Understanding AAS 34
Audit Evidence – Additional Considerations for Specific Items[1]

The Council of the Institute has been issuing extensive literature on auditing to help its members discharge their duties and responsibilities as auditors in an optimum manner. One of the earliest such literature was the Statement on Auditing, issued originally in 1964, at a time when no auditing standards were in existence. The Statement dealt with an array of relevant issues for auditors such as general considerations in an audit, audit of fixed assets, investments, inventories, cash and bank balances etc. As the Institute began issuing detailed and issue specific literature in auditing such as auditing standards and guidance notes, etc., on the areas covered by the Statement, the relevant sections of the Statement were withdrawn.

It may also be noted that the auditing standards are designed primarily to cover the basic principles in an audit whereas the Guidance Notes are designed primarily to provide guidance on procedural aspects of an audit. However, this does not precludes the Institute from issuing auditing standards on procedural aspects of audit and of late, certain auditing standards have also been issued covering the procedural aspects of audit.

Further, though Guidance Notes are recommendatory in nature, the Council of the Institute vide paragraph 5 of Section I of the "Announcements of the Council Regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India" (first published in December 1985 issue of the Journal) has made it amply clear that "a member should ordinarily follow recommendations in a guidance note relating to auditing matter except where he is satisfied that, in the circumstances of the case it may not be necessary to do so. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary."

The Auditing and Assurance Standard (AAS) 34 was issued with the basic objective of establishing standards and providing guidance to help the auditor in obtaining audit evidence with respect to certain specific items – amounts and disclosures – in financial statements, *viz*., inventory, litigation and claims, valuation and disclosure of long-term investments and segment information. A reading of the title as well as the "Introduction" paragraph of the AAS will make it clear that this AAS have to be read in conjunction with the requirements of AAS 5, Audit Evidence. AAS 34 has, accordingly, been divided in the following four parts:

Part A: Attendance at Physical Inventory Counting
Part B: Inquiry Regarding Litigation and Claim
Part C: Valuation and Disclosure of Long Term Investments
Part D: Segment Information

Attendance at Physical Inventory Counting

As the readers might be aware, the Institute had in November 1994 issued Guidance Note on Audit of Inventories. The Guidance Note dealt with the duties, responsibilities as well as the procedures of the auditor while conducting an audit of inventories and covered areas such as internal control evaluation, verification, considerations in case of work in progress etc., not withstanding the fact whether he is required to attend the physical inventory count or not. Attendance of the auditor at physical count of inventory by management has, however, been discussed in brief in the Guidance Note.

The focus of AAS 34, however, is narrower in the sense that it restricts only to discussing the principles defining the duties and responsibilities of the auditor with respect to attendance at physical inventory counting when the auditor is so required to do. The AAS mandates what has already been recommended in the Guidance Note on Audit of Inventories issued by the Institute in November 1994, that, the auditor should attend the physical verification of the inventories where such inventories are material. The AAS, however, does not at any point envisage that auditor should attend all physical inventory counts. Further, the AAS also provides guidance in respect of critical issues related to attendance at physical inventory counting, which are not there in the abovementioned Guidance Note, such as auditor's responsibilities where he is unable to attend the physical inventory count, factors to consider in planning attendance at physical inventory count, factors to consider when requesting third party confirmations with respect to inventories, as also the underlying principles for obtaining management representations in this regard.

It may be noted that AAS 34 states that where the inventory is in the custody and control of a third party, the auditor would ordinarily obtain direct confirmation therefrom. Thus, AAS 34 does not mandate that the auditor should obtain a third party confirmation in all the cases, rather leaves the decision to the professional judgment of the auditor. More importantly, the AAS 34 also lays down the prin-

[1] This write up has been contributed by the Secretariat of the Auditing and Assurance Standards Board.
The views expressed in this write up are those of the Secretariat and do not necessarily represent the views of the Council of the Institute or any of its Committees or Boards. Further, the readers are requested to refer to the complete text of the AAS 34, as released by the ICAI to properly understand the requirements of the Standard.

ciples governing the report to be made by the auditor when he is unable to obtain sufficient appropriate audit evidence concerning existence of inventory as well as adequacy of procedures adopted by management in respect of physical inventory count. Readers may note that the Guidance Note does not cover those reporting aspects.

Inquiry Regarding Litigation and Claim

The AAS 34 contains a separate section on auditor's duties & responsibilities with respect to audit of litigation and claims. The AAS for the first time brings out a definition of the terms, "litigation" and "claims". The AAS guides the auditor in audit of litigation and claims material to the financial statements – how to identify such claims etc., how and when to seek direct communication with the entity's lawyers, factors to consider in the direct confirmation letters, situations of disagreement between entity's management and entity's lawyers etc., refusal of management to permit auditors to communicate with the entity's lawyers, management representations with respect to litigation and claims etc. It may be noted that the Institute had, in December 1995, issued the Guidance Note on Audit of Liabilities, containing detailed procedures with respect to audit of liabilities, such as loans and borrowings, trade creditors and other current liabilities as well as contingent liabilities including claims.

An important point to note is that once again the AAS 34 does not mandate the auditor to communicate directly with the entity's lawyers, rather leaves that decision also to the judgment of the auditor and understandably so since AAS 30, External Confirmations, requires the auditor to consider factors such as auditor's assessment of inherent and control risks as well as characteristics of the operating environment of the entity being audited, practice of potential respondents in dealing with requests for direct confirmations. Another reason for not *per se* mandating direct communication/ confirmation from entity's lawyers is the conditions prevailing in India, wherein it is a normal practice to have different lawyers/ advocates for different aspects of operations of an entity, for example, sales tax, income tax, pollution laws, trade marks and copyrights laws, labour laws etc. in such a scenario, it would be difficult for an auditor to always directly communicate with these lawyers and advocates etc. The need therefore, has been left to the judgment of the auditor.

Valuation and Disclosure of Long Term Investments

This section of the AAS 34 deals with the principles underlying audit of long-term investments. As the readers might be aware, the Institute had in November 1994 issued a Guidance Note on Audit of Investments. This Guidance Note outlined comprehensive procedures for audit of investments – whether long term or current – such as the internal control evaluation, verification of transactions, physical verification of investments, analytical review procedures, management representations, documentation requirements etc. AAS 34 guides the auditor as to the audit of such long term investments which are quoted, those which are not quoted, are in a form other than securities etc., guiding factors in seeking management representations with respect to long term investments, as also guidance on the reporting aspects.

Segment Information

The last section of the AAS 34 deals with audit of segment information. The AAS clarifies that the audit procedures with respect to segment information would normally consist of analytical procedures and other tests appropriate in the circumstances. The AAS also requires the auditor to discuss with management the method adopted for determining segments. The AAS also guides the auditor in respect of the factors to consider while obtaining management representation with respect to segment information as also manner of reporting where the auditor has not been able to obtain sufficient appropriate audit evidence concerning segment information.

It may also be worthwhile to mention that as has been mentioned in the Preface to the Statements on Standard Auditing Practices, the auditing standards aim to codify the existing best practices in the area of auditing. Further, the Institute being a member of the International Federation of Accountants (IFAC), as a membership obligation, the AAS issued by the Institute need to be in harmonisation with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) of the IFAC. However, the Preface also makes it abundantly clear that while formulating the auditing standards, regard would also be had to prevailing customs and usage of trade. The IAASB too accepts the fact that all the ISAs cannot be adopted and implemented by the member bodies as they are and that the latter would need to be modified in the light of the peculiar situations prevailing in the member countries. Accordingly, though AAS 34 is generally consistent in all material respects with ISA 501, certain modifications have been made to the AAS 34 to make it more compatible and suitable for Indian conditions and auditing practices. One of these modifications is not to mandate that the auditor would have to communicate with the entity's lawyers in case of litigations/ claims rather leaves that to the judgment of the auditor. This departure from the ISA does not, however, preclude the auditor from communicating with the lawyers of the entity altogether. Similarly, the AAS 34 unlike ISA 501 requires the auditor to obtain management representations with respect to all the significant issues/ aspects covered in this AAS.

Finally, auditing is not an exact science, much depending, among other things, on the professional judgment and skills and competence of each auditor. It is, therefore, neither possible nor feasible to mandate each and every aspect in a Standard, thus, making it rigid or rule based instead of principle based beyond reason and turning it into a run-of-the-mill affair. Some aspects, indicated by way of the word, "may", have, therefore, to be left to the judgment of each individual auditor. ■