schedule VI applicable for the financial year 2011-2012, though does not contain explicit requirements as Clause (3) (xv) as aforementioned, but states that where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes interse, in the financial statements or statements forming part thereof, the same shall be made and the requirements of the Schedule VI shall stand modified accordingly. The disclosure requirements specified in Part I and Part II of this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 1956. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule. On these considerations, on the first appointment it is necessary that the auditor should review the financial statements of the past several years, audited by his predecessors specially those of the immediately preceding previous year. This would reveal to him a great deal of information regarding accounting and management policies which have been followed in the past and whether these have been employed consistently. The policies affecting accounts of business engaged in diverse trades differ; but they invariably deal with the following matters:

- (i) The method of maintaining the record of stocks, preparation of the closing inventory and the basis of its valuation.
- (ii) The basis adopted for making a provision for payment of bonus to staff.
- (iii) Treatment to be accorded to research and development expenses.
- (iv) Provision of depreciation in respect of assets, which strictly do not require to be depreciated according to Sub-section (2) of Section 205 of the Companies Act, e.g., goodwill, development expenses, mining rights and leaseholds, etc.
- (v) Provisions for gratuities payable to staff on retirement.

- (vi) Provision for expenses on post sale services that would have to be rendered to customers in respect of sales of various items of machinery or equipment.
- (vii) Treatment to be accorded to items of deferred revenue expenditure.
- (viii) Procedure for inclusion of expenses for arriving at cost of fixed assets.

In this regard, it is important to note that the Institute of Chartered Accountants of India has always recommended that the auditor should critically examine the accounting policies adopted by the management and test them for conformity with the accounting standards recommended by the Institute, where available, or with any other authoritative statement. It may also be noted that the Institute of Chartered Accountants of India has issued Accounting Standard-1 and recommended disclosure of significant Accountants Policies. Similarly, the Revised Schedule VI to the Companies Act effective from 01.04.2011 requires disclosure of Accounting Policies. The prime test should be that whether the treatment is consistent with the basic principles of accounts. It may be noted that AS-1 is mandatory for all corporate as well certain specified non-corporate entities. The Companies (Amendment) Act, 1999 has also made it obligatory on the part of companies to follow Accounting Standards (Refer to Section 211).

2.2.1 Drawing up the audit programme: After the auditor has collected the aforementioned information, he will be in a position to draw up the programme of audit. He can now decide the areas to be covered by audit, also those to be covered in detail and those which should be covered by the applications of the test checks. He will also be able to decide the specific audit procedures which should be applied in each case. These procedures vary widely because of the conditions under which each concern operates, its form of organisation, its nature of business and the condition of its accounts. On this account, it is not practicable to draw up a typical audit programme. When an auditor is appointed to audit the accounts of an entity for the first time, the audit programme should be developed in three stages stated below:

- (i) To begin with, a broad outline of the audit programme should be drawn up.
- (ii) After the internal and accounting procedures have been reviewed, the details should be filled up on a consideration of the deficiencies in the system of internal control.
- (iii) After the detailed checking formality is over, the extent to which the special procedures need to be applied should be determined, e.g., independent verification of balances of debtors and creditors, physical inspection of fixed assets, personal inspection of various items of stock included in closing inventories and testing their values. At times, special procedures may have to be applied on a consideration of the nature of business e.g. verification of provision for tax liability in case of a shipping company regarding freight booked in different countries or for making a provision for unexpired liability in case of an insurance company, etc.

At each subsequent engagement the programme should be reviewed and, if necessary, modified on account of:

- (i) experience gained during the previous audits;

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- (ii) important changes that have taken place in the business specially in the system of internal control, accounting procedures or in the structure of management or of the scope of business; and
- (iii) evaluation of internal control made for the current year.

Given below are a few circumstances where in the audit programme would have to be suitably altered:

- (1) If the audit procedures were designed for a certain volume of turnover and subsequently the volume have substantially increased. Also, when there have been significant changes in the accounting organisation, procedures and personnel subsequent to the audit procedures.
- (2) Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.
- (3) Where there has been an extraordinary increase in the amount of book debts or that in the value of stocks as compared to that in the previous year.
- (4) When a suspicion is aroused during the course of audit or information has been received that assets of the company have been misappropriated.

It may be noted that the audit plan and related programme should be reconsidered as the audit progresses. Such re-consideration is based on the auditor's review of internal control, his preliminary evaluation thereof and the result of his compliance and substantive procedures.

2.2.2 Development of an overall plan: Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- ◆ Terms of his engagement and any statutory responsibilities
- ◆ Nature and timing of reports or other communication.
- ◆ Applicable legal or statutory requirements.
- ◆ Accounting policies adopted by the client and changes in those policies.
- ◆ Effect of new accounting or auditing pronouncements on the audit.
- ◆ Identification of significant audit areas.
- ◆ Setting of materiality levels for audit purposes.
- ◆ Conditions requiring special attention, such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- ◆ Degree of reliance he expects to be able to place on accounting system and internal control.

- ◆ Possible rotation of emphasis on specific audit areas.
- ◆ Nature and extent of audit evidence to be obtained.
- ◆ Work of internal auditors and the extent of their involvement, if any, in the audit.
- ◆ Involvement of other auditors in the audit of subsidiaries or branches of the client.
- ◆ Involvement of experts.
- ◆ Allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- ◆ Establishing and coordinating staffing requirements;

Documentation of the overall planning on due consideration of the above should be done for drawing a systematic, logical and an adequate audit programme. An illustration of documentation of overall plan may be as under:

Plan dated 17.10.XX

1.	Name and address of the client	: Progressive Industries Ltd., 52, J. Bose Road, Calcutta.
2.	Nature of professional work	: Annual audit under the provisions of Companies Act, 20XX
3.	Period for which the professional	: Accounting year ending on 31 st services required March, XXXXY
4.	Particulars of establishment of the client	: (i) Registered office and Head office client at the above address. (ii) Factory at Tiljala. (iii) Branches at Bombay, Madras, Delhi and Kanpur (all the branches to be audited by separate branch auditors).
5.	Latest date within which the company is to hold its annual general meeting	: 30th September, XXXX
6.	Manner of audit agreed to with the client	: Interim checking up to 30.XX. to be completed by December, XYXX. and followed by an interim report to the Board. Final audit to be completed and report submitted by 5th August, 19XX.
7.	Man hours required to completing the audit in preceding year in two phases	: Interim audit for the first half-year involved 350 man hours and the final phase of audit involved 450 man hours.
8.	Assistants deputed in the previous year	: Mr. Jayanta –Senior Mr. Alokesh - Semi-Senior Mr. Pulokesh - Articled Student

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		Mr. Bilkash – Inventory, cash Mr. Raman - Security verification Mr. Robin - alongwith the other three.
9.	Partner-in-charge of the previous year	: Mr. T. Roychowdhury
10.	Letter of appointment for 2011-2012	: Received on 5.10.XXXX
11.	Any non-statutory duty	: Yes, Certification to Royalty statement and Export statement besides reports to the Board on interim verification
12.	Any letter of engagement issued	: Yes, dated on 12.10.XXXX.
13.	Any change in the scope, volume or nature of work intimated, or assessed	: No significant change intimated/assessed.
14.	Assistants to be deputed for 2011-2012	: Mr. Alokesh - Senior Mr. Pulokesh - Semi-Senior Mr. Rohin – Articled Student for interim checking. Plan for final checking will be made later.
15.	Number of man hours expected to be devoted in the interim checking	: 320 man hours
16.	Is thorough evaluation of internal control due this year?	: No, It will be due next year. This year, apart from overall evaluation, in depth evaluation will be done on payroll and transport.
17.	Any change in the accounting policies compared with the previous year	: No, as per the discussion held on 15.10.XXXX with the company management.
18.	Any statement/ standard pronouncement/note issued by the ICAI during the period that may have a bearing on the present audit	: -----
19.	Does any area of accounting require special attention in view of the observations made on the previous year's accounts in the audit report or in the working papers?	: Yes, Payroll, Transport Discounts, Rebates, Reliefs on sales, consumption of raw materials.
20.	Detailed audit or test audit	: Normally test audit; verification of debtor's balance and value of inventory will be done by

		adopting statistical sampling plan.
21.	Whether inventory verification will be witnessed	: Yes, by arrangement with the client. Also, surprise verification of some of the selected items should be done after the physical verification by the management is over.
22.	Whether cash and investment will be physically verified	: Yes, also surprise verification before year-end day.
23.	How the fixed assets shall be verified	: Documentary verification and scrutiny of physical verification of working papers of the company.
24.	How other areas to be examined/ verified	: By reference to documents, vouchers, confirmations, etc. as may be appropriate.
25.	Associated party transaction	: Officially confirmed list of associated parties should be obtained and bonafides and reasonableness of transactions ascertained.
26.	How to establish materiality of transaction	: Bases provided by Schedule VI and the SA 320. Partner-in-charge should be consulted where consultation is required.
27.	Is there only internal audit system headed by a qualified internal auditor? If yes, to whom does the internal auditor report?	: Yes, the internal auditor reports to the Managing Director.
28.	Review of internal audit programme and report/reports	: Should be completed before drawing up detailed audit programme. Also, Areas of work sharing should be discussed with the Internal Auditor at that stage.
29.	When, the reports of Branches auditor expected	: On 15.7.XXXX
30.	Need for review of previous year's audit programme	: Yes, should be done in the light of points 16, 19, 20, 21, 22, 25 and 28 by the Senior-in-charge and shown to partner-in-charge.
31.	Partner-in-charge of this year's audit	: Mr. T. Roychowdhury.

2.3 Designing Audit Strategy

As stated earlier, audit planning is the process of gathering information and designing audit strategies; the main output of audit planning is a tailored audit approach supported by appropriate administrative arrangements. Audit strategy is concerned with designing optimised audit approaches that seek to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. Audit procedures should be relevant to the important assertions, and as cost effective as possible to perform. Audit strategy generally involves the following steps:

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- (i) Obtaining knowledge of business.
- (ii) Performing analytical procedures at initial stages.
- (iii) Evaluating inherent risk.
- (iv) Evaluating Internal Control system for strategy purpose.
- (v) Formulating the strategy.

Let us deal with above stages step-wise:

- (i) **Obtaining Knowledge of Business** - SA 315 on, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment " states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:

- ◆ Assessing risks and identifying problems.
- ◆ Planning and performing the audit effectively and efficiently.
- ◆ Evaluating audit evidence.
- ◆ Providing better service to the client.

Finally, the auditor should ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. The auditor would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and other audit staff.

To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

- (ii) **Performing Analytical Procedures** - SA 520 on, "Analytical Procedures" states that the auditor should apply analytical procedures at the planning and overall review stages of the audit. Analytical procedures may also be applied at other stages.

The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage beyond this stage beyond the discussions that would usually take place with the client during the planning of the audit. The use of analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as

the analytical techniques at the substantive stage.

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

At the Level of Financial Statements:

- ◆ Management's experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
- ◆ Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
- ◆ The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- ◆ Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the level of Account Balance and Class of Transactions:

- ◆ Quality of the accounting system.
 - ◆ Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
 - ◆ The complexity of underlying transactions and other events which might require using the work of an expert.
 - ◆ The degree of judgement involved in determining account balances.
 - ◆ Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
 - ◆ The completion of unusual and complex transactions, particularly at or near period end.
 - ◆ Transactions not subjected to ordinary processing.
- (iv) **Evaluating Internal Control** - The auditors' assessment of the control environment is crucial to the decision on whether to make an extended assessment of controls. This is because a good control environment is conducive to the maintenance of a reliable

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system of accounting and control procedures. For strategy purposes the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This should be done by:

- (a) documenting the extent to which the system is computerised; and
- (b) preparing or updating overview flowcharts to record the files and transactions relating to significant systems-derived account balances.

If there are significant computer systems, the auditor should obtain an understanding of the IT controls so decide whether to make an extended assessment of monitoring controls. Whether it is necessary to carry out any preliminary work for strategy purposes to ascertain whether IT controls are likely to be satisfactory will depend on the auditor's previous knowledge about IT controls. For an existing audit, the objective will normally be to carry out the minimum work necessary to update this previous understanding. If more information is needed, or if the engagement is new or substantially changed, the auditor should carry out an overview assessment of IT controls. However, even if auditor has not carried out an overview assessment of the IT controls for strategy purposes, it may be necessary to do so later, to help design and perform substantive tests and draw conclusions on whether proper accounting records have been kept. Whether this work is done before determining the strategy or subsequently as part of the fieldwork is a matter of audit efficiency.

- (v) **Formulating the Strategy** - The auditor should develop the strategy by:
 - (a) considering the results of gathering or updating information about the client; and
 - (b) making preliminary judgements about materiality, inherent risk and control effectiveness. These will include identification of the system(s) the auditor proposes to subject to an extended assessment of controls.

The initial assessment of the quality and complexity of the client's systems will affect the amount of the information the auditor needs to gather. Sometimes, on a new engagement, the appropriate strategy may be obvious from a limited amount of investigative work. In other cases, the necessary information gathering will be extensive. The auditor should consider the following matters:

- (a) For many existing clients, the majority of the information the auditor needs will already exist in the prior year's strategy and in the audit programme. Accordingly, it will often be possible to restrict the work to updating existing knowledge, considering whether there are any significant new or changed risks and confirming that there are no new or substantially changed significant systems.
- (b) On a new, large or complex engagement the auditor may be uncertain about the extent of information that should be gathered. Accordingly, in such cases the engagement partner, the engagement manager and the in-charge should consider together their knowledge of the matters listed in the preceding paragraph before undertaking further information gathering. This will ensure that the information-

gathering process is carried out in as efficient and effective a manner as possible.

- (c) If the auditor determines that there have been significant changes to risks, systems and other client circumstances, it may be necessary to gather extensive information before determining the strategy. For example, more information would be required for a client with an acquisition or a significant new system than for a client with a stable, unchanging business and accounting environment.
- (d) If the auditor has had substantial contact with the client in the current period it may be possible to determine the strategy without gathering additional information.

Finally, audit strategy may be evolved after considering the following:

- (a) The engagement objectives.
- (b) The results of the business review, including major developments in the client's business and industry, significant operating results and financial arrangements.
- (c) Preliminary judgements as to materiality.
- (d) Identified inherent risks. The team should also consider the risk of fraud and, in particular, any evidence of a high level of risk to the firm. They should take into account the results of procedures for the acceptance and continuation of clients.
- (e) The degree to which the team should carry out further assessment of controls as a means of reducing substantive tests.
- (f) The broad nature, extent and timing of substantive tests, or changes to the previous year's strategy for substantive testing.
- (g) Main points relating to planning and controlling the audit or comments on the adequacy of the existing arrangements.

2.4 Using the Work of an Expert

As per SA 620(Revised) "Using the Work of an Auditor's Expert", auditor's expert may be defined as an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

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- The estimation of oil and gas reserves.
- The valuation of environmental liabilities, and site clean-up costs.
- The interpretation of contracts, laws and regulations.
- The analysis of complex or unusual tax compliance issues.

In many cases, distinguishing between expertise in accounting or auditing, and expertise in another field, will be straightforward, even where this involves a specialised area of accounting or auditing. For example, an individual with expertise in applying methods of accounting for deferred income tax can often be easily distinguished from an expert in taxation law. The former is not an expert for the purposes of this SA as this constitutes accounting expertise; the latter is an expert for the purposes of this SA as this constitutes legal expertise. Similar distinctions may also be able to be made in other areas, for example, between expertise in methods of accounting for financial instruments, and expertise in complex modeling for the purpose of valuing financial instruments. In some cases, however, particularly those involving an emerging area of accounting or auditing expertise, distinguishing between specialised areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment. Applicable professional rules and standards regarding education and competency requirements for accountants and auditors may assist the auditor in exercising that judgment.

It is necessary to apply judgment when considering how the requirements of this SA are affected by the fact that an auditor's expert may be either an individual or an organisation. For example, when evaluating the competence, capabilities and objectivity of an auditor's expert, it may be that the expert is an organisation the auditor has previously used, but the auditor has no prior experience of the individual expert assigned by the organisation for the particular engagement; or it may be the reverse, that is, the auditor may be familiar with the work of an individual expert but not with the organisation that expert has joined. In either case, both the personal attributes of the individual and the managerial attributes of the organisation (such as systems of quality control the organisation implements) may be relevant to the auditor's evaluation.

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

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

(For details Students may refer SA 620, given in Appendix Part I of Volume II)

2.5 Using the Work of Internal Auditor

SA 610 entitled 'Using the Work of an Internal Auditor' deals with the procedure which should be applied by the internal auditor for the purpose of placing reliance upon that work. It should, however, be remembered that the external auditor has sole responsibility for his report and for the determination of the nature, timing, extent of the auditing procedures but much of the work of the internal audit function may be useful to him in his examination of the financial

information. The responsibility of the external auditor is not reduced by any means because of the reliance placed upon the internal auditor's work.

(For details Students may refer SA 610, given in Appendix Part I of Volume II)

2.6 Using the Work of Another Auditor

SA 600 "Using the Work of another Auditor" deals with the situations when the auditor uses work performed by other auditors, the auditor should obtain reasonable assurance that such work is adequate for the purpose of the audit. Such a situation may arise in case a company having branch or having different branch auditors or the auditor is using the work of another independent auditor with respect to the financial statement of one or more subsidiaries or associated companies. Generally when another auditor has been appointed for the branch / division/ component, the principal auditor would be entitled to rely upon the work of such auditor unless there are circumstances to indicate that he should not rely. The procedure to be followed by the company auditor in relation to branch auditor is outlined in Chapter on the Company Audit. It should however be noted that the aforesaid instances do not cover cases where two or more auditors are appointed as joint auditors nor does it deal with the auditor's relationship with the predecessor auditor..

(For details Students may refer SA 600, given in Appendix Part I of Volume II)

2.7 Principal's Ultimate Responsibility

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

2.8 Reliance on the Management or Other Certificates by the Auditor

It is customary for the company auditor to obtain certificates from the management certifying the value of inventories, Provision for liabilities, the disclosure of contingent liabilities etc. The object of this practice is to obtain information for which the management can be specifically held responsible. However, possession of such certificates does not absolve the auditor from carrying out a proper audit. Letter of representation obtained from the management will not protect the auditor in a legal action for negligence if he has failed to perform his duties according to the generally accepted auditing standards and procedures. Thus, an auditor who fails to count cash, put to test the inventory figures, verify debtors and liabilities according to the recognised practices, will derive little support from certificates of directors or company officials certifying the accuracy of these items. At best certificates can only act as the second line of defence for an auditor who has carried out his work with reasonable care and skill.

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Although the judgement in the *Kingston Cotton Mill's* case held that there is no duty on the auditor to take stock physically, that he may, in the absence of suspicious circumstances rely upon the certificate of a responsible official has not been categorically overruled, contemporary professional auditing practice requires a thorough investigation into the adequacy or otherwise of the internal check system regarding the movement and periodic counting of stocks with particular enquiry into deviations from the prescribed procedure.

Certain cases, decided long after the *Kingston Cotton Mill's* case were quite forthright in stating that a blind acceptance of certificate from the management by the auditor, without putting the same to appropriate tests and intelligent scrutiny, does not amount to a proper performance of duty. Mention may be made in this connection of the case of *Thomas Gerrard & Son* (1967) and *Colmer v Merrett Son & Street* (1964). The development of the professional practices mentioned above is the result of the timely notice taken by the accounting profession of the gradual erosion of the dictum in the Kingston Cotton Mills case.

It is clear, therefore, that the request for a certificate and its receipt constitute no more than the initial step in the auditor's verification of the relevant item whereby he seeks to obtain from those legally responsible, viz., the directors, the conscious acknowledgement of the amount at which the item concerned is stated. It should, however, be noted that it would not be considered proper for an auditor to seek or accept certificates from the management when the subject-matter is such as is capable of direct verification by the auditor himself. For example, cash in hand at the end of the year can be verified by the auditor himself and obtaining a certificate without actually undertaking the verification will amount to a non-performance of duty.

Notwithstanding anything stated above, the auditor can accept certificates from the director and the officials under the following circumstances:

- (1) The subject matter should not be capable of direct verification of the auditor and should be one which is accepted to be beyond the competence of a professionally qualified accountant.
- (2) There exist proper records and "internal check" in the client's system that can enable the directors or the officials to prepare and issue the certificate. The auditor should review such records and internal checks to ascertain their reliability,
- (3) The certificate should *be prima facie* in agreement with the records maintained.
- (4) The certificate should be put to common sense tests by the auditor.

During the course of an audit, an auditor may have to deal with certificates from outside parties such as the company's bankers, architects, agents, warehousemen, etc.

The bankers may certify the investments or securities held by them on behalf of the company, the architect may certify the value of property held as security and an agent or distributor may certify the value of property held as representatives of the company. The question of auditor's duty in such circumstances was discussed in *Re. City Equitable Fire Insurance Co. Ltd.* It was held that a company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be. On the other hand, banks in the

ordinary course of business hold securities for their customers and, therefore, an auditor would be justified in accepting the certificate of a respectable bank whilst verifying the existence of the securities.

As a general rule, it may be stated that, before accepting and relying upon a certificate from a third party, the auditor should satisfy himself that:

- (a) the party issuing the certificate is reputable and trustworthy;
- (b) the certificate relates to an item which is normally dealt with or held by such party;
- (c) the auditor himself is not in a position to verify the item because of its technical nature or because it would be too costly, cumbersome for him to do so.
- (d) the certificate *is prima facie* reliable and reasonable; and reference to the third party is available in the books and documents of the client as in possession of the concerned goods, property and/or securities belonging to the client.

(iii) Not infrequently, during the course of an audit, local issues arise which have a bearing on accounts. A chartered accountant is not necessarily competent to interpret law and, therefore, it may be desirable for him to obtain legal advice from his own or his client's attorney or counsel. But before accepting a legal opinion, the auditor should satisfy himself about the competence and impartiality of the lawyer. If a written opinion is sought, the auditor should ensure that the case for opinion is properly drawn up so that all the relevant facts are brought to the notice of the legal adviser. If a verbal opinion is being obtained, the auditor should attend the conference at which the matter is to be discussed to make sure that the facts are correctly presented.

Even if the legal opinion turns out to be erroneous the auditor cannot be held to be negligent in the performance of his duties if he has acted honestly and in good faith and if the opinion relied upon was *prima facie* reasonable. However, an auditor is under no compulsion to accept a legal opinion, if he has reasons to believe that such opinion is erroneous or inadequate.

2.9 Written Representations

As per SA 580 "Written Representation", 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.

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.

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.

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Objectives : 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.

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 about Management's Responsibilities

Preparation of the Financial Statements : The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

Doubt as to the Reliability of Written Representations

1. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.
2. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.
3. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

Requested Written Representations Not Provided : If management does not provide one or more of the requested written representations, the auditor shall:

- (a) Discuss the matter with management;
- (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

- (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705,

Written Representations about Management's Responsibilities : *The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if:*

- (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required are not reliable; or
- (b) Management does not provide the written representations.

(For details Students may refer SA 580, given in Appendix Part I of Volume II)

2.10 Drafting of Report

SA 700(Revised), "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements.

The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. The auditor's report includes the following basic elements, ordinarily, in the following layout:

- (a) Title
- (b) Addressee
- (c) Introductory Paragraph
- (d) Management's Responsibility for the Financial Statements
- (e) Auditor's Responsibility
- (f) Auditor's Opinion
- (g) Other Reporting Responsibilities
- (h) Signature of the Auditor
- (i) Date of the Auditor's Report
- (j) Place of Signature

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report.

(For details Students may refer SA 700, given in Appendix Part I of Volume II)

2.11 Control of Quality of Audit Work

As per SA 220 "Quality Control for an Audit of Financial Statements" Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

- (a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
- (b) The reports issued by the firm or engagement partners are appropriate in the circumstances

Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise.

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

- (a) The audit complies with professional standards and regulatory and legal requirements; and
- (b) The auditor's report issued is appropriate in the circumstances.

(For details Students may refer SA 220, given in Appendix Part I of Volume II)

CASE STUDY – 1

*Client Acceptance Considerations**

Mr. John is a partner with M/s. JKN & Co., a firm of Chartered Accountants, which has been invited by the Board of Directors of Trinca Ltd. to accept appointment as external auditors. Trinca Ltd. operates a number of car dealerships and has grown rapidly over the past three years through an aggressive take-over strategy. Mr. Johns is aware that the company's existing auditors, a much smaller firm, qualified their last auditor's report. During discussions, the CFO of Trinca Ltd. Mentioned that their existing auditors could not cope with audit of a company of their size and, in particular, were not equipped to audit the recently installed sophisticated accounting software. He communicated that their company needed a firm of reputation and caliber like M/s. JKN & Co., in order to reassure the market as they intend to seek a public listing within two years.

A background check on the prospective client by M/s. JKN & Co revealed as follows:

- *Management gives insufficient consideration to developing an accounting system adequate and appropriate to the expanding business. In particular, there is a lack of*

* Adapted from a Case Study published in Modern Auditing, Grahan W. Cosserrat (Second Edition), John Wiley & Sons pg. 206.

concern as to control. A number of petty employee frauds as a result of control weaknesses have been reported. However, no action is taken against the employees identified as engaged in fraud. The management attitude seems to be to encourage risk taking employees, who, in turn, make money on the side, whilst securing good deals for the company.

- The newly installed accounting software is unreasonably complicated though Trinca Ltd. claims this is necessary because of the need to maintain records to justify the company's claims for volume rebates, and bonuses under the complex incentive schemes by which car manufacturers reward dealers.

On an enquiry from the existing auditors, the former have advised M/s. JKN & Co. against accepting the engagement on grounds, including, that though they have no evidence of deliberate misrepresentation by the directors of Trinca Ltd. but the audit staff was hindered in their audit work by a less than helpful attitude by senior management who adopted an aggressive stance whenever a query was raised. The CFO of Trinca Ltd. was constantly on the phone to the partner claiming the audit staff was incompetent and accusing them of wasting his time asking unnecessary questions.

Queries to the Readers

- What factors should partners of M/s. JKN & Co. should considered for and against accepting the appointment?
- In the case of acceptance of appointment, what matters should be taken into consideration in obtaining the required knowledge of the business and in developing the audit plan?

CASE STUDY 2

Planning the Audit

Gamma Surgical Equipment (GSE), a New Delhi-based company, is a distributor of surgical equipment. It is the principal distributor for British Laboratories in the northern region where it has a market-share of 30 per cent. For the accounting year 2006-07, the annual sales of GSE were about ₹ 20 crore, and its net income ₹ 1.80 crore. GSE's income figure also included a substantial income of about ₹ 50 lakh from investments, both long-term as well as current. R. Krish and Co., Chartered Accountants, have been auditing the financial statements of GSE for the past three years. As a matter of policy, the firm has a well-established practice of rotating the partner-in-charge of audit every three years so that the quality of audit is maintained. Pursuant to this policy, V.S. Narayan, CA, a partner of the firm was given the charge of GSE audit for the current accounting period for the first time. While going through the previous year's audit working papers. Narayan noted that the overall performance of GSE had been quite impressive and its markets share had gone up steadily over a period of time.

A close review of the organization chart showed that marketing was the dominant activity of the company, and a major part of the workforce comprised sales personnel in all, there are

eight sales executives representing different territories in the region headed by a sales manager who are responsible not only for booking orders and ensuring delivery of goods to hospitals in far-flung villages and remote areas, but also for follow-up of incollectible amount. As against this, Narayan felt that a host of functions were being performed by a single individual and, practically, there was no adequate segregation of duties as far as staff functions were concerned. There was also no separate dispatch department, and the mail including cheques was distributed directly to the officer to whom it was addressed.

The following day, Narayan reached GSE's corporate office to commence the audit for the year. Since debtors constituted a significant aspect of the business. Narayan decided to concentrate on the sales cycle. He observed that there were three persons working in the accounts section whose duties had been allocated. S.K. Pai, accounts officer and overall in-charge of the accounts section, dealt with sales from the receipt of orders to the collection and recording of cash from debtors. Sonam, accounts executive, dealt with all purchases and expected payments including entries in the cashbook. Prachi, accounts clerk, maintained the petty cashbook and dealt with preparation and payment of wages. The preliminary review revealed that the total debtors outstanding at the end of the year as per the ageing schedule were as follows:

- | | | |
|-----|--|------------|
| i) | Outstanding debts for over six months: | |
| | Considered good | ₹ 6 crore |
| | Considered doubtful | ₹ 2 lakh |
| ii) | Other debts considered good | ₹ 17 crore |
| | (Outstanding for less than six months) | |

Narayan was perplexed as to how the debtors considered good could exceed the annual turnover by about ₹ 3 crore. He wondered that even if sales of the last six months were counted on an average basis, the excess of debtors over sales would be about ₹ 8 crore. As per analysis of the past trends in debtors expressed as percentage of total sales, no cyclical fluctuations were noticeable and GSE did not belong to the category of a seasonal industry.

Further, while reviewing investment operations, Narayan noted that R.V. Manan had been working as manager (investments) for the last five years. The company had authorized Manan to open accounts with various brokers in his own name. To provide maximum flexibility, all purchases and sales investments were authorised by Manan. Broker's advices and other correspondence from brokers, including cheques for sale proceeds, were directly mailed to Manan. The cheques were drawn in favour of R.V. Manan C/o GSE A/c. The investment ledger was maintained by Manan but the general ledger was maintained by Pai.

Narayan noted, to his dismay, that the procedure offered considerable scope for defalcation of sums received from brokers, particularly in view of the fact that cheques were received directly by Manan. It was quite likely that he might not have passed on broker's advices to Pai for recording in the general ledger. During his two day stay at GSE, Narayan felt that both Manan and Pai had been maintaining quite a luxurious lifestyle that did not quite match their monthly salary and perks. He was stunned to learn that both had been planning their next vacation abroad and planned to spend about ₹ 5 lakh. Narayan brought all these facts to the notice of the managing director (MD). However, there was lukewarm response from

the MD since he felt that given the number of persons working in the accounts section, he was able to supervise the activities more closely.

With regard to the above, Narayan concluded that the internal control system was quite weak and, thus, called for detailed substantive audit procedures and periodic surprise checks. He was, however, unable to lay down a concrete plan of action on certain issues regarding the course of action to be followed under the circumstances.

Queries to the Readers

- i) Whether to inform the board of directors about the weaknesses in the internal control system on an immediate basis.*
- ii) How the division of duties should be restructured, given the number of employees working in the company, with regard to cost-benefit analysis, and whether the same should be carried out by the auditors themselves.*
- iii) The type of substantive audit procedures that should be performed to assess that sundry debtors and investments are reflected properly in all respects.*
- iv) Whether auditors can be held liable for not detecting defalcation, if any, perpetrated and concealed by the top management.*

CASE STUDY – 3

Audit Quality Control^λ

The senior partner of Krishnan Menon & Co., L. Krishnan, glanced at the newspaper in disbelief. "This can't be true," he muttered. "How did we ever manage to remain unaware of this?" he asked R.K. Menon. With him was a small news item adorning the front page of a leading financial newspaper. It concerned their new client an upcoming textile manufacturer, the ₹ 220 crore Nataraj Ltd. The announcement stated in bold letters that Nataraj had violated provisions of the Foreign Exchange Management Act (FEMA), and had been booked by the Reserve Bank of India. It went on to say that of the ₹ 70 crore worth of yarn imported during the year, the company was found to have over-invoiced imports by ₹ 33 crore.

Menon, who was also a founder partner, looked equally nonplussed. "Let us call a meeting day after tomorrow," he suggested. "The other partners can also fly down." That evening, Krishnan settled in his plush room and let his thoughts go back some 35 years...

Krishnan Menon & Co., chartered accountants, was established in 1970 in Coimbatore. During the initial years, the audit work was closely monitored and supervised by its two partners. The list of clients included small scale industrialist and partnership firms of professional and traders. Most of these clients shared as associated with the city that went back several generations. They were men of repute well-known for their integrity, and their business dealings were straightforward. As a matter of fact, the perceived audit risk factor was quite low. Even then, each time before finalising an audit report, Krishnan & Menon

^λ Adapted from Case Study contributed by Vijay Kapur published in The Chartered Accountant, April 1997, pg. 82-83.

would sit down and discuss the issues raised during the audit. This was regardless of who acted as the principal auditor. They kept up a lively interest in professional issues and kept track of all new developments.

This was not all. Once every week, Krishnan would hold a meeting in the office. The discussions would centre around the day-to-day queries and issues specific to each audit client. In addition, there were exchanges on the current developments affecting the accounting profession. Articles appearing in professional journals were dissected and debated. Taxation and corporate law issues, in particular, were subjects of some extremely painstaking analysis.

With the passage of time, the firm witnessed steady growth and the annual gross billings swelled. The client portfolio too registered an impressive horizontal and vertical expansion. Their operations now ranged across industries and, of course, their numbers also puffed up. By 1990, the firm had three partners and eight qualified employees, and a branch at Trichur. During all these years of practice, all the partners were well-acquainted with each other, and the staff kept track of all clients. In the next decade, the growth of practice was exponential. The firm's gross billings increased by more than five times. Two more branches (at Visakhapatnam and Bangalore) were opened. By 2001, with nine partners and all of 36 qualified chartered accountants, Krishnan and Menon had a formidable reputation to live up to.

The sound of the phone ringing shook Krishnan out of his reverie. It was his secretary with the message that all the partners had confirmed they would attend the meeting. Krishnan now braced himself for the meeting on Wednesday. The meeting was attended by all the partners. They shared Krishnan's concern and were unanimous on initiating an action plan. One of the significant conclusions that emerged was that the firm had no formal policies and procedures for assigning personnel to undertake audit assignments, or for hiring staff members. The situation called for a thorough investigation. Accordingly, Menon was assigned the task of identifying instances. If any, that could be potentially embarrassing to the firm. A schedule was drawn up for his visit to all the branch offices, and they all agreed to meet again in a fortnight.

The report that was submitted two weeks later was a revelation. It was a replete with interesting findings. (See Menon's Report : Executive Summary) The founder partners were appalled. All this time, their constant effort had been to instill a work culture that would encourage professionalism and continuous learning. This was, after all, a pre-requisite for the growth of the firm. Obviously, the cracks were now beginning to show. What exactly were the implications of all this? We must do something fast, they concurred but what?

MENON'S REPORT: EXECUTIVE SUMMARY

- The Swamy Group of Industries accounts for about 28 per cent of gross audit billings for the year 1995-96.
- In 1995, three traders paid audit fees less than ₹ 5,000.

- *The EDP in-charge of a branch was suspended for fraudulent transfer of funds to his saving accounts. The partner in-charge of the concurrent audit of the branch has admitted to lack of EDP knowledge.*
- *An audit manager accepted an expensive gift from an officer in the client company.*
- *Documentation was found to be woefully inadequate in the case of certain audits.*
- *One of the partners purchased a car, the finance for which was arranged by a finance company which is audited by the firm. Terms of credit extended are normal.*
- *A partner was assigned an engagement where a close relative was an officer in the company concerned.*
- *During the last two to three years, only 10 staff members attended seminars and workshops organized by professional accounting bodies.*

Queries to the Readers

Views of the readers are invited on the shortcomings in the audit quality control system in Krishnan Menon & Co., and remedial measures.