PART – I : STANDARDS

Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services[1]

(Effective from April 1, 2008)

Introduction

1. This Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services has been issued to facilitate understanding of the scope and authority of the pronouncements of the AASB issued under the authority of the Council of the Institute of Chartered Accountants of India (the ICAI).

2. The ICAI is committed to the goal of enabling the accountancy profession in India to provide services of high quality in the public interest and which are accepted worldwide. To further this goal, the ICAI develops and promulgates technical Standards and other professional literature. The ICAI being one of the founder members of the International Federation of Accountants (IFAC), the Standards developed and promulgated by the AASB under the authority of the Council of the ICAI are in conformity with the corresponding International Standards issued by the International Auditing and Assurance Standards Board (IAASB), established by the IFAC. The "Due Process" of the AASB for formulation of Standards, Statements, Guidance Notes and its other pronouncements is given in the **Appendix** to this Preface.

Standards Issued by AASB under the Authority of the Council of ICAI

3. The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

(a) Standards on Auditing (SAs), to be applied in the audit of historical financial information.

(b) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

(c) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, other than audits and reviews of historical financial information.

(d) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

4. Standards on Quality Control (SQCs), issued by the AASB under the authority of the Council, are to be applied for all services covered by the Engagement Standards as described in paragraph 3 above.

A diagram containing the structure of the Standards issued by the Auditing and Assurance Standards Board under the authority of the Council is given as **Annexure** to this Preface.

Standards on Auditing

5. The Standards on Auditing (SAs) referred to in Paragraph 3(a) above are formulated in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of SAs is set out in SA 200[2].

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[1] Issued in July, 2007.

[2] SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing".

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Standards on Quality Control

6. SQCs are written to apply to firms[3] in respect of all their services falling under the Engagement Standards issued by the AASB of ICAI. The authority of SQCs is set out in the introduction to the SQCs.

Other Standards

7. The other Engagement Standards identified in paragraph 3 (b) to (d) as well as Standards on Quality Control referred to in paragraph 4 contain basic principles and essential procedures (identified in **bold type** lettering and by the word "should") together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures. Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself. An individual Standard should be read in the context of the objective stated in the Standard as well as this Preface. Any limitation of the applicability of a specific Standard is made clear in the Standard itself.

Statements on Auditing

8. Statements on Auditing are issued with a view to securing compliance by professional accountants on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. Statements are, therefore, mandatory.

General Clarifications

9. General Clarifications are issued by the Board under the authority of the Council of the Institute with a view to clarify any issues arising from the Standards. General Clarifications are mandatory in nature.

Professional Judgment

10. The nature of the Standards/Statements/General Clarifications requires the professional accountant[4] to exercise professional judgment in applying them.

Authority Attached to Other Standards, Statements on Auditing and General Clarifications

11. It is the duty of the professional accountants to ensure that the Standards/Statements/General Clarifications are followed in the engagements undertaken by them[5]. The need for the professional accountants to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the engagement, that procedure would be ineffective. If because of that reason, a professional accountant has not been able to perform an engagement procedure in accordance with any Standard/Statement/General Clarification, he is required to document how alternative procedures performed achieve the purpose of the procedure, and, unless

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[3] The term "firm" refers to a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

[4] The term "professional accountant" refers to a member of the Institute of Chartered Accountants of India.

[5] Members' attention is invited to Clause 5 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, according to which a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity. Further Clause 7 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

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otherwise clear, the reasons for the departure. Further, his report should draw attention to such departures. However, a mere disclosure in his report does not absolve a professional accountant from complying with the applicable Standards/Statements/General Clarifications [6].

12. There may be a situation where a matter is covered both by a Standard as also by a Statement on Auditing. In such a situation, the Statement shall prevail till the time the Standard becomes mandatory. Once a Standard becomes mandatory, the concerned Statement or the relevant portion(s) thereof will automatically be withdrawn.

Guidance Notes

13. Guidance Notes are issued to assist professional accountants in implementing the Engagement Standards and the Standards on Quality Control issued by the AASB under the authority of the Council. Guidance Notes are also issued to provide guidance on other generic or industry specific audit issues, not necessarily arising out of a Standard. Professional accountants should be aware of and consider Guidance Notes applicable to the engagement. A professional accountant who does not consider and apply the guidance included in a relevant Guidance Note should be prepared to justify the appropriateness and completeness of the alternate procedures adopted by him to deal with the objectives and basic principles set out in the Guidance Note.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

14. The Board may also publish Technical Guides, Practice Manuals, Studies and other papers. Technical Guides are ordinarily aimed at imparting broad knowledge about a particular aspect or of an industry to the professional accountants. Practice Manuals are aimed at providing additional guidance to professional accountants in performing audit and other related assignments. Studies and other papers are aimed at promoting discussion or debate or creating awareness on issues relating to quality control, auditing, assurance and related service, affecting the profession. Such publications of the Board do not establish any basic principles or essential procedures to be followed in audit, review, other assurance or related services engagements, and accordingly, have no authority of the Council attached to them.

Material Modifications to the Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

Addition

This Preface deals, apart from the Standards, with the Statements on Auditing and the General Clarifications as the mandatory documents for use by the professional accountants in performing engagements by them, whereas, the Preface issued by the IAASB does not deal with such aspects. Further, the nomenclature of International Auditing Practice Statements (IAPSs) referred in the Preface issued by the IAASB has been changed to Guidance Notes in this Preface.

Deletion

The Preface issued by the IAASB provides to include, in appropriate cases, additional considerations specific to public sector entities within the body of the Standard. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Preface does not deal separately with the public sector perspective.

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[6] Attention of the members is also drawn to Clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, whereby, a member is deemed to be guilty of professional misconduct if he fails to invite attention to any material departure from the generally accepted procedures of audit applicable to the circumstances.

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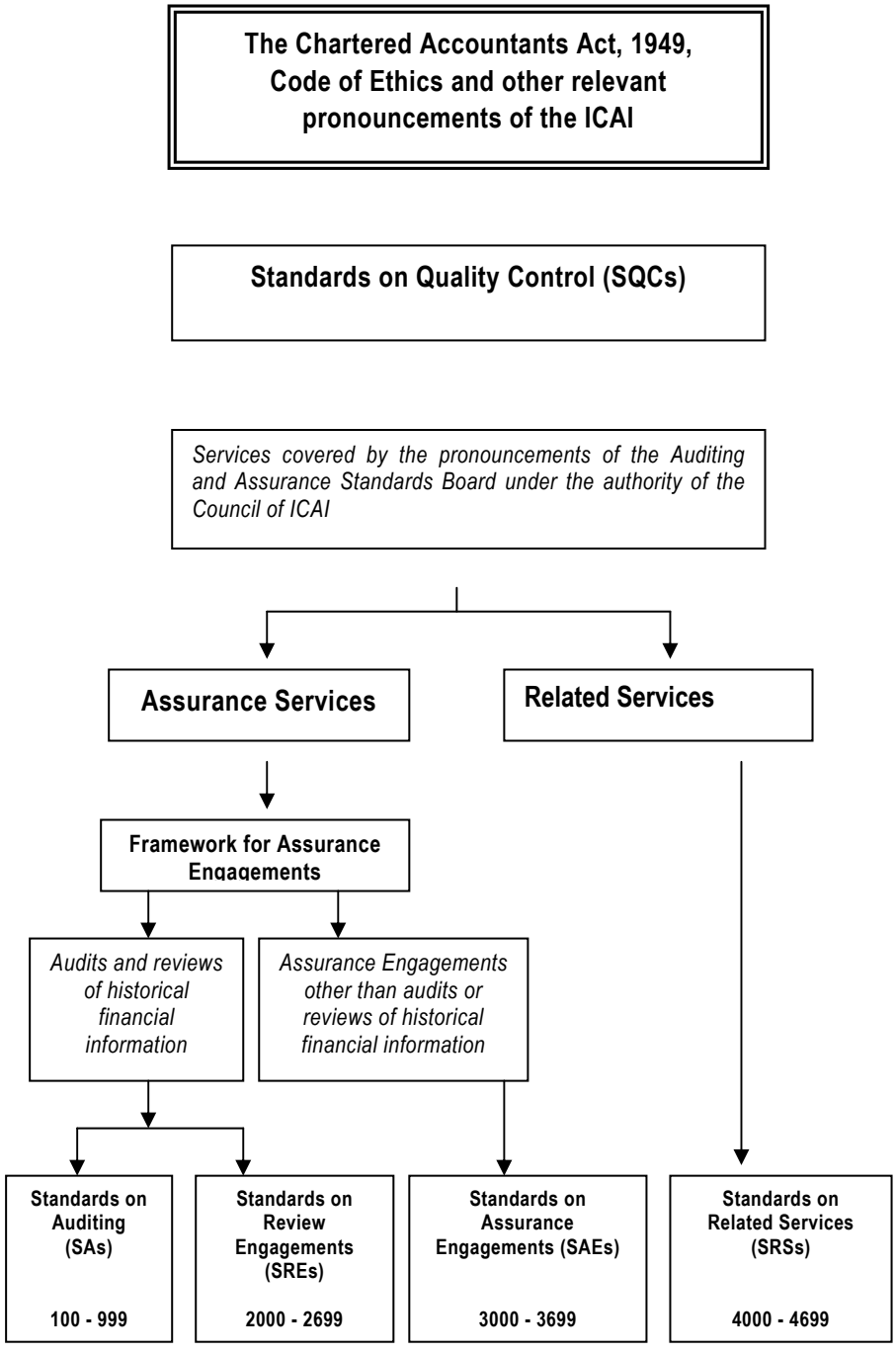
Annexure

Structure of Standards issued by the Auditing and Assurance Standards Board under the Authority of the Council of ICAI



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Appendix

Auditing and Assurance Standards Board and its Due Process

Brief History

1. The Institute of Chartered Accountants of India (ICAI) constituted the Auditing Practices Committee (APC) on 17th September 1982, to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices so that these may be issued under the authority of the Council of the Institute. Subsequently, at its 226th meeting held in July 2002, the Council of the Institute approved certain recommendations of the APC to strengthen its role in the growth and development of the accountancy profession in India. The Council, at the said meeting, also approved the renaming of the Auditing Practices Committee as the Auditing and Assurance Standards Board (AASB) as well as renaming of the Statements on Standard Auditing Practices as Auditing and Assurance Standards (AASs).

2. The ICAI is one of the founder members of the International Federation of Accountants (IFAC). It is one of the membership obligations of the Institute to actively propagate the pronouncements of the International Auditing and Assurance Standards Board (IAASB) of the IFAC to contribute towards global harmonisation and acceptance of the Standards issued by the IAASB. Accordingly, while formulating Engagement and Quality Control Standards, the AASB takes into consideration the corresponding Standards, if any, issued by the IAASB. In addition, the AASB also takes into consideration the applicable laws, customs, usages and business environment prevailing in India within the parameters of the July 2006 Policy Paper, A Guide for National Standard Setters that Adopt IAASB's International Standards but Find it Necessary to Make Limited Modifications, issued by the IAASB.

Objectives and Functions of the Auditing and Assurance Standards Board

3. The following are the objectives and functions of the Auditing and Assurance Standards Board:

(i) To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.

(ii) To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.

(iii) To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.

(iv) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.

(v) To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.

(vi) To formulate General Clarifications, where necessary, on issues arising from Standards.

(vii) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

Composition

4. The composition of the AASB is fairly broad-based and attempts to ensure participation of all interest groups in the standard-setting process. Apart from amongst the elected members of the Council of the ICAI the following are also represented on AASB:

(i) Eminent members of the profession, whether in industry or in practice, as co-opted members on the Board.

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(ii) One special invitee from each three regulatory bodies, *viz*., the Securities and Exchange Board of India, the Reserve Bank of India and the Insurance Regulatory and Development Authority.

(iii) One special invitee from the Indian Institute(s) of Management, or from any other prominent academic and/or research organisation, as considered appropriate.

(iv) One special invitee from a prominent Industry association.

(v) One special invitee representing public interest, e.g., not for profit organization, etc.

The special invitees mentioned at (ii) through (v) above are decided in consultation with the President of the Institute. Further, special invitees do not constitute the members of the Board, as referred to in this document.

Term of the Members

5. The term of the Chairman of the Board is three years. Where such period of three years exceeds the term of the Council of ICAI during which the Chairman has been appointed, the term of the Chairman is restricted to the abovementioned term of the Council. The Council of the ICAI may fill any vacancy in the Office of the Chairman and the Chairman so appointed holds office for the unexpired term of the Council. The term of other members of the Board and the special invitees is one year. However, in case the period of one year exceeds the term of the Council during which the members have been appointed, the term of the members is restricted to the abovementioned term of the Council.

Attendance at the Meetings

6. Each AASB meeting requires the presence, in person, of at least one third of the members of the Board. However, the AASB meetings whereat a Standard or Statement, at whatever stage (as envisaged in the following paragraphs), is proposed to be considered, requires attendance of at least two thirds of the AASB members, in person or by simultaneous telecommunication link (such as teleconferencing, videoconferencing, etc.).

7. In case any member of the AASB absents himself from three consecutive meetings of the Board, without seeking leave of absence the AASB would bring such fact to the attention of the Council.

AASB Working Procedure

Standards, Statements on Auditing and General Clarifications

Project Identification, Prioritization and Approval

8. Project proposals to develop new, or revise existing Standards, Statements or General Clarifications are identified based on international and national developments, input from members of the Council of the ICAI, AASB members, members of other committees of the ICAI and/or recommendations received from other interested parties, such as regulators or professional accountants.

9. The AASB determines the priorities of various projects on hand for commencement.

10. In the preparation of Standards, Statements and General Clarifications, AASB is assisted by Study Groups/Task Forces constituted to consider specific projects. The AASB appoints one of the professional accountants as a convenor of the Study Group/Task Force. The convenor, in consultation with the Chairman, AASB, nominates other members of the Study Group/Task Force, ordinarily five to seven in number. For operating convenience and economy, a study group is usually based in the area where the convenor is located. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such an expert need not necessarily be a professional accountant. The Study Group/Task Force is responsible for preparing the basic draft of the Standard/ Statement/ General Clarification. In addition, a separate group of experts may be formed to advice the Study Group /Task Force.

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11. The AASB may also conduct projects jointly with regulators and/or others. In such cases, the joint Study Group/Task Force is ordinarily chaired by the convenor appointed with mutual consent.

Consultation and Debate

12. The Study Group/Task Force develops the preliminary draft of the Standard/ Statement/ General Clarification based on appropriate research and consultation, which may include, depending on the circumstances, consultation with the other professionals, regulators and other interested parties, as well as reviewing professional pronouncements issued by IFAC member bodies and other professional bodies. The draft submitted by the study group, along with issue papers/background papers, is sent to the Chairman, AASB for approval.

13. The draft Standard/Statement/General clarification, along with other agenda papers, as approved by the Chairman, is hosted on the website of the AASB, ordinarily, at least twenty one days in advance of the AASB meeting at which such draft Standard/ Statement is planned to be considered. A notification to that effect is also sent to the AASB members. The printed version of the agenda papers, including background papers and draft Standard/ Statement/General Clarification prepared by the Study Group/Task Force for review and debate are made available to the members of and special invitees to the AASB at the concerned meeting.

14. The AASB considers the preliminary draft of the Standard/ Statement/General Clarification prepared by the Study Group/Task Force. The AASB may refer the draft to the Study Group/Task Force to examine the issues arising out of the deliberations of the AASB and accordingly modify the draft Standard/ Statement/General Clarification.

15. In case the revision to the Standard/ Statement/General Clarification is made by the Study Group/ Task Force in terms of the requirements of paragraph 14 above, the procedure laid down in paragraphs 12 to 14 above is followed for the revised draft of the Standard/ Statement/General Clarification.

16. The draft of the proposed Standard/ Statement/General Clarification, as modified in the light of the deliberations of the Board and approved by the Chairman, AASB, is circulated to the Council members of the ICAI for their comments before being issued as an Exposure Draft. Normally, a period of ten days is given for receiving comments on the Draft Exposure Draft. AASB finalises the Exposure Draft of the proposed Standard/ Statement on the basis of the comments so received, if any. Ordinarily, an Exposure Draft of a General Clarification is not issued.

Public Exposure

17. The Exposure Draft of the proposed Standard / Statement is issued, by way of publication in the monthly Journal of the Institute and/or hosted on the website of the ICAI wherefrom it is downloadable free of charge, for comments by the professional accountants and the public. The Board, however, may decide not to issue an Exposure Draft of a Statement, in which case, the reasons for such a decision is recorded in the minutes of the relevant AASB meeting. Each Exposure Draft is, ordinarily, accompanied by an explanatory memorandum that highlights the objectives and significant proposals contained in the draft. The explanatory memorandum may also direct the respondents to those aspects of the Exposure Draft on which specific feedback is sought.

18. The Exposure Draft is sent to the members of the Council of the ICAI, the Institute's past Presidents, Regional Councils and their branches. Copies of the Exposure Draft are also sent to the following bodies:

i. The Ministry of Company Affairs, Government of India
ii. The Comptroller and Auditor General of India
iii. The Reserve Bank of India

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iv. The Insurance Regulatory and Development Authority
v. The Central Board of Direct Taxes
vi. The Central Board of Excise and Customs
vii. The Securities and Exchange Board of India
viii. The Central Registrar of Co-operative Societies
ix. The Institute of Cost and Works Accountants of India
x. The Institute of Company Secretaries of India
xi. The Indian Banks Association
xii. Industry organizations such as Federation of Indian Chambers of Commerce and Industry, Associated Chambers of Commerce, Confederation of Indian Industry
xiii. Indian Institute(s) of Management
xiv. The Telecom Regulatory Authority of India
xv. The Standing Conference on Public Enterprises
xvi. Recognised stock exchanges in India
xvii. Any other body considered relevant by the AASB keeping in view the nature and requirement of AAS/Statement.

19. To allow adequate time for due consideration and comment from all interested parties, exposure period is ordinarily 45 (forty five) days or such other period, but not less than 45 days in any case, as may be decided by the AASB. Further, the exposure period would be reckoned from the date of hosting of the Exposure Draft on the website of the Institute.

Responses to Exposure Drafts and Consideration of Respondents' Comments

20. An acknowledgement is sent to every respondent to an Exposure Draft. Except where the respondent has specifically indicated otherwise, the respondents' comments are considered a matter of public records. Comments which are received upto ten days prior to the date of the AASB meeting at which such comments are proposed to be considered, are hosted on the website of the AASB and kept there till the date of the AASB meeting at which the Exposure Draft and comments thereon are considered. The members of the AASB as well as the Council of the Institute are notified when the comments are hosted on the website of the AASB. Copies of the Exposure Draft and comment letters are also made available to the AASB members at the AASB meeting at which the Exposure Draft is scheduled for discussion.

21. The comments and suggestions received within the exposure period are read and considered by the AASB. The AASB's deliberations on the significant issues raised in the comments letters received together with the AASB's decision thereon are recorded in the minutes of the relevant AASB meeting and also hosted on the website of the AASB. The AASB may decide to discuss with the respondents their comment letters or explain to them the reasons for not having accepted their proposals. The nature and outcome of such discussions are reported and recorded in the minutes of the relevant AASB meeting.

22. Such part of the AASB meetings whereat the Exposure Draft of proposed Standard/ Statement and the comments thereon are to be discussed is open for public. The members of the public, at their own expenditure, can attend the said part of the meeting(s) as observers. Such observers, however, do not have the right to participate in the discussions at the meeting. The notification as to the date of the said AASB meeting is hosted on the website of the Institute at least 30 days in advance and the members of the public desirous of attending the said meeting(s) are required to send their request for the same to the Board at least 15 days prior to the date of the concerned AASB meeting. The seats for the members of the public at such

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meetings are limited to such numbers as may be decided by the AASB and allotted on a first come first serve basis. The AASB may also hold a meeting with the representatives of the specified bodies, as may be identified by the Board on a case to case basis, to ascertain their views on the draft of the proposed Standard/ Statement.

23. After taking into consideration the comments received, the draft of the proposed Standard/ Statement is finalized by the AASB and submitted to the Council of the ICAI for its consideration and approval. The draft of the General Clarification, as finalised by the AASB, is submitted to the Council of ICAI for its consideration and approval.

24. The Council of the ICAI considers the final draft of the proposed Standard/ Statement/General Clarification, and if found necessary, modifies the same in consultation with AASB. The concerned Standard/ Statement/ General Clarification is then issued under the authority of the Council of the ICAI.

Re-exposure

25. The AASB on a direction from the Council of the ICAI or on its own, in cases considered appropriate, may re-expose a proposed Standard/ Statement. The need for re-exposure may arise on account of factors such as significant issues coming to the notice of the Board subsequently, including, significant changes in the laws or regulations having an impact on the requirements of the Standard/ Statement or revision of the corresponding International Standard by IAASB. In cases where a re-exposure of a Standard or a Statement is required, the procedures as listed in paragraphs 12 to 24 are followed.

Procedure for Issuing the Guidance Notes

26. The AASB identifies the issues on which Guidance Notes need to be formulated and the priority in regard to selection thereof.

27. In the preparation of the Guidance Note, the AASB is assisted by Study Groups/Task Forces constituted to consider specific projects. The AASB appoints one of the professional accountants as a convenor of the Study Group / Task Force. The Convenor nominates other members of the Study Group/Task Force and in the formation of Study Groups / Task Forces, provision is made for participation of a cross-section of members of the ICAI. In situations considered necessary, the Board may also consider having an outside expert on such Study Groups/Task Forces and such "expert" need not necessarily be a professional accountant. The Study Group/Task Force will be responsible for preparing the basic draft of the Guidance Note.

28. The Study Group/Task Force develops the preliminary draft of the Guidance Note based on appropriate research and consultation, which may include, depending on the circumstances, consulting with the other professionals, regulators and other interested parties, as well as reviewing professional pronouncements issued by IFAC member bodies and other parties and submits the preliminary draft Guidance Note to the AASB. The draft Guidance Note, along with the background papers, if any, is sent to the Chairman, AASB for approval.

29. The AASB considers the preliminary draft prepared by the Study Group/Task Force and may refer the same to the Study Group/Task Force to examine the issues arising out of the deliberations of the AASB and accordingly modify the draft Guidance Note. The modified Draft Guidance Note is once again considered by the Board. The draft Guidance Note as finalised by the Board is submitted for the consideration of the Council of the ICAI.

30. Unlike Standards/Statements, ordinarily, no proposed Guidance Note is exposed for comments of the professional accountants and others. However, in situations considered necessary by the Board, an Exposure Draft of a Guidance Note may well be issued for public comments. In case an Exposure Draft of a Guidance Note is to be issued, the same procedures as required for an Exposure Draft of the Standard/

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Statement (as mentioned in paragraphs 17 to 22 above) is required to be followed. The reasons for issuing an Exposure Draft of the Guidance Note are recorded in the minutes of the relevant AASB meeting. However, the part of the AASB meeting at such Exposure Draft is considered is not open for public.

31. The Council of the Institute considers the final draft of the proposed Guidance Note and, if necessary, suggests modifications thereto in consultation with the AASB. The Guidance Note is then issued under the authority of the Council of the ICAI.

Limited or Substantive Revision to the Standard, Statement or Guidance Note

32. Subsequent to issuance of a Standard, Statement or Guidance Note, the introduction of any new legal or professional requirement or any other national or international development in the field of auditing, may require a substantive revision to that Standard, Statement or Guidance Note. In that case, the Council of the ICAI makes substantive revision to such Standard/ Statement /Guidance Note. The procedure followed for substantive revision is the same as that followed for formulation of a new Standard, Statement or the Guidance Note, as the case may be, as detailed above.

33. Similarly, subsequent to issuance of a Standard, Statement or Guidance Note, some aspect(s) may require revision which are not substantive in nature. For this purpose, the Council of the ICAI may make limited revision to a Standard/ Statement /Guidance Note. In case of the Standards on Auditing (SAs), any revision to a Standard is treated as limited only if that revision is restricted to the application guidance of that Standard. The procedure followed for the limited revision is, in principle, the same as that followed for formulation of a Standard, Statement or Guidance Note, as the case may be. However, the AASB may decide to cut short some time limits, e.g. period of public exposure in case of a limited revision to a Standard/Statement, as detailed above, for the process.

Technical Guides, Practice Manuals, Studies and Other Papers Published by the Auditing and Assurance Standards Board

34. For issuance of a Technical Guides/Studies, etc., the procedure adopted by the AASB is ordinarily the same as in case of a Guidance Note except that the draft Technical Guide/ Practice Manual/ Study is not exposed for public comments nor such part of the AASB meeting at which the proposed Technical Guide, Practice Manual, etc., is considered, open for public. Also, since the Technical Guides, Practice Manuals, Studies, etc., are not issued under the authority of the Council, these are not required to be placed for consideration and final approval of the Council, and are issued by the AASB under its own authority.

Voting

35. The affirmative votes of a majority of the members of the Board, in person or by simultaneous telecommunication link, are required to approve the final draft of a Standard or Statement for submission to the Council.

36. Each member of the AASB has the right to one vote.

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Glossary of Terms*

Access controls - Procedures designed to restrict access to on-line terminal devices, programs and data. Access controls consist of "user authentication" and "user authorization." "User authentication" typically attempts to identify a user through unique logon identifications, passwords, access cards or biometric data. "User authorization" consists of access rules to determine the computer resources each user may access. Specifically, such procedures are designed to prevent or detect:

(a) Unauthorized access to on-line terminal devices, programs and data;

(b) Entry of unauthorized transactions;

(c) Unauthorized changes to data files;

(d) The use of computer programs by unauthorized personnel; and

(e) The use of computer programs that have not been authorized.

Accounting estimate - An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where SA 540[1] addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

Accounting records - The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

Accuracy Assertion - Amounts and other data relating to recorded transactions and events have been recorded appropriately.

Agreed-upon procedures engagement - An engagement in which an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures may misinterpret the results.

Analytical procedures - Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Annual report - A document issued by an entity, ordinarily on an annual basis, which includes its financial statements together with the auditor's report thereon.

Anomaly - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Applicable financial reporting framework - The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

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*Definitions given in this Glossary should be read in the context of the respective Standards where they are appearing.

[1] SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

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The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.

Application controls in information technology - Manual or automated procedures that typically operate at a business process level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data.

Applied criteria (in the context of SA 810[2]) - The criteria applied by management in the preparation of the summary financial statements.

Appropriateness (of audit evidence) - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Arm's length transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Assertion-based Engagements - In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements".

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

Assess - Analyze identified risks of to conclude on their significance. "Assess," by convention, is used only in relation to risk. (also see *Evaluate*)Association - (see *Auditor association with financial information*)

Assurance - (see *Reasonable assurance*)

Assurance engagement - An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria (also see *Subject matter information*). Under the "Framework for Assurance Engagements" issued by the Institute of Chartered Accountants of India there are two types of assurance engagement a

[2] SA 810, "Engagements to Report on Summary Financial Statements."

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practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

Reasonable assurance engagement—The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement[3] as the basis for a positive form of expression of the practitioner's conclusion.

Limited assurance engagement—The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Assurance engagement risk - The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

Audit documentation - The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

Audit evidence - Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. (See *Sufficiency of audit evidence* and *Appropriateness of audit evidence*.)

Audit file - One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Audit firm - (see *Firm*)

Audit opinion - (see *Modified opinion and Unmodified opinion*)

Audit risk - The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Audit sampling (sampling) - The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Audited financial statements (in the context of SA 810) - Financial statements[4] audited by the auditor in accordance with SAs, and from which the summary financial statements are derived.

Auditor - "Auditor" is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used.

Auditor association with financial information - An auditor is associated with financial information when the auditor attaches a report to that information or consents to the use of the auditor's name in a professional connection.

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[3] Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

[4] SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing," paragraph 13(f), defines the term "financial statements."

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Auditor's expert - An individual or organization 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.

Auditor's point estimate or auditor's range - The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Auditor's range - (see *Auditor's point estimate*)

Block Selection - Block selection involves selection of a block(s) of contiguous items from within the population.

Business risk - A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Capabilities (of management's expert) - Capability relates the ability of the management's expert to exercise that competence in the circumstances.

Classification assertion - Transactions and events have been recorded in the proper accounts.

Comparative financial statements - Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparative information - The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Competence (of management's expert) - Competence relates to the nature and level of expertise of the management's expert.

Compilation engagement -An engagement in which accounting expertise, as opposed to auditing expertise, is used to collect, classify and summarize financial information.

Complementary user entity controls - Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

Completeness Assertion - All transactions and events that should have been recorded have been recorded.

Completion memorandum - A summary that describes the significant matters identified during the audit and how they were, or that includes cross reference to other relevant supporting audit documentation that provides such information.

Compliance framework - (see *Applicable financial reporting framework* and *General purpose framework*)

Component - An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Component auditor - An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Component management - Management responsible for the preparation of the financial information of a component.

Component materiality - The materiality for a component determined by the group engagement team.

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Computer-assisted audit techniques - Applications of auditing procedures using the computer as an audit tool (also known as CAATs).

Control activities - Those policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

Control environment - Includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment is a component of internal control.

Control risk - The risk that a material misstatement that could occur will not be prevented, or detected or corrected, on a timely basis by related internal controls (see *Risk of material misstatement*)

Corresponding figures—Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Corporate governance - (see *Governance*)

Capabilities (of management's expert) - Capability relates the ability of the management's expert to exercise that competence in the circumstances.

Criteria - The benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal or less formal. There can be different criteria for the same subject matter. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment.

Suitable criteria—Exhibit the following characteristics:

(a) *Relevance*: relevant criteria contribute to conclusions that assist decision-making by the intended users.

(b) *Completeness*: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.

(c) *Reliability*: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.

(d) *Neutrality*: neutral criteria contribute to conclusions that are free from bias.

(e) *Understandability*: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

Cut-off Assertion - Transactions and events have been recorded in the correct accounting period.

Date of approval of the financial statements - The date on which all the statements that comprise the financial statements, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Date of report (in relation to quality control) - The date selected by the practitioner to date the report.

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Date of the auditor's report - The date the auditor dates the report on the financial statements in accordance with Revised SA 700.[5]

Date of the financial statements—The date of the end of the latest period covered by the financial statements.

Date the financial statements are issued - The date that the auditor's report and audited financial statements are made available to third parties.

Deficiency in internal control - This exists when:

(a) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or

(b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Detection risk - The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Direct Reporting Engagements - In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".

Documentation of the audit plan - A record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

Documentation of the overall audit strategy - A record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

Element - (see *Element of a financial statement*)

Element of a financial statement (in the context of SA 805[6]**)**— An element, account or item of a financial statement.

Emphasis of Matter paragraph - A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Engagement documentation— The record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used). The documentation for a specific engagement is assembled in an engagement file.

Engagement letter - Written terms of an engagement in the form of a letter.

Engagement partner - The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

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5 SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements."

6 SA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement.".

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Engagement quality control review - A process designed to provide an objective evaluation, before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report.

Engagement quality control reviewer- A partner, other person[7] in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report. However, in case the review is done by a team of individuals, such tem should be headed by a member of the Institute.

Engagement team - All personnel performing the engagement, including any experts contracted by the firm in connection with that engagement.[8]

Entity's risk assessment process - A component of internal control that is the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

Environmental matters - (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);

(b) Consequences of violating environmental laws and regulations;

(c) Consequences of environmental damage done to others or to natural resources; and

(d) Consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners).

Environmental performance report - A report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

Environmental risk - In certain circumstances, factors relevant to the assessment of inherent risk for the development of the overall audit plan may include the risk of material misstatement of the financial statements due to environmental matters.

Error - An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Estimation uncertainty - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Evaluate - Identify and analyze the relevant issues, including performing further procedures as necessary, to come to a specific conclusion on a matter. "Evaluation," by convention, is used only in relation to a range of matters, including evidence, the results of procedures and the effectiveness of management's response to a risk. (also see *Assess*)

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

Existence Assertion - Assets, liabilities, and equity interests exist.

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[7] Such other person should be a member of the Institute of Chartered Accountants of India.

[8] SA 620, "Using the Work of an Auditor's Expert," paragraph 6(a), defines the term "auditor's expert".

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Experienced auditor - An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

(a) Audit processes;

(b) SAs and applicable legal and regulatory requirements;

(c) The business environment in which the entity operates; and

(d) Auditing and financial reporting issues relevant to the entity's industry.

Expert - (see *Auditor's expert* and *Management's expert*)

Expertise - Skills, knowledge and experience in a particular field.

Extent of Audit Procedure - Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

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

Fair presentation framework - (see *Applicable financial reporting framework* and *General purpose framework*)

Financial Reporting Standards - Means the Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

Financial statements - A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but it can also refer to a single financial statement.

Firm - A sole practitioner/proprietor, partnership or any such entity of professional accountants, as may be permitted by law.

Forecast - Prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

Fraud - An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud risk factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraudulent financial reporting - Involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

General IT-controls - Policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT-controls commonly include controls over data center and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance.

General purpose financial statements - Financial statements prepared in accordance with a general purpose framework.

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General purpose framework - A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.[9]

Governance - Describes the role of person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Group - All the components whose financial information is included in the group financial statements. A group always has more than one component.

Group audit - The audit of group financial statements.

Group audit opinion - The audit opinion on the group financial statements.

Group engagement partner - The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.

Group engagement team - Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group financial statements - Financial statements that include the financial information of more than one component. The term "group financial statements" also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

Group management - Management responsible for the preparation of the group financial statements.

Group-wide controls - Controls designed, implemented and maintained by group management over group financial reporting.

Haphazard Selection - Haphazard selection is a sample selection method in which the auditor selects the sample without following a structured technique.

Historical financial information - Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Inconsistency - Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

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9 SA 200, paragraph 13(a).

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Independence - Comprises:

(a) Independence of mind—the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

(b) Independence in appearance—the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Information system relevant to financial reporting - A component of internal control that includes the financial reporting system, and consists of the procedures and records designed and established to

- Initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

Inherent risk - (see *Risk of material misstatement*)

Initial audit engagement - An engagement in which either:

(a) The financial statements for the prior period were not audited; or

(b) The financial statements for the prior period were audited by a predecessor auditor.

Inquiry - Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.

Inspection (as an audit procedure) - Examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

Inspection (in relation to quality control) - In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

Intended users - The person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

Interim financial information or statements - Financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

Internal audit function - An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.

Internal auditors - Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

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Internal control - The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

International Financial Reporting Standards - The International Financial Reporting Standards issued by the International Accounting Standards Board.

Investigate - Inquire into matters arising from other procedures to resolve them.

IT environment - The policies and procedures that the entity implements and the IT infrastructure (hardware, operating systems, etc.) and application software that it uses to support business operations and achieve business strategies.

Limited assurance engagement - (see *Assurance engagement*)

Listed entity - An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.

Material Weakness - A weakness in internal control that could have a material effect on the financial statements.

Management - The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

Management bias - A lack of neutrality by management in the preparation and presentation of information.

Management's expert - An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Management's point estimate - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate

Misappropriation of assets - Involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

Misstatement - A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Misstatement of fact - Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

Modified opinion - A qualified opinion, an adverse opinion or a disclaimer of opinion.

Monitoring (in relation to quality control) - A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed

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engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

Monitoring of controls - A process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary remedial actions modified for changes in conditions. Monitoring of controls is a component of internal control.

Monetary Unit Sampling - Monetary Unit Sampling is a type of value-weighted sample selection method in which sample size, selection and evaluation results in a conclusion in monetary amounts.

Nature of Audit Procedure - The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedures) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure).

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

Network - A larger structure:

(a) That is aimed at cooperation, and

(b) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

Network firm - A firm or entity that belongs to a network.

Non-compliance (in the context of SA 250[10]) - Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

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

Non-sampling risk - The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Objectivity (of management's expert) - Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert.

Observation - Consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.

Occurrence Assertion - Transactions and events that have been recorded have occurred and pertain to the entity.

Opening balances - Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

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[10] SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

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Other information - Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation, or custom, in a document containing audited financial statements and the auditor's report thereon.

Other Matter paragraph - A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Outcome of an accounting estimate - The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Outcome of the evaluation or measurement of a subject matter - The information that results from applying the criteria to the subject matter.

Overall audit strategy - Sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Partner - Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

Performance materiality - The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Personnel - Partners and staff.

Pervasive - A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

(a) Are not confined to specific elements, accounts or items of the financial statements;

(b) If so confined, represent or could represent a substantial proportion of the financial statements; or

(c) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Population - The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

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

Practitioner - A professional accountant in public practice.

Practitioner's Association with Subject Matter - A practitioner is associated with a subject matter when the practitioner reports on information about the subject matter or consents to the use of the practitioner's name in a professional connection with that subject matter.

Preconditions for an audit - The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise[11] on which an audit is conducted.

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[11] SA 200, paragraph 13(j).

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Predecessor auditor - The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted - That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:

(a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

(b) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide the auditor with:

(i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records,

(ii) documentation and other matters;

(iii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and

(iv) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, (a) above may be restated as "for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework," or "for the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework."

The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise."

Professional accountant - Member of the Institute of Chartered Accountants of India.

Professional accountant in public practice - Refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

Professional judgment - The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional skepticism - An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

Professional standards - Engagement Standards as defined in the AASB's "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", and relevant ethical requirements as contained in the Code.

Projection - Prospective financial information prepared on the basis of:

(a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

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(b) A mixture of best-estimate and hypothetical assumptions.

Prospective financial information - Financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (See *Forecast* and *Projection*)

Public sector - National governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises).

Random Selection - It is a sample selection method involving application of random number generators, for example, random number tables.

Reasonable assurance (in the context of assurance engagements, including audit engagements, and quality control) - A high, but not absolute, level of assurance.

Reasonable assurance engagement - (see *Assurance engagement*)

Recalculation - Consists of checking the mathematical accuracy of documents or records.

Related party - A party that is either:

(a) A related party as defined in the applicable financial reporting framework; or

(b) Where the applicable financial reporting framework establishes minimal or no related party requirements:

  (i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;

  (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or

  (iii) Another entity that is under common control with the reporting entity through having:

    a. Common controlling ownership;

    b. Owners who are close family members; or

    c. Common key management.

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

Related services - Comprise agreed-upon procedures and compilations.

Relevant ethical requirements - Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Code of Ethics issued by Institute of Chartered Accountants of India (ICAI) together with other relevant pronouncements issued by the Institute.

Reperformance - The auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal controls.

Report on the description and design of controls at a service organization (referred to in SA 402[12] (Revised) as a Type 1 report) - A report that comprises:

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12 SA 402, "Audit Considerations Relating to an Entity Using a Service Organization".

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(a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and

(b) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organization's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

Report on the description, design, and operating effectiveness of controls at a service organization (referred to in SA 402) as a Type 2 report) - A report that comprises:

(a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

(b) A report by the service auditor with the objective of conveying reasonable assurance that includes:

  (i) The service auditor's opinion on the description of the service organization's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and

  (ii) A description of the service auditor's tests of the controls and the results thereof.

Responsible party - The person (or persons) who:

(a) In a direct reporting engagement, is responsible for the subject matter; or

(b) In an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

Review (in relation to quality control) - Appraising the quality of the work performed and conclusions reached by others.

Review engagement - The objective of a review engagement is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

Review procedures - The procedures deemed necessary to meet the objective of a review engagement, primarily inquiries of entity personnel and analytical procedures applied to financial data.

Rights and Obligations Assertion - The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

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

Risk of material misstatement - The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(a) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

(b) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with

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other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Sampling - (see *Audit sampling*)

Sampling risk - The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(a) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(b) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Sampling unit - The individual items constituting a population.

Scope of a review - The review procedures deemed necessary in the circumstances to achieve the objective of the review.

Service auditor - An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.

Service organization - A third-party organization (or segment of a third-party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

Service organization's system - The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor's report.

Significance - The relative importance of a matter, taken in context. The significance of a matter is judged by the practitioner in the context in which it is being considered. This might include, for example, the reasonable prospect of its changing or influencing the decisions of intended users of the practitioner's report; or, as another example, where the context is a judgment about whether to report a matter to those charged with governance, whether the matter would be regarded as important by them in relation to their duties. Significance can be considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and effect on the subject matter and the expressed interests of intended users or recipients

Significant component - A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Significant deficiency in internal control - A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Significant risk - An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Single financial statement (for example, a cash flow statement) or to a specific element of a financial statement (for example, cash and bank balances) - Includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

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Smaller entity - An entity which typically possesses qualitative characteristics such as:

(a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and

(b) One or more of the following:

  (i) Straightforward or uncomplicated transactions;

  (ii) Simple record-keeping;

  (iii) Few lines of business and few products within business lines;

  (iv) Few internal controls;

  (v) Few levels of management with responsibility for a broad range of controls; or

  (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

Special purpose financial statements - Financial statements prepared in accordance with a special purpose framework.

Special purpose framework - A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.[13]

Staff - Professionals, other than partners, including any experts the firm employs.

Statistical sampling - An approach to sampling that has the following characteristics:

(a) Random selection of the sample items; and

(b) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

Stratification - The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Subject matter information - The outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

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

Subservice organization - A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

Substantive procedure - An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(a) Tests of details (of classes of transactions, account balances, and disclosures); and

(b) Substantive analytical procedures.

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13 SA 200, paragraph 13(a).

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Sufficiency (of audit evidence) - The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Suitable criteria - (see *Criteria*)

Suitably qualified external person - An individual outside the firm with the competence and capabilities to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of another firm.

Summary financial statements (in the context of ISA 810) - Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.[14] Different jurisdictions may use different terminology to describe such historical financial information.

Supplementary information - Information that is presented together with the financial statements that is not required by the applicable financial reporting framework used to prepare the financial statements, normally presented in either supplementary schedules or as additional notes.

Systematic Selection - Systematic selection is a sample selection method, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

Test - The application of procedures to some or all items in a population.

Tests of controls - An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Those charged with governance - The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.[15]

Timing of Audit Procedure - Timing of an audit procedure refers to when it is performed, or the period to date to which the audit evidence applies.

Tolerable misstatement - A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Total rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Uncertainty - A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

Uncorrected misstatements - Misstatements that the auditor has accumulated during the audit and that have not been corrected.

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14 SA 200, paragraph 13(f).

15 For discussion of the diversity of governance structures, see paragraphs A1-A8 of SA 260, "Communication with Those Charged with Governance."

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Unmodified opinion - The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.[16]

User auditor - An auditor who audits and reports on the financial statements of a user entity.

User entity - An entity that uses a service organization and whose financial statements are being audited.

Valuation and Allocation Assertion - Assets, liabilities and equity interest are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Walk-through test - Involves tracing a few transactions through the financial reporting system.

Written representation - 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.

[16] SA 700 (Revised), paragraphs 35-36, deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

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Standard on Quality Control (SQC) 1

Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*

(Effective for all engagements relating to accounting periods beginning on or after April 1, 2009)

Introduction

1. The purpose of this Standard on Quality Control (SQC) is to establish standards and provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This SQC is to be read in conjunction with the requirements of the Chartered Accountants Act, 1949, the Code of Ethics and other relevant pronouncements of the Institute[1] (hereinafter referred to as "the Code").

2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the Auditing and Assurance Standards Board (AASB) issued under the authority of the Council. For example, Standard on Auditing (SA) 220, "*Quality Control for an Audit of Financial Statements*", establishes standards and provides guidance on quality control procedures for audits of historical financial information.

3. The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm[2] or engagement partner(s) are appropriate in the circumstances.

4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.

5. This SQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this SQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

Definitions

6. In this SQC, the following terms have the meanings attributed below:

(a) *Engagement documentation* – the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are also sometimes used). The documentation for a specific engagement is assembled in an engagement file;

(b) *Engagement partner* – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(c) *Engagement quality control review* – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

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* Published in October, 2007 issue of the Journal.

[1] Attention of the members is invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the Committee on Ethical Standards.

[2] It is clarified that in India the reports are not issued/signed in the firm's name, rather they are issued/signed on behalf of the firm by the sole practitioner, proprietor or a partner of the firm, as the case may be, in his individual name. The definition of a 'firm' has been given in paragraph 6(f) of this Standard.

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(d) *Engagement quality control reviewer* – a partner, other person[3] in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.

(e) *Engagement team* – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

(f) *Firm* – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

(g) *Inspection* – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

(h) *Listed entity* – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.

(i) *Monitoring* – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

(j) *Network firm*– A firm or entity that belongs to a network.

(k) Network – A larger structure:

(i) That is aimed at cooperation, and

(ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

(l) *Partner* – any individual with authority to bind the firm with respect to the performance of a professional services engagement.

(m) *Personnel* – partners and staff.

(n) *Professional standards* – engagement standards, as defined in the AASB's "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," and relevant ethical requirements as contained in the Code.

(o) *Reasonable assurance* – in the context of this SQC, a high, but not absolute, level of assurance.

(p) *Staff* – professionals, other than partners, including any experts which the firm employs.

(q) *Suitably qualified external person* – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee[4] (with appropriate experience) of another firm.

Elements of a System of Quality Control

7. The firm's system of quality control should include policies and procedures addressing each of the following elements:

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[3] Such other person should be a member of the Institute of Chartered Accountants of India.

[4] Such employee should be a member of the Institute of Chartered Accountants of India.

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(a) Leadership responsibilities for quality within the firm.

(b) Ethical requirements.

(c) Acceptance and continuance of client relationships and specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

8. **The quality control policies and procedures should be documented and communicated to the firm's personnel.** Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Leadership Responsibilities for Quality within the Firm

9. The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.

10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality control policies and procedures, and the requirement to:

(a) Perform work that complies with professional standards and regulatory and legal requirements; and

(b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:

(a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;

(b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and

(c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

12. Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.

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13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

14. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

15. Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements are contained in the Code. The Code establishes the fundamental principles of professional ethics, which include:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

16. The Code includes a conceptual approach to independence for assurance engagements, including aspects such as threats to independence, accepted safeguards and the public interest.

17. **The firm's policies and procedures should emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring, and (d) a process for dealing with non-compliance.** Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

Independence

18. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code. Such policies and procedures should enable the firm to:

(a) **Communicate its independence requirements to its personnel and, where applicable, to others subject to them; and**

(b) **Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.**

19. Such policies and procedures should require:

(a) **Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;**

(b) **Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and**

(c) **The accumulation and communication of relevant information to appropriate personnel so that:**

  (i) **The firm and its personnel can readily determine whether they satisfy independence requirements;**

  (ii) **The firm can maintain and update its records relating to independence; and**

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(iii) **The firm can take appropriate action regarding identified threats to independence.**

20. The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

(a) **All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;**

(b) **The firm to promptly communicate identified breaches of these policies and procedures to:**

(i) **The engagement partner who, with the firm, needs to address the breach; and**

(ii) **Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and**

(c) **Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.**

21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations are contained in the Code.

22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm, as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.

23. At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. **Accordingly, the firm should establish policies and procedures:**

(a) **Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and**

(b) **For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.**

26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. Therefore, the firm should establish criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as (a) the nature of the engagement, including the extent to which it involves a matter of public interest, and (b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

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27. The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. **For these audits, the engagement partner should be rotated after a pre-defined period, normally not more than seven years[5].**

Acceptance and Continuance of Client Relationships and Specific Engagements

28. The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it:

(a) **Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;**

(b) **Is competent to perform the engagement and has the capabilities, time and resources to do so; and**

(c) **Can comply with the ethical requirements.**

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

29. With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

30. Information on such matters that the firm obtains may come from, for example:

- Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code, and discussions with other third parties.
- Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
- Background searches of relevant databases.

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[5] The provision of rotation of partners shall not be applicable in case the audit of listed entities is being done by a sole practitioner/proprietor. However, in order to ensure that appropriate system of quality control exists in the firm and that appropriate reports are issued in the circumstances by sole practitioners/proprietors, such practice unit(s) shall be compulsorily reviewed under the process of peer review. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

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31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:

- Firm personnel have knowledge of relevant industries or subject matters;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Experts are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
- The firm would be able to complete the engagement within the reporting deadline.

32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of interest[6]. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.

33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.

34. Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

(a) **The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and**

(b) **The possibility of withdrawing from the engagement or from both the engagement and the client relationship.**

35. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

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[6] Attention of the members is invited to the 'Code of Ethics' and the 'Guidance Note on Independence of Auditors' issued by the ICAI.

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Human Resources

36. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

37. Such policies and procedures address the following personnel issues:

(a) Recruitment;

(b) Performance evaluation;

(c) Capabilities;

(d) Competence;

(e) Career development;

(f) Promotion;

(g) Compensation; and

(h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Coaching by more experienced staff, for example, other members of the engagement team.

39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain and also enhance their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures, the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.

40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:

(a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;

(b) Provides personnel with evaluation of, and counseling on, performance, progress and career development; and

(c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

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41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Assignment of Engagement Teams

42. The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:

(a) **The identity and role of the engagement partner are communicated to key members of the client's management and those charged with governance;**

(b) **The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and**

(c) **The responsibilities of the engagement partner are clearly defined and communicated to that partner.**

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

44. The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning engagement teams, and in determining the level of supervision required, include the following:

- An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- An understanding of professional standards and regulatory and legal requirements.
- Appropriate technical knowledge, including knowledge of relevant information technology.
- Knowledge of the relevant industries in which the clients operate.
- Ability to apply professional judgment.
- An understanding of the firm's quality control policies and procedures.

Engagement Performance

46. The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.

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- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

49. Supervision includes the following:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.
- Addressing significant issues arising during the engagement, considering their significance and appropriately modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.

50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:

(a) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(b) Significant matters have been raised for further consideration;

(c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(d) There is a need to revise the nature, timing and extent of work performed;

(e) The work performed supports the conclusions reached and is appropriately documented;

(f) The evidence obtained is sufficient and appropriate to support the report; and

(g) The objectives of the engagement procedures have been achieved.

Consultation

51. The firm should establish policies and procedures designed to provide it with reasonable assurance that:

(a) **Appropriate consultation takes place on difficult or contentious matters;**

(b) **Sufficient resources are available to enable appropriate consultation to take place;**

(c) **The nature and scope of such consultations are documented; and**

(d) **Conclusions resulting from consultations are documented and implemented.**

52. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.

53. Consultation uses appropriate research resources as well as the collective experience and technical

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expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. The firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.

55. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by (a) other firms, or (b) professional and regulatory bodies. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:

(a) The issue on which consultation was sought; and

(b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

57. The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.

58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. **The report should not be issued until the matter is resolved.**

59. A firm using a suitably qualified external person(s) to conduct an engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

60. The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:

(a) **Require an engagement quality control review for all audits of financial statements of listed entities;**

(b) **Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and**

(c) **Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).**

61. The firm's policies and procedures should require the completion of the engagement quality

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control review before the report is issued.

62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

63. The firm should establish policies and procedures setting out:

(a) **The nature, timing and extent of an engagement quality control review;**

(b) **Criteria for the eligibility of engagement quality control reviewers; and**

(c) **Documentation requirements for an engagement quality control review.**

Nature, Timing and Extent of the Engagement Quality Control Review

64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments that the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

65. An engagement quality control review for audits of financial statements of listed entities includes considering the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
- The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.

67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

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Criteria for the Eligibility of Engagement Quality Control Reviewers

68. The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:

(a) **The technical qualifications required to perform the role, including the necessary experience and authority; and**

(b) **The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.**

69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:

(a) Is not selected by the engagement partner;

(b) Does not otherwise participate in the engagement during the period of review;

(c) Does not make decisions for the engagement team; and

(d) Is not subject to other considerations that would threaten the reviewer's objectivity.

71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.

72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 69-72.

Documentation of the Engagement Quality Control Review

73. Policies and procedures on documentation of the engagement quality control review should require documentation that:

(a) **The procedures required by the firm's policies on engagement quality control review have been performed;**

(b) **The engagement quality control review has been completed before the report is issued; and**

(c) **The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.**

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Engagement Documentation

Completion of the Assembly of Final Engagement Files

74. The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.

75. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation, the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

76. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

77. The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.

78. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

79. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for engagement documentation to:

(a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;

(b) Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties *via* the Internet;

(c) Prevent unauthorized changes to the engagement documentation; and

(d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

80. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of

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engagement, processing it during engagement, and collating it at the end of engagement.

- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

81. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

(a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;

(b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and

(c) Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

Retention of Engagement Documentation

82. The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.

83. The needs of the firm for retention of engagement documentation, and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than seven years[7] from the date of the auditor's report, or, if later, the date of the group auditor's report.

84. Procedures that the firm adopts for retention of engagement documentation include those that:

- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Ownership of Engagement Documentation

85. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm.

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[7] The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, 'Audit Documentation', issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

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The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

86. The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

87. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(a) Adherence to professional standards and regulatory and legal requirements;

(b) Whether the quality control system has been appropriately designed and effectively implemented; and

(c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

88. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.

89. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:

- Analysis of:
  - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
  - Written confirmation of compliance with policies and procedures on independence;
  - Continuing professional development, including training; and
  - Decisions related to acceptance and continuance of client relationships and specific engagements.
- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

90. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.

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- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

91. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

92. Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

93. The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:

(a) **Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or**

(b) **Systemic, repetitive or other significant deficiencies that require prompt corrective action.**

94. The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

95. The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

(a) **Taking appropriate remedial action in relation to an individual engagement or member of personnel;**

(b) **The communication of the findings to those responsible for training and professional development;**

(c) **Changes to the quality control policies and procedures; and**

(d) **Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.**

96. Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.

97. At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing partner(s). Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should

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include the following:

(a) **A description of the monitoring procedures performed.**

(b) **The conclusions drawn from the monitoring procedures.**

(c) **Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.**

98. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

99. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this SQC, and these firms place reliance on such a monitoring system:

(a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;

(b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and

(c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.

100. Appropriate documentation relating to monitoring:

(a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;

(b) Records the evaluation of:

(i) Adherence to professional standards and regulatory and legal requirements;

(ii) Whether the quality control system has been appropriately designed and effectively implemented; and

(iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and

(c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

Complaints and Allegations

101. The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

(a) **Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and**

(b) **Allegations of non-compliance with the firm's system of quality control.**

102. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.

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103. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

104. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

105. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 95.

Documentation

106. The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.

107. How such matters are documented is the firm's decision. For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more simpler and informal methods such as manual notes, checklists and forms.

108. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:

- The size of the firm and the number of offices.
- The degree of authority both personnel and offices have.
- The nature and complexity of the firm's practice and organization.

109. The firm retains this documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

110. This Standard on Quality Control is recommendatory for all engagements relating to accounting periods beginning on or after April 1, 2008 and is mandatory for all engagements relating to accounting periods beginning on or after April 1, 2009.

Material Modifications to the International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"

Additions

1. Paragraph 6(d) of the ISQC 1, dealing with the definition of "engagement quality control reviewer" mentions that "other person in the firm" with sufficient and appropriate experience and authority can also act as quality control reviewer. The SQC 1 has retained this concept subject to the condition that such "other person in the firm" should also be a member of the Institute of Chartered Accountants of India.

2. Paragraph 6(d) of the ISQC 1, while defining the "engagement quality control reviewer" provides that the review can be done by a team of individuals comprising the partner, other person in the firm and/or the suitably qualified external person. The SQC 1 has retained this concept subject to the condition that in case of review by a team of individuals, such team should be headed by a member of the Institute.

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3. Paragraph 6(f) of the ISQC 1 defines "firm" as "a sole practitioner, partnership, corporation or other entity of professional accountants". Since in India an individual can practice in his individual name and also in the name of the firm as proprietor of that firm, accordingly, the term 'Proprietor' has been added to the definition of the firm.

4. Paragraph 83 of the ISQC 1 prescribes the minimum period of engagement documentation as five years. The SQC 1 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, including regulations therein, prescribes the minimum period of retention of working papers as seven years.

Deletions

1. Paragraph 6(f) of the ISQC 1 defines "firm" as "a sole practitioner, partnership, corporation or other entity of professional accountants". Since in India, the practitioners establish any corporate entity for practice, the word 'Corporation' has been deleted from the definition.

2. In terms of paragraph 6(p) of the ISQC 1, defining a "suitably qualified external person" as a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organisation that provides relevant quality control services. Since, in India only the Institute of Chartered Accountants of India is the professional body whose members can carry out an audit or a review of historical financial information or other assurance engagement, a specific reference to this fact appearing in the context of "partner of another firm or an employee" has been deleted from the definition of "suitably qualified external person".

3. Paragraph 6(p) lays down that "an organisation that provides relevant quality control services" can also act as a suitably qualified person. The SQC does not include any such requirement since it is felt that a review of a firm of accountants should be done by a similar firm of accountants only.

4. Paragraph 27 of the ISQC 1 requires that in all engagements of audit of listed companies, the engagement partner of the firm should be rotated within a period of seven years in order to avoid the familiarity threat. The SQC 1 does not mandate such a provision in the audit engagements of the listed entities that are audited by the sole practitioners/proprietors as it is not possible to apply the provision in such cases. However, the SQC 1 provides for peer review of those firms in order to mitigate familiarity threat.

5. The ISQC 1 also deals with the public sector perspective. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Standard does not specifically mention that aspect.

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Framework for Assurance Engagements*

(Effective From April 1, 2008)

Introduction

1. This Framework defines and describes the elements and objectives of an assurance engagement, and identifies engagements to which Standards on Auditing (SAs), Standards on Review Engagements (SREs) and Standards on Assurance Engagements (SAEs) apply. It provides a frame of reference for:

(a) Professional accountants in public practice[1] (practitioners) when performing assurance engagements. Professional accountants who are neither in public practice nor in the public sector are encouraged to consider the Framework when performing assurance engagements[2]

(b) Others involved with assurance engagements, including the intended users of an assurance report and the responsible party; and

(c) The Auditing and Assurance Standards Board (AASB) in its development of SAs, SREs and SAEs.

This Framework does not cover engagements covered by Standards on Related Services (SRSs), such as engagements to perform agreed-upon procedures and engagements to compile financial or other information since the members do not express any assurance on the financial information or any other subject matter of their report.

2. This Framework does not itself establish standards or provide procedural requirements for the performance of assurance engagements. SAs, SREs and SAEs contain basic principles, essential procedures and related guidance, consistent with the concepts in this Framework, for the performance of assurance engagements.

3. The following is an overview of this Framework:

- *Introduction*: This Framework deals with assurance engagements performed by practitioners. It provides a frame of reference for practitioners and others involved with assurance engagements, such as those engaging a practitioner (the "engaging party").
- *Definition and objective of an assurance engagement*: This section defines assurance engagements and identifies the objectives of the two types of assurance engagements a practitioner is permitted to perform. This Framework calls these two types reasonable assurance engagements and limited assurance engagements.[3]
- *Scope of the Framework*: This section distinguishes assurance engagements from other engagements, such as consulting engagements.

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[1] As defined in the Preface, the term "professional accountant" refers to the member of the Institute of Chartered Accountants of India. Further, the term "professional accountant in public practice (practitioner)" refers to the member of the Institute of Chartered Accountants of India who is in practice in terms of section 2 of the Chartered Accountants Act, 1949. The term is also used to refer to a firm of chartered accountants in public practice.

[2] If a professional accountant not in public practice applies this Framework, and (a) this Framework, the SAs, SREs or the SAEs are referred to in the professional accountant's report; and (b) the professional accountant or other members of the assurance team and, when applicable, the professional accountant's employer, are not independent of the entity in respect of which the assurance engagement is being performed, the lack of independence and the nature of the relationship(s) with the entity are prominently disclosed in the professional accountant's report. Also, that report does not include the word "independent" in its title, and the purpose and users of the report are restricted.

[3] For assurance engagements relating to historical financial information in particular, such engagements which provide reasonable assurance are called audits, and those engagements which provide limited assurance are called reviews.

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- *Engagement acceptance*: This section sets out characteristics that must be exhibited before a practitioner can accept an assurance engagement.
- *Elements of an assurance engagement*: This section identifies and discusses five elements that assurance engagement performed by practitioners' exhibit: a three party relationship, a subject matter, criteria, evidence and an assurance report. It explains important distinctions between reasonable assurance engagements and limited assurance engagements (also outlined in ***Appendix*** to the Framework). This section also discusses, for example, the significant variation in the subject matters of assurance engagements, the required characteristics of suitable criteria, the role of risk and materiality in assurance engagements, and how conclusions are expressed in each of the two types of assurance engagements.
- *Inappropriate use of the practitioner's name*: This section discusses implications of a practitioner's association with a subject matter.

Ethical Principles and Quality Control Standards

4. In addition to this Framework and SAs, SREs and SAEs, practitioners who perform assurance engagements are governed by:

(a) The requirements of the Chartered Accountants Act, 1949;

(b) The Code of Ethics (the Code), issued by the Institute, which establishes fundamental ethical principles for professional accountants;

(c) Other relevant pronouncements of the Institute of Chartered Accountants of India[4]; and

(d) Standards on Quality Control (SQCs), which establish standards and provide guidance on a firm's system of quality control[5].

5. The Code of Ethics sets out the fundamental ethical principles that all professional accountants are required to observe, including:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behaviour.

Definition and Objective of an Assurance Engagement

6. "Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

7. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. For example:

- The recognition, measurement, presentation and disclosure represented in the financial statements (outcome) result from applying a financial reporting framework for recognition, measurement,

[4] Attention of the members is invited, for instance, to the *Guidance Note on Independence of Auditors*, issued by the Institute of Chartered Accountants of India.

[5] Additional Standards and guidance on quality control procedures for specific types of assurance engagements are set out in SAs, SREs and SAEs.

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presentation and disclosure, such as the Accounting Standards, (criteria) to an entity's financial position, financial performance and cash flows (subject matter).

- An assertion about the effectiveness of internal control (outcome) results from applying a framework for evaluating the effectiveness of internal control, (criteria) to internal control, a process (subject matter).

In the remainder of this Framework, the term "subject matter information" will be used to mean the outcome of the evaluation or measurement of a subject matter. It is the subject matter information about which the practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion in an assurance report.

8. Subject matter information can fail to be properly expressed in the context of the subject matter and the criteria, and can therefore be misstated, potentially to a material extent. This occurs when the subject matter information does not properly reflect the application of the criteria to the subject matter, for example, when an entity's financial statements do not give a true and fair view of (or present fairly, in all material respects) its financial position, financial performance and cash flows in accordance with the generally accepted accounting principles, or when an entity's assertion that its internal control is effective is not fairly stated, in all material respects, based on the established internal control framework.

9. In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. These engagements are called "assertion-based engagements". In other assurance engagements, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report. These engagements are called "direct reporting engagements".

10. Under this Framework, there are two types of assurance engagements a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement. The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement[6] as the basis for a positive form of expression of the practitioner's conclusion. The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Scope of the Framework

11. Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements that do not meet the above definition (and therefore are not covered by this Framework) include:

- Engagements covered by Standards for Related Services, such as agreed-upon procedures engagements and compilations of financial or other information.
- The preparation of tax returns where no conclusion conveying assurance is expressed.

[6] Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

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- Consulting (or advisory) engagements[7], such as management and tax consulting.

12. An assurance engagement may be part of a larger engagement, for example, when a business acquisition consulting engagement includes a requirement to convey assurance regarding historical or prospective financial information. In such circumstances, this Framework is relevant only to the assurance portion of the engagement.

13. The following engagements, which may meet the definition in paragraph 6, need not be performed in accordance with this Framework:

(a) Engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters; and

(b) Engagements that include professional opinions, views or wording from which a user may derive some assurance, if all of the following apply:

  (i) Those opinions, views or wording are merely incidental to the overall engagement;

  (ii) Any written report issued is expressly restricted for use by only the intended users specified in the report;

  (iii) Under a written understanding with the specified intended users, the engagement is not intended to be an assurance engagement; and

  (iv) The engagement is not represented as an assurance engagement in the professional accountant's report.

Reports on Non-Assurance Engagements

14. A practitioner reporting on an engagement that is not an assurance engagement within the scope of this Framework, clearly distinguishes that report from an assurance report. So as not to confuse users, a report that is not an assurance report avoids, for example:

- Implying compliance with this Framework, SAs, SREs or SAEs.
- Inappropriately using the words "assurance," "audit" or "review."
- Including a statement that could reasonably be mistaken for a conclusion designed to enhance the degree of confidence of intended users about the outcome of the evaluation or measurement of a subject matter against criteria.

15. The practitioner and the responsible party may agree to apply the principles of this Framework to an engagement when there are no intended users other than the responsible party but where all other requirements of the SAs, SREs or SAEs are met. In such cases, the practitioner's report includes a statement restricting the use of the report to the responsible party.

Engagement Acceptance

16. A practitioner accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

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[7] Consulting engagements employ a professional accountant's technical skills, education, observations, experiences and knowledge of the consulting process. The consulting process is an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results and sometimes implementation and follow-up. Reports (if issued) are generally written in a narrative (or "long form") style. Generally the work performed is only for the use and benefit of the client. The nature and scope of work is determined by agreement between the professional accountant and the client. Any service that meets the definition of an assurance engagement is not a consulting engagement but an assurance engagement.

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(a) Relevant ethical requirements, such as independence and professional competence will be satisfied, and

(b) The engagement exhibits all of the following characteristics:

(i) The subject matter is appropriate;

(ii) The criteria to be used are suitable and are available to the intended users;

(iii) The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;

(iv) The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and

(v) The practitioner is satisfied that there is a rational purpose for the engagement. If there is a significant limitation on the scope of the practitioner's work (see paragraph 54), it may be unlikely that the engagement has a rational purpose. Also, a practitioner may believe the engaging party intends to associate the practitioner's name with the subject matter in an inappropriate manner (see paragraph 60).

Specific SAs, SREs or SAEs may include additional requirements that need to be satisfied prior to accepting an engagement.

17. When a potential engagement cannot be accepted as an assurance engagement because it does not exhibit all the characteristics in the previous paragraph, the engaging party may be able to identify a different engagement that will meet the needs of intended users. For example:

(a) If the original criteria were not suitable, an assurance engagement may still be performed if:

(i) the engaging party can identify an aspect of the original subject matter for which those criteria are suitable, and the practitioner could perform an assurance engagement with respect to that aspect as a subject matter in its own right. In such cases, the assurance report makes it clear that it does not relate to the original subject matter in its entirety; or

(ii) alternative criteria suitable for the original subject matter can be selected or developed.

(b) The engaging party may request an engagement that is not an assurance engagement, such as a consulting or an agreed-upon procedures engagement.

18. Having accepted an assurance engagement, a practitioner may not change that engagement to a non-assurance engagement, or from a reasonable assurance engagement to a limited assurance engagement without reasonable justification. A change in circumstances that affects the intended users' requirements, or a misunderstanding concerning the nature of the engagement, ordinarily will justify a request for a change in the engagement. If such a change is made, the practitioner does not disregard evidence that was obtained prior to the change.

Elements of an Assurance Engagement

19. The following elements of an assurance engagement are discussed in this section:

(a) A three party relationship involving a practitioner, a responsible party, and intended users;

(b) An appropriate subject matter;

(c) Suitable criteria;

(d) Sufficient appropriate evidence; and

(e) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

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Three Party Relationship

20. Assurance engagements involve three separate parties: a practitioner, a responsible party and intended users.

21. The responsible party and the intended users may be from different entities or the same entity. As an example of the latter case, in a two-tier board structure, the supervisory board may seek assurance about information provided by the management board of that entity. The relationship between the responsible party and the intended users needs to be viewed within the context of a specific engagement and may differ from more traditionally defined lines of responsibility. For example, an entity's senior management (an intended user) may engage a practitioner to perform an assurance engagement on a particular aspect of the entity's activities that is the immediate responsibility of a lower level of management (the responsible party), but for which senior management is ultimately responsible.

Practitioner

22. The term "practitioner" as used in this Framework is broader than the term "auditor" as used in SAs and SREs, which relates only to practitioners performing audit or review engagements with respect to historical financial information.

23. A practitioner may be requested to perform assurance engagements on a wide range of subject matters. Some subject matters may require specialized skills and knowledge beyond those ordinarily possessed by an individual practitioner. As noted in paragraph 17 (a), a practitioner does not accept an engagement if preliminary knowledge of the engagement circumstances indicates that ethical requirements regarding professional competence will not be satisfied. In some cases this requirement can be satisfied by the practitioner using the work of persons from other professional disciplines, referred to as experts. In such cases, the practitioner is satisfied that those persons carrying out the engagement collectively possess the requisite skills and knowledge, and that the practitioner has an adequate level of involvement in the engagement and understanding of the work for which any expert is used.

Responsible Party

24. The responsible party is the person (or persons) who:

(a) in a direct reporting engagement, is responsible for the subject matter; or

(b) in an assertion-based engagement, is responsible for the subject matter information (the assertion), and may be responsible for the subject matter. An example of when the responsible party is responsible for both the subject matter information and the subject matter, is when an entity engages a practitioner to perform an assurance engagement regarding a report it has prepared about its own sustainability practices. An example of when the responsible party is responsible for the subject matter information but not the subject matter, is when a government organization engages a practitioner to perform an assurance engagement regarding a report about a private company's sustainability practices that the organization has prepared and is to distribute to intended users.

The responsible party may or may not be the party who engages the practitioner (the engaging party).

25. The responsible party ordinarily provides the practitioner with a written representation that evaluates or measures the subject matter against the identified criteria, whether or not it is to be made available as an assertion to the intended users. In a direct reporting engagement, the practitioner may not be able to obtain such a representation when the engaging party is different from the responsible party.

Intended Users

26. The intended users are the person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

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27. Whenever practical, the assurance report is addressed to all the intended users, but in some cases there may be other intended users. The practitioner may not be able to identify all those who will read the assurance report, particularly where there is a large number of people who have access to it. In such cases, particularly where possible readers are likely to have a broad range of interests in the subject matter, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, or by law.

28. Whenever practical, intended users or their representatives are involved with the practitioner and the responsible party (and the engaging party, if different) in determining the requirements of the engagement. Regardless of the involvement of others however, and unlike an agreed-upon procedures engagement (which involves reporting findings based upon the procedures, rather than a conclusion):

(a) The practitioner is responsible for determining the nature, timing and extent of procedures; and

(b) The practitioner is required to pursue any matter the practitioner becomes aware of that leads the practitioner to question whether a material modification should be made to the subject matter information.

29. In some cases, intended users (for example, bankers and regulators) impose a requirement on, or request the responsible party (or the engaging party, if different) to arrange for, an assurance engagement to be performed for a specific purpose. When engagements are designed for specified intended users or a specific purpose, the practitioner considers including a restriction in the assurance report that limits its use to those users or that purpose.

Subject Matter

30. The subject matter, and subject matter information, of an assurance engagement can take many forms, such as:

- Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
- Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
- Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
- Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
- Behaviour (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.

31. Subject matters have different characteristics, including the degree to which information about them is qualitative versus quantitative, objective versus subjective, historical versus prospective, and relates to a point in time or covers a period. Such characteristics affect the:

(a) precision with which the subject matter can be evaluated or measured against criteria; and

(b) the persuasiveness of available evidence.

The assurance report notes characteristics of particular relevance to the intended users.

32. An appropriate subject matter is:

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(a) identifiable, and capable of consistent evaluation or measurement against the identified criteria; and

(b) such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate.

Criteria

33. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria can be formal, for example in the preparation of financial statements, the criteria may be Accounting Standards issued by the Institute; when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the engagement; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).

34. Suitable criteria are required for reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding. Suitable criteria are context-sensitive, that is, relevant to the engagement circumstances. Even for the same subject matter there can be different criteria. For example, one responsible party might select the number of customer complaints resolved to the acknowledged satisfaction of the customer for the subject matter of customer satisfaction; another responsible party might select the number of repeat purchases in the three months following the initial purchase.

35. Suitable criteria exhibit the following characteristics:

(a) *Relevance*: relevant criteria contribute to conclusions that assist decision-making by the intended users.

(b) *Completeness*: criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.

(c) *Reliability*: reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.

(d) *Neutrality*: neutral criteria contribute to conclusions that are free from bias.

(e) *Understandability*: understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

The evaluation or measurement of a subject matter on the basis of the practitioner's own expectations, judgments and individual experience would not constitute suitable criteria.

36. The practitioner assesses the suitability of criteria for a particular engagement by considering whether they reflect the above characteristics. The relative importance of each characteristic to a particular engagement is a matter of judgment. Criteria can either be established or specifically developed. Established criteria are those embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process. Specifically developed criteria are those designed for the purpose of the engagement. Whether criteria are established or specifically developed affects the work that the practitioner carries out to assess their suitability for a particular engagement.

37. Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured. Criteria are made available to the intended users in one or more of the

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following ways:

(a) Publicly.

(b) Through inclusion in a clear manner in the presentation of the subject matter information.

(c) Through inclusion in a clear manner in the assurance report.

(d) By general understanding, for example the criterion for measuring time in hours and minutes.

Criteria may also be available only to specific intended users, for example, the terms of a contract, or criteria issued by an industry association that are available only to those in the industry. When identified criteria are available only to specific intended users, or are relevant only to a specific purpose, use of the assurance report is restricted to those users or for that purpose.[8]

Evidence

38. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. The practitioner considers materiality, assurance engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence-gathering procedures.

Professional Skepticism

39. The practitioner plans and performs an assurance engagement with an attitude of professional skepticism recognizing that circumstances may exist that cause the subject matter information to be materially misstated. An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. For example, an attitude of professional skepticism is necessary throughout the engagement process for the practitioner to reduce the risk of overlooking suspicious circumstances, of over generalizing when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence-gathering procedures and evaluating the results thereof.

40. An assurance engagement rarely involves the authentication of documentation, nor is the practitioner trained as or expected to be an expert in such authentication. However, the practitioner considers the reliability of the information to be used as evidence, for example, photocopies, facsimiles, filmed, digitized or other electronic documents, including consideration of controls over their preparation and maintenance where relevant.

Sufficiency and Appropriateness of Evidence

41. Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The quantity of evidence needed is affected by the risk of the subject matter information being materially misstated (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence may not compensate for its poor quality.

42. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of

[8] While an assurance report may be restricted whenever it is intended only for specified intended users or for a specific purpose, the absence of a restriction regarding a particular reader or purpose, does not itself indicate that a legal responsibility is owed by the practitioner in relation to that reader or for that purpose. Whether a legal responsibility is owed will depend on the circumstances of each case and the relevant jurisdiction.

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evidence can be made; however, such generalizations are subject to important exceptions. Even when evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of evidence may be useful:

- Evidence is more reliable when it is obtained from independent sources outside the entity.
- Evidence that is generated internally is more reliable when the related controls are effective.
- Evidence obtained directly by the practitioner (for example, observation of the application of a control) is more reliable than evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Evidence is more reliable when it exists in documentary form, whether paper, electronic, or other media (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of what was discussed).
- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

43. The practitioner ordinarily obtains more assurance from consistent evidence obtained from different sources or of a different nature than from items of evidence considered individually. In addition, obtaining evidence from different sources or of a different nature may indicate that an individual item of evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the practitioner obtains from a representation from the responsible party. Conversely, when evidence obtained from one source is inconsistent with that obtained from another, the practitioner determines what additional evidence-gathering procedures are necessary to resolve the inconsistency.

44. In terms of obtaining sufficient appropriate evidence, it is generally more difficult to obtain assurance about subject matter information covering a period than about subject matter information at a point in time. In addition, conclusions provided on processes ordinarily are limited to the period covered by the engagement; the practitioner provides no conclusion about whether the process will continue to function in the specified manner in the future.

45. The practitioner considers the relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an evidence-gathering procedure for which there is no alternative. The practitioner uses professional judgment and exercises professional skepticism in evaluating the quantity and quality of evidence, and thus its sufficiency and appropriateness, to support the assurance report.

Materiality

46. Materiality is relevant when the practitioner determines the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of misstatement. When considering materiality, the practitioner understands and assesses what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

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Assurance Engagement Risk

47. Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated[9]. In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence-gathering procedures. However, in a limited assurance engagement, the combination of the nature, timing and extent of evidence-gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users' confidence about the subject matter information to a degree that is clearly more than inconsequential.

48. In general, assurance engagement risk can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements:

(a) The risk that the subject matter information is materially misstated, which in turn consists of:

  (i) *Inherent risk*: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and

  (ii) *Control risk*: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and

(b) *Detection risk*: the risk that the practitioner will not detect a material misstatement that exists.

The degree to which the practitioner considers each of these components is affected by the engagement circumstances, in particular by the nature of the subject matter and whether a reasonable assurance or a limited assurance engagement is being performed.

Nature, Timing and Extent of Evidence-gathering Procedures

49. The exact nature, timing and extent of evidence-gathering procedures will vary from one engagement to the next. In theory, infinite variations in evidence-gathering procedures are possible. In practice, however, these are difficult to communicate clearly and unambiguously. The practitioner attempts to communicate them clearly and unambiguously and uses the form appropriate to a reasonable assurance engagement or a limited assurance engagement.[10]

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[9] (a) This includes the risk, in those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, that the practitioner inappropriately concludes that the subject matter does, in all material respects, conform with the criteria, for example: "In our opinion, internal control is effective, in all material respects, based on *XYZ criteria*".

(b) In addition to assurance engagement risk, the practitioner is exposed to the risk of expressing an inappropriate conclusion when the subject matter information is not materially misstated, and risks through loss from litigation, adverse publicity, or other events arising in connection with a subject matter reported on. These risks are not part of assurance engagement risk.

[10] Where the subject matter information is made up of a number of aspects, separate conclusions may be provided on each aspect. While not all such conclusions need to relate to the same level of evidence-gathering procedures, each conclusion is expressed in the form that is appropriate to either a reasonable assurance or a limited assurance engagement.

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50. "Reasonable assurance" is a concept relating to accumulating evidence necessary for the practitioner to conclude in relation to the subject matter information taken as a whole. To be in a position to express a conclusion in the positive form required in a reasonable assurance engagement, it is necessary for the practitioner to obtain sufficient appropriate evidence as part of an iterative, systematic engagement process involving:

(a) Obtaining an understanding of the subject matter and other engagement circumstances which, depending on the subject matter, includes obtaining an understanding of internal control;

(b) Based on that understanding, assessing the risks that the subject matter information may be materially misstated;

(c) Responding to assessed risks, including developing overall responses, and determining the nature, timing and extent of further procedures;

(d) Performing further procedures clearly linked to the identified risks, using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures including, where applicable, obtaining corroborating information from sources independent of the responsible party, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and

(e) Evaluating the sufficiency and appropriateness of evidence.

51. "Reasonable assurance" is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control.
- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive.
- The use of judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

52. Both reasonable assurance and limited assurance engagements require the application of assurance skills and techniques and the gathering of sufficient appropriate evidence as part of an iterative, systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances. The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. For some subject matters, there may be specific pronouncements to provide guidance on procedures for gathering sufficient appropriate evidence for a limited assurance engagement. For example, SRE 2400[11] (Revised), "Engagements to Review Financial Statements" establishes that sufficient appropriate evidence for reviews of financial statements is obtained primarily through analytical procedures and inquiries. In the absence of a relevant pronouncement, the procedures for gathering sufficient appropriate evidence will vary with the circumstances of the engagement, in particular, the subject matter,

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and the needs of the intended users and the engaging party, including relevant time and cost constraints. For both reasonable assurance and limited assurance engagements, if the practitioner becomes aware of a matter that leads the practitioner to question whether a material modification should be made to the subject matter information, the practitioner pursues the matter by performing other procedures sufficient to enable the practitioner to report.

Quantity and Quality of Available Evidence

53. The quantity or quality of available evidence is affected by:

(a) The characteristics of the subject matter and subject matter information. For example, less objective evidence might be expected when information about the subject matter is future-oriented rather than historical (see paragraph 31); and

(b) Circumstances of the engagement other than the characteristics of the subject matter, when evidence that could reasonably be expected to exist is not available because of, for example, the timing of the practitioner's appointment, an entity's document retention policy, or a restriction imposed by the responsible party.

Ordinarily, available evidence will be persuasive rather than conclusive.

54. An unqualified conclusion is not appropriate for either type of assurance engagement in the case of a material limitation on the scope of the practitioner's work, that is, when:

(a) Circumstances prevent the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level; or

(b) The responsible party or the engaging party imposes a restriction that prevents the practitioner from obtaining evidence required to reduce assurance engagement risk to the appropriate level.

Assurance Report

55. The practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. SAs, SREs and SAEs establish basic elements for assurance reports. In addition, the practitioner considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.

56. In an assertion-based engagement, the practitioner's conclusion can be worded either:

(a) In terms of the responsible party's assertion (for example: "In our opinion *the responsible party's* assertion that internal control is effective, in all material respects, based on *XYZ criteria*, is fairly stated"); or

(b) Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on *XYZ criteria*").

In a direct reporting engagement, the practitioner's conclusion is worded directly in terms of the subject matter and the criteria.

57. In a reasonable assurance engagement, the practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria". This form of expression conveys "reasonable assurance". Having performed evidence-gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant engagement circumstances described in the assurance report, the practitioner has obtained

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sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level.

58. In a limited assurance engagement, the practitioner expresses the conclusion in the negative form, for example, "based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria". This form of expression conveys a level of "limited assurance" that is proportional to the level of the practitioner's evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

59. A practitioner does not express an unqualified conclusion for either type of assurance engagement when the following circumstances exist and, in the practitioner's judgment, the effect of the matter is or may be material:

(a) There is a limitation on the scope of the practitioner's work (see paragraph 54). The practitioner expresses a qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the limitation is. In some cases the practitioner considers withdrawing from the engagement.

(b) In those cases where:

  (i) The practitioner's conclusion is worded in terms of the responsible party's assertion, and that assertion is not fairly stated, in all material respects; or

  (ii) The practitioner's conclusion is worded directly in terms of the subject matter and the criteria, and the subject matter information is materially misstated,[12]

  The practitioner expresses a qualified or adverse conclusion depending on how material or pervasive the matter is.

(c) When it is discovered after the engagement has been accepted, that the criteria are unsuitable or the subject matter is not appropriate for an assurance engagement. The practitioner expresses:

  (i) A qualified conclusion or adverse conclusion depending on how material or pervasive the matter is, when the unsuitable criteria or inappropriate subject matter is likely to mislead the intended users; or

  (ii) A qualified conclusion or a disclaimer of conclusion depending on how material or pervasive the matter is, in other cases.

In some cases, the practitioner considers withdrawing from the engagement.

Inappropriate Use of the Practitioner's Name

60. A practitioner is associated with a subject matter when the practitioner reports on information about that subject matter or consents to the use of the practitioner's name in a professional connection with that subject matter. If the practitioner is not associated in this manner, third parties can assume no responsibility of the practitioner. If the practitioner learns that a party is inappropriately using the practitioner's name in association with a subject matter, the practitioner requires the party to cease doing so. The practitioner also considers what other steps may be needed, such as informing any known third party users of the inappropriate use of the practitioner's name or seeking legal advice.

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[12] In those direct reporting engagements where the subject matter information is presented only in the practitioner's conclusion, and the practitioner concludes that the subject matter does not, in all material respects, conform with the criteria, for example: "In our opinion, except for *[…],* internal control is effective, in all material respects, based on *XYZ criteria,*" such a conclusion would also be considered to be qualified (or adverse as appropriate).

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Material Modifications to International Framework for Assurance Engagements

Deletions

1. The International Framework issued by the IAASB specifically makes it clear that such Framework is also relevant to professional accountants in public sector. However, since the Standards, Statements, General Clarifications and Guidance Notes issued by the ICAI are equally applicable in case of all engagements, irrespective of the form, nature and size of the entity, this Framework does not specifically mention that aspect.

2. Paragraph 6 of the International Framework issued by the IAASB refers to Part B of the International Code of Ethics regarding threats to independence, accepted safeguards and the public interest, which is applicable to professional accountants in public practice, has been deleted since the Code of Ethics issued by the ICAI is woven around the Chartered Accountants Act, 1949 and Schedules annexed thereto.

Appendix

Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements

This Appendix outlines the differences between a reasonable assurance engagement and a limited assurance engagement discussed in the Framework (see in particular the referenced paragraphs).

Type of Engage-ment	Objective	Evidence-gathering procedures[13]	The Assurance Report
Reasonable Assurance Engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion (Paragraph 10)	➢ Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: ➢ Obtaining an understanding of the engagement circumstances; ➢ Assessing risks; ➢ Responding to assessed risks; ➢ Performing further procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and ➢ Evaluating the evidence obtained (Paragraphs 50 and 51)	Description of the engage-ment circum-stances and a positive form of expression of the conclusion (Paragraph 57)

[13] A detailed discussion of evidence-gathering requirement is only possible within SAEs for specific subject matters.

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Limited Assurance Engagement	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion (Paragraph 10)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to reasonable assurance engagement (Paragraph 52)	Description of the engage-ment circum-stances, and a negative form of expression of the conclusion (Paragraph 58)

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SA 200 *
Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as "the auditor" hereafter.

2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)

5. As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an

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inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A28-A52)

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements[1]. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13)

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations[2].

Effective Date

10. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the

[1] SA 320, "Materiality in Planning and Performing an Audit" and SA 450, "Evaluation of Misstatements Identified during the Audit".

[2] See, for example, SA 260, "Communication with Those Charged with Governance"; and paragraph 43 of SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

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auditor's findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

Definitions

13. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

(b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:

(i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

(ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

(c) Audit risk – The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

(d) Auditor – "Auditor" is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.

(e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

(f) Financial statements – A structured representation of historical financial information, including related

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notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

(g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

(h) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

(i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

(j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with SAs. That is, responsibility:

(i) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(ii) To provide the auditor with:

a. All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

b. Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

c. Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework. This applies to all references to "preparation and presentation of the financial statements" in the SAs.

The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise".

(k) Professional judgment – The application of relevant training, knowledge and experience, within the

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context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

(l) Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

(m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

(n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

  (i) Inherent risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

  (ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

(o) Those charged with governance – The person(s) or organisation(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A14-A17)

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-A22)

Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23-A27)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A28-A52)

Conduct of an Audit in Accordance with SAs

Complying with SAs Relevant to the Audit

18. The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit when the SA is in effect and the circumstances addressed by the SA exist. (Ref: Para. A53-A56)

19. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A57-A65)

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20. The auditor shall not represent compliance with SAs in the auditor's report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

Objectives Stated in Individual SAs

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to: (Ref: Para. A66-A68)

(a) Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and (Ref: Para. A69)

(b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A70)

Complying with Relevant Requirements

22. Subject to paragraph 23, the auditor shall comply with each requirement of an SA unless, in the circumstances of the audit:

(a) The entire SA is not relevant; or

(b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

Failure to Achieve an Objective

24. If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor's opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230 [3]. (Ref: Para. A74-A75)

Application and Other Explanatory Material

An Audit of Financial Statements

Scope of the Audit (Ref: Para. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

[3] SA 230, "Audit Documentation", paragraph 8(c).

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Preparation of the Financial Statements (Ref: Para. 4)

A2. An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:

(a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) To provide the auditor with:

  (i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

  (ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

  (iii) Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (i.e., "general purpose financial statements"); or
- The financial information needs of specific users (i.e., "special purpose financial statements").

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
- Published views of varying authority on emerging accounting issues issued by standards setting,

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professional or regulatory organisations;

- General and industry practices widely recognised and prevalent; and
- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation.

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; statement of profit and loss; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:

- For example, normally, in government departments and local bodies, the primary financial statement is a statement of cash receipts and payments.
- Other examples of a single financial statement, each of which would include related notes, are:
  - Balance sheet.
  - Statement of profit & loss.
  - Statement of cash flows.
  - Statement of operations by product lines.

A9. SA 210 establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework[4]. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework[5].

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement[6]. The auditor is also required to obtain written representations about whether

[4] SA 210, "Agreeing the Terms of Audit Engagements", paragraph 6(a).

[5] SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 8.

[6] SA 210, paragraph 6(b).

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management and, where appropriate, those charged with governance have fulfilled those responsibilities[7].

Considerations Specific to Central/State Governments and Related Government Entities

A11. The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Form of the Auditor's Opinion (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor's opinion cover both forms of opinion.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India.

A15. The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

[7] SA 580, "Written Representations", paragraphs 10-11.

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A17. Standard on Quality Control (SQC) 1[8] sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence[9]. SA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement[10]. SA 220 recognises that the engagement team is entitled to rely on a firm's systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

Professional Skepticism (Ref: Para. 15)

A18. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence[11]. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and

[8] Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements".
[9] SQC 1, paragraphs 14-27.
[10] SA 220, "Quality Control for an Audit of Financial Statements", paragraphs 9-12.
[11] SA 500, "Audit Evidence", paragraphs 7-9.

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determine what modifications or additions to audit procedures are necessary to resolve the matter[12].

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by SA 220[13], assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit[14]. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

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[12] SA 240, paragraph 13; SA 500, paragraph 11; and SA 505, paragraphs 10-11, and 16.
[13] SA 220, paragraph 18.
[14] SA 230, paragraph 8.

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Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)

Sufficiency and Appropriateness of Audit Evidence

A28. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit[15]) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

A29. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A30. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A31. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. SA 500 and other relevant SAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

Audit Risk

A32. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A34. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and

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[15] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 9.

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- The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed[16].

A40. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

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[16] SA 330, "The Auditor's Reponses to Assessed Risks", paragraphs 7-17.

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Detection Risk

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. SA 300 [17] and SA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A45. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

The Nature of Financial Reporting

A46. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting

[17] SA 300, "Planning an Audit of Financial Statements".

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practices, including indicators of possible bias in management's judgments[18].

The Nature of Audit Procedures

A47. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A48. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognised in certain financial reporting frameworks (see, for example, the "Framework for the Preparation and Presentation of Financial Statements" issued by the Institute of Chartered Accountants of India (ICAI)). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A49. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the SAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities[19]; and
- Use testing and other means of examining populations in a manner that provides a reasonable basis

[18] SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", and Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

[19] SA 315, paragraphs 5-10.

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for the auditor to draw conclusions about the population[20].

Other Matters that Affect the Inherent Limitations of an Audit

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See SA 240 for further discussion.
- The existence and completeness of related party relationships and transactions. See SA 550 [21] for further discussion.
- The occurrence of non-compliance with laws and regulations. See SA 250 [22] for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See SA 570 [23] for further discussion.

Relevant SAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with SAs

Nature of the SAs (Ref: Para. 18)

A53. The SAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The SAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A54. The scope, effective date and any specific limitation of the applicability of a specific SA is made clear in the SA. Unless otherwise stated in the SA, the auditor is permitted to apply an SA before the effective date specified therein.

A55. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the SAs, an audit conducted only in accordance with laws and regulations will not automatically comply with SAs.

A56. The SAs are also relevant to engagements in case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions).The auditor's responsibilities of those entities, however, may be affected by the audit mandate, or by obligations on those

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[20] SA 330; SA 500; SA 520, "Analytical Procedures", and SA 530, "Audit Sampling".

[21] SA 550, "Related Parties".

[22] SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements".

[23] SA 570, "Going Concern".

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entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the SAs. These additional responsibilities are not dealt with in the SAs. They may be dealt with in the relevant laws and regulations in which the entities are operating.

Contents of the SAs (Ref: Para. 19)

A57. In addition to objectives and requirements (requirements are expressed in the SAs using "shall"), an SA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the SA, and definitions. The entire text of an SA, therefore, is relevant to an understanding of the objectives stated in an SA and the proper application of the requirements of an SA.

A58. Where necessary, the application and other explanatory material provides further explanation of the requirements of an SA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an SA. The application and other explanatory material may also provide background information on matters addressed in an SA.

A59. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.

A60. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the SA, including how the SA relates to other SAs.
- The subject matter of the SA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the SA.
- The context in which the SA is set.

A61. An SA may include, in a separate section under the heading "Definitions", a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs. The Glossary of Terms relating to Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board contains a complete listing of terms defined in the SAs. It also includes descriptions of other terms found in SAs to assist in common and consistent interpretation.

A62. When appropriate, additional considerations specific to audits of smaller entities and to certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), are included within the application and other explanatory material of an SA. These additional considerations assist in the application of the requirements of the SA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SAs.

Considerations Specific to Smaller Entities

A63. For purposes of specifying additional considerations to audits of smaller entities, a "smaller entity"

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refers to an entity which typically possesses qualitative characteristics such as:

(a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and

(b) One or more of the following:

  (i) Straightforward or uncomplicated transactions;

  (ii) Simple record-keeping;

  (iii) Few lines of business and few products within business lines;

  (iv) Few internal controls;

  (v) Few levels of management with responsibility for a broad range of controls; or

  (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A64. The considerations specific to smaller entities included in the SAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A65. The SAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the "owner-manager".

Objectives Stated in Individual SAs (Ref: Para. 21)

A66. Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A68. In using the objectives, the auditor is required to have regard to the interrelationships among the SAs. This is because, as indicated in paragraph A53, the SAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. At a more detailed level, SA 315 and SA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An SA dealing with specific aspects of the audit (for example, SA 540) may expand on how the objectives and requirements of such SAs as SA 315 and SA 330 are to be applied in relation to the subject of the SA but does not repeat them. Thus, in achieving the objective stated in SA 540 , the auditor has regard to the objectives and requirements of other relevant SAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

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A69. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the SAs by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the SAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the SAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the SAs to meet the objectives specified in the SAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other SAs;
- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances. Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the SAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

A71. In some cases, an SA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in SA 610 [24] is not relevant.

A72. Within a relevant SA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope[25] represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance[26], which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework[27], which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

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[24] SA 610, "Using the Work of Internal Auditors".

[25] SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 13.

[26] SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9.

[27] SA 501, "Audit Evidence – Specific Considerations for Selected Items", paragraph 13.

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Departure from a Requirement (Ref: Para. 23)

A73. SA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement[28]. The SAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Failure to Achieve an Objective (Ref: Para. 24)

A74. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the SAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the SAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an SA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example due to a limitation in the available audit evidence.

A75. Audit documentation that meets the requirements of SA 230 and the specific documentation requirements of other relevant SAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

Modifications *vis-à-vis* ISA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing"

Deletion

Paragraph A11 of ISA 200 deals with the additional responsibilities for the execution of transactions and events in accordance with legislation or proper authority in case of public sector entities. Further, paragraph A57 of ISA 200 (A56 of SA 200) deals with the auditor's additional responsibility arising out of the mandatory or obligatory laws or regulations applicable to that public sector entity. These additional responsibilities are not dealt by the SAs but dealt by the laws or regulations under which the public sector entity operates. Also, paragraph A63 of ISA 200 (A62 of SA 200) deals with the inclusion of the paragraph specific to public sector entities in the application and explanatory material section. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of paragraphs A11, A57 and A63 in ISA, highlighting such fact, has been retained.

[28] SA 230, paragraph 12.

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SA 210*
Agreeing the Terms of Audit Engagements
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. SA 220[1] deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

(a) Establishing whether the preconditions for an audit are present; and

(b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

4. For purposes of the SAs, the following term has the meaning attributed below:

Preconditions for an audit – The use by management of an acceptable financial reporting framework[2] in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise[3] on which an audit is conducted.

5. For the purposes of this SA, references to "management" should be read hereafter as "management and, where appropriate, those charged with governance".

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A9)

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*Published in September, 2009 issue of the Journal.

[1] SA 220, "Quality Control for an Audit of Financial Statements", published in March, 2010 issue of the Journal.

[2] SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", paragraph 13 (a).

[3] SA 200, Paragraph 13 (j).

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(b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A10-A13, A19)

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A14)

(ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A15-A18)

(iii) To provide the auditor with:

a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

b. Additional information that the auditor may request from management for the purpose of the audit; and

c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Limitation on Scope Prior to Audit Engagement Acceptance

7. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

(a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or

(b) If the agreement referred to in paragraph 6(b) has not been obtained.

Agreement on Audit Engagement Terms

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A20)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A21-A24)

(a) The objective and scope of the audit of the financial statements;

(b) The responsibilities of the auditor;

(c) The responsibilities of management;

(d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A21, A25-A26)

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12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A25)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A27)

Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A28-A30)

15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A31-A32)

16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under applicable law or regulation; and

(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards[4] Supplemented by Law or Regulation

18. If financial reporting standards established by an authorised or recognised standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:

(a) The additional requirements can be met through additional disclosures in the financial statements; or

(b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with SA 705[5]. (Ref: Para. A33)

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[4] Accounting Standards issued by the ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

[5] Standard on Auditing (SA) 705, "Modifications to the Opinion in the Independent Auditor's Report"; published in February, 2010 issue of the Journal.

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Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A34)

(a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and

(b) It is recognised in the terms of the audit engagement that:

(i) The auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures, in accordance with SA 706[6] ; and

(ii) Unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases "present fairly, in all material respects", or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:

(a) Evaluate the effect of the misleading nature of the financial statements on the auditor's report; and

(b) Include appropriate reference to this matter in the terms of the audit engagement.

Auditor's Report Prescribed by Law or Regulation

21. In some cases, the law or regulation applicable to the entity prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs. In these circumstances, the auditor shall evaluate:

(a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,

(b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding[7].

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with SAs[8]. (Ref: Para. A35-A36)

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics[9]. The auditor's responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they

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[6] Standard on Auditing (SA) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", published in February, 2010 issue of the Journal.

[7] SA 706.

[8] SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 43.

[9] "Framework for Assurance Engagements," paragraph 16.

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are within the control of the auditor are dealt with in SA 220[10]. This SA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users[11]. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the SAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, or a not for profit organization);
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.

A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. SA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.[12]

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[10] SA 220, "Quality Control for an Audit of Financial Statements", paragraphs 9-11.

[11] "Framework for Assurance Engagements," paragraph 16(b)(ii).

[12] Standard on Auditing (SA) 800, "Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework", paragraph 8.

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A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

A8. At present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and/ or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, as may be applicable;
- Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI);
- International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board; and
- International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. Appendix 2 contains guidance on determining the acceptability of the financial reporting framework. In case of some entities, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

Agreement of the Responsibilities of Management (Ref: Para. 6(b))

A10. An audit in accordance with SAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b)[13]. In case of certain entities, such responsibilities may be specified in the applicable law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. SAs do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an

[13] SA 200, Paragraph A2.

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independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9-12.

A11. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.

A12. SA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities[14]. It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other SAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

A13. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence[15]. In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

A14. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the financial reporting framework includes presentation. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will "give a true and fair view" in accordance with the financial reporting framework.

Internal Control (Ref: Para. 6(b)(ii))

A15. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives due to the inherent limitations of internal control[16].

A16. An independent audit conducted in accordance with the SAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its

[14] SA 580, "Written Representations," paragraphs 10-11.

[15] SA 580, paragraph A26.

[16] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," paragraph A46.

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purpose or will be free of deficiencies.

A17. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term "internal control" encompasses a wide range of activities within components that may be described as the control environment; the entity's risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.[17] An entity's internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

A18. In some cases, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some other cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A19. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

A20. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

Audit Engagement Letter or Other Form of Written Agreement[18] (Ref: Para. 10-11)

A21. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some entities, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A22. The form and content of the audit engagement letter may vary for each entity. Information included in

[17] SA 315, paragraph A51 and Appendix 1.

[18] In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

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the audit engagement letter on the auditor's responsibilities may be based on SA 200[19]. 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.

A23. 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.

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A24. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;

[19] SA 200, paragraph 3-9.

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- Whether a separate auditor's report is to be issued on the component;
- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A25. If, in the circumstances described in paragraphs A22 and A27, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b).

A26. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), law or regulation governing the operations of that entities generally mandate the appointment of the auditor and commonly set out the auditor's responsibilities and powers, including the power to access an entity's records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A27. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

A28. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A29. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

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A30. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

A31. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may need to assess, in addition to the matters referred to in paragraphs A29-A31 above, any legal or contractual implications of the change.

A32. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

(a) The original audit engagement; or

(b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed- upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

A33. In case of some entities, law or regulation may supplement the financial reporting standards established by an authorised or recognised standards setting organization with additional requirements relating to the preparation of financial statements. In such cases, the applicable financial reporting framework for the purposes of applying the SAs encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards[20].

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

A34. Law or regulation may prescribe that the wording of the auditor's opinion use the phrases "present fairly, in all material respects" or "give a true and fair view" in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor's report are significantly different from the requirements of SAs (see paragraph 21).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 21)

A35. SAs require that the auditor shall not represent compliance with SAs unless the auditor has complied with all of the SAs relevant to the audit[21]. When law or regulation prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of SAs and the auditor concludes that additional explanation in the auditor's report cannot mitigate possible

[20] SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 15.

[21] SA 200, paragraph 20.

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misunderstanding, the auditor may consider including a statement in the auditor's report that the audit is not conducted in accordance with SAs. The auditor is, however, encouraged to apply SAs, including the SAs that address the auditor's report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with SAs.

A36. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a regulator or the legislative body or the stakeholders if the entity attempts to limit the scope of the audit.

Material Modifications to ISA 210, "Agreeing the Terms of Audit Engagements"

Addition

Paragraph A8 of ISA 210 provides the examples of the financial reporting standards, which can be used for the preparation and presentation of general purpose financial statements. Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be 'Accounting Standards issued by the Institute of Chartered Accountants of India or Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006' or 'Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI)', these have been added in the list of examples of financial reporting standards. References have accordingly been changed.

Deletions

1. Paragraph A10 of the ISA 210 deals with situations where the entity operates in a jurisdiction that does not have a standard setting organization or a prescribed financial reporting framework. Since in India, this kind of situation does not exist, paragraph A10 has been deleted. However, the reference to Appendix 2, *Determining Acceptability of General Purpose Frameworks*, has been shifted to paragraph A9.

2. Paragraph A27 of ISA 210 deals with the condition where the law or regulation governs the operations of public sector audits, and also prescribes the public sector auditor's responsibilities and powers. Paragraph A37 of ISA 210 deals with the specific reporting requirements within the legislation governing the audit which may mandate; for example, the auditor may be required to report directly to a minister or the legislature or to public if the entity attempts to limit the scope of the audit in case of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted. However, since it is also possible that such situations may also exist in case of certain non-public entities pursuant to a requirement under the statute or regulation under which they operate the spirit of erstwhile A27 and A37 has been retained.

Appendix 1

(Ref: Paras. A22-A23)

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with Financial Reporting Standards[22] of a company registered under the Companies Act, 1956. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would

[22] Refer footnote 6.

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require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this SA). It may be appropriate to seek legal advice that any proposed letter is suitable.

To the Board of Directors of ABC Company Limited:[23]

[*The objective and scope of the audit*]

You[24] have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements. [25]

[*The responsibilities of the auditor*]

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

[*The responsibilities of management and identification of the applicable financial reporting framework (for*

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[23] The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A21.

[24] Throughout this letter, references to "you", "we", "us", "management", "those charged with governance" and "auditor" would be used or amended as appropriate in the circumstances.

[25] Where the financial statements of the entity include financial statements/ information of its component(s) which have been audited by another auditor/ auditors, the engagement letter may be modified as under:

> "You have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow S*tatement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.*

Further, as informed by you, the financial statements of the components of ABC Company Limited, *viz*., PQR Company Limited and XYZ Company Pvt Limited, whose financial information/ financial statements have been included in the financial statements of ABC Company would be/ have been audited by another auditor/ auditors. However, we expect to be furnished the reports of such other auditor(s) before the date of our audit report so as to enable us to deal with such reports in accordance with the principles enunciated in the Standard on Auditing (SA) 600, *Using the Work of Another Auditor*, issued by the Institute of Chartered Accountants of India".

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purposes of this example it is assumed that the auditor has determined that the provisions of the Companies Act, 1956 relating to responsibility of the Board of Directors be supplemented by the descriptions in paragraph 6(b) of this SA).]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance][26] acknowledge and understand that they have responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.[27] This includes:

- the responsibility for the preparation of financial statements on a going concern basis.
- the responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
- The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

(b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide us with:

(i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that we may request from [management] for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

[*Other relevant information*]

[*Insert other information, such as fee arrangements, billings[28] and other specific terms, as appropriate*.]

[Reporting]

[*Insert appropriate reference to the expected form and content of the auditor's report.*]

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[26] Use terminology as appropriate in the circumstances.

[27] Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".

[28] For example, "Our fees will be billed as the work progresses".

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The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.
Chartered Accountants
Firm's Registration Number
……
(Signature)

Date : (Name of the Member)

Place : (Designation[29])

Acknowledged on behalf of ABC Company by

……..
(Signature)
Name and Designation
Date

Appendix 2

(Ref: Para. A9)

Determining the Acceptability of General Purpose Frameworks

1. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:

(a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.

(b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.

(c) Reliability, in that the information provided in the financial statements:

  (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and

  (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.

(d) Neutrality, in that it contributes to information in the financial statements that is free from bias.

(e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

2. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to IFRSs. For an audit of a small entity, the auditor may decide to compare the

[29] Partner or proprietor, as the case may be.

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accounting conventions to a financial reporting framework specifically developed for such entities by an authorised or recognised standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation and presentation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.

3. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the industry to which the entity belongs by preparers and users.

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SA 220*
Quality Control for an Audit of Financial Statements
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements.

System of Quality Control and Role of Engagement Teams

2. 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[1].

This SA is premised on the basis that the firm is subject to SQC 1. (Ref: Para. A1)

3. 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.

4. 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. (Ref: Para. A2)

Effective Date

5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

6. 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.

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* Published in March, 2010 issue of the Journal.

[1] Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", paragraph 10.

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Definitions

7. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Engagement partner – the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

(b) Engagement quality control review – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

(c) Engagement quality control reviewer – a partner, other person[2] in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.

(d) Engagement team – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

(e) Firm – a sole practitioner/proprietor, partnership, or any such entity of professional accountants, as may be permitted by law.

(f) Inspection – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

(g) Listed entity – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are traded under the regulations of a recognized stock exchange or other equivalent body.

(h) Monitoring – a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively.

(i) Network firm – A firm or entity that belongs to a network.

(j) Network – A larger structure:

  (i) That is aimed at cooperation, and

  (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

(k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.

(l) Personnel – partners and staff.

(m) Professional Standards – Engagement Standards, as defined in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", issued by the Institute of Chartered Accountants of India and relevant ethical requirements as contained in the Code of Ethics issued by the Institute.

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[2] Such other person should be a member of the Institute of Chartered Accountants of India.

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(n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.

(o) Staff – professionals, other than partners, including any experts which the firm employs.

(p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee[3] (with appropriate experience) of another firm.

Requirements

Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

Independence

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A5-A7)

Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

[3] Such employee should be a member of the Institute of Chartered Accountants of India.

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Assignment of Engagement Teams

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

(a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and

(b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

Engagement Performance

Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:

(a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and (Ref: Para. A13-A15, A20)

(b) The auditor's report being appropriate in the circumstances.

Reviews

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)

17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

Consultation

18. The engagement partner shall:

(a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

(b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

(c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and

(d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)

Engagement Quality Control Review

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(a) Determine that an engagement quality control reviewer has been appointed;

(b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

(c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)

20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report.

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This evaluation shall involve:

(a) Discussion of significant matters with the engagement partner;

(b) Review of the financial statements and the proposed auditor's report;

(c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and

(d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A27, A29-A31)

21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

(a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;

(b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and

(c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached. (Ref: Para. A28-A31)

Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

Documentation

24. The auditor shall document:

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A35)

25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

(a) The procedures required by the firm's policies on engagement quality control review have been performed;

(b) The engagement quality control review has been completed on or before the date of the auditor's report; and

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(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Application and Other Explanatory Material

System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

A1. SQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

Reliance on the Firm's System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

  (i) Performing work that complies with professional standards and regulatory and legal requirements;

  (ii) Complying with the firm's quality control policies and procedures as applicable;

  (iii) Issuing auditor's reports that are appropriate in the circumstances; and

  (iv) The engagement team's ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

Relevant Ethical Requirements

Compliance with Relevant Ethical Requirements (Ref: Para. 9)

A4. The Code of Ethics issued by the Institute of Chartered Accountants of India establishes the fundamental principles of professional ethics, which include:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

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(d) Confidentiality; and

(e) Professional behavior.

Definition of "Firm", "Network" and "Network Firm" (Ref: Para. 9-11)

A5. The definitions of "firm", "network" or "network firm" in relevant ethical requirements may differ from those set out in this SA. For example, the Code of Ethics of the Institute of Chartered Accountants of India (ICAI) defines the "Network Firm" as:

> *"Networking amongst two or more firms under common control, ownership or management with the firm or having affiliation with an accounting entity or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally".*

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

A7. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), statutory measures may provide safeguards for the independence of auditors of certain entities. However, such auditors or audit firms carrying out audits on behalf of the statutory auditor may, depending on the terms of the applicable legal or regulatory framework, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the auditor's applicable law or regulation does not permit withdrawal of the auditor from the engagement, disclosure through a public report, of circumstances that have arisen that would, have otherwise lead the auditor to withdraw.

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

A8. SQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client[4]. Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

A9. In case of certain entities, such as, Central/State governments and related government entities (for

[4] SQC 1, paragraph 28.

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example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A7 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to the auditors of such entities in performing risk assessments and in carrying out reporting responsibilities.

Assignment of Engagement Teams (Ref: Para. 14)

A10. An engagement team also includes a member using expertise in a specialised area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

A12. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of audit of such entities may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with legislative authorities and preventing and detecting fraud and corruption.

Engagement Performance

Direction, Supervision and Performance (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by SA 200[5].
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.

[5] SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", paragraph 15.

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- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A15. Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

Reviews

Review Responsibilities (Ref: Para. 16)

A16. Under SQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members[6].

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

The Engagement Partner's Review of Work Performed (Ref: Para. 17)

A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and

[6] SQC 1, paragraph 50.

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- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by SA 230, the partner documents the extent and timing of the reviews[7].

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraphs A17 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialised Area of Accounting or Auditing Is Used (Ref: Para. 15-17)

A20. Where a member of the engagement team with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

Consultation (Ref: Para. 18)

A21. Effective consultation on significant technical, ethical, and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

Engagement Quality Control Review

Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))

A23. SA 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements[8]. In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph

[7] SA 230, "Audit Documentation", paragraph 9(c).

[8] SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 41.

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22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. SA 230 establishes requirements and provides guidance in this regard[9].

Nature, Extent and Timing of Engagement Quality Control Review (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

A27. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with SA 315[10], and the responses to those risks in accordance with SA 330[11], including the engagement team's assessment of, and response to, the risk of fraud in accordance with SA 240[12].
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Considerations Specific to Smaller Entities (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for such audit engagements also that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

Considerations Specific to Central/State Governments and Related Government Entities (Ref: Para. 20-21)

A30. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for certain entities audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for

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[9] SA 230, paragraphs 14-16 and A21-A24.

[10] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

[11] SA 330, "The Auditor's Responses to Assessed Risks".

[12] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

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independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A31. Certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may not necessarily be listed entities yet may be significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the certain entities may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, auditors of such entities evaluate which of these entities may be of sufficient significance to warrant performance of an engagement quality control review.

Monitoring (Ref: Para. 23)

A32. SQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control is relevant, adequate and operating effectively[13].

A33. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A34. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor's report was not appropriate.

Documentation

Documentation of Consultations (Ref: Para. 24(d))

A35. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Modifications *vis-à-vis* ISA 220, "Quality Control for an Audit of Financial Statements"

Deletion

Paragraphs A7, A9, A12, A30 and A31 of the Application Section of ISA 220 dealt with the application of the requirements of ISA 220 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that these requirements may also exist in case of non public sector entities pursuant to a requirement under the statute. Accordingly, the spirit of paragraphs A7, A9, A12, A30 and A31 has, accordingly, been made more generic in its application.

[13] SQC 1, Paragraph 86.

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SA 230*
Audit Documentation
(Effective for audits of financial statements for periods beginning on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:

(a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

3. Audit documentation serves a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220[1].
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1[2].
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective

5. The objective of the auditor is to prepare documentation that provides:

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* Published in January, 2009 issue of the Journal.

[1] SA 220, "Quality Control for an Audit of Financial Statements", paragraph 15-17.

[2] SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", paragraphs 46, 60, 63, 65 and 85.

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(a) A sufficient and appropriate record of the basis for the auditor's report; and

(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

(a) ***Audit documentation*** – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

(b) ***Audit file*** – One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

(c) ***Experienced auditor*** – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

(i) Audit processes;

(ii) SAs and applicable legal and regulatory requirements;

(iii) The business environment in which the entity operates; and

(iv) Auditing and financial reporting issues relevant to the entity's industry.

Requirements

Timely Preparation of Audit Documentation

7. The auditor shall prepare audit documentation on a timely basis. *(Ref: Para. A1)*

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: *(Ref: Para. A2-A5, A16- A17)*

(a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; *(Ref: Para. A6-A7)*

(b) The results of the audit procedures performed, and the audit evidence obtained; and

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. *(Ref: Para. A8- A11)*

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

(a) The identifying characteristics of the specific items or matters tested; *(Ref: Para. A12)*

(b) Who performed the audit work and the date such work was completed; and

(c) Who reviewed the audit work performed and the date and extent of such review. *(Ref: Para. A13)*

10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. *(Ref: Para. A14)*

11. If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. *(Ref: Para. A15)*

Departure from a Relevant Requirement

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement

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in a SA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. *(Ref: Para. A18-A19)*

Matters Arising after the Date of the Auditor's Report

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document: *(Ref: Para. A20)*

(a) The circumstances encountered;

(b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

(c) When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the Final Audit File

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. *(Ref: Para. A21-A22)*

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. *(Ref: Para. A23)*

16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document: *(Ref: Para. A24 -A25)*

(a) The specific reasons for making them; and

(b) When and by whom they were made and reviewed.

Application and Other Explanatory Material

Timely Preparation of Audit Documentation (Ref: Para. 7)

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation (Ref: Para. 8)

A2. The form, content and extent of audit documentation depend on factors such as:

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

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A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

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

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

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

***Documentation of Compliance with SAs* (Ref: Para. 8(a))**

A6. In principle, compliance with the requirements of this SA will result in the audit documentation being sufficient and appropriate in the circumstances. Other SAs contain specific documentation requirements that are intended to clarify the application of this SA in the particular circumstances of those SAs. The specific documentation requirements of other SAs do not limit the application of this SA. Furthermore, the absence of a documentation requirement in any particular SA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that SA.

A7. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
    - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's

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exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.

- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315[3].

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- Matters that give rise to significant risks (as defined in SA 315)[4].
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

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

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross- references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews

[3] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10.

[4] SA 315, paragraph 4(e).

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and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer (Ref: Para. 9)

A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period April 1 to September 30, starting with report number 12345 and selecting every 125th report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A13. SA 220[5] requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others (Ref: Para. 10)

A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of How Inconsistencies have been addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref: Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team

[5] SA 220, paragraph17.

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(for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, determined in accordance with SA 320[6], assessed risks, significant matters noted during the audit, and conclusions reached.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant[7] only in the cases where:

(a) The entire SA is not relevant [for example, if an entity does not have an internal audit function, nothing in SA 610[8] is relevant]; or

(b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

Matters Arising after the Date of the Auditor's Report (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.[9] The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in SA 220[10], with the engagement partner taking final responsibility for the changes.

Assembly of the Final Audit File (Ref: Para. 14-16)

A21. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files.[11] An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.[12]

A22. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if

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[6] SA 320, "Materiality in Planning and Performing an Audit".

[7] Refer paragraph 22 of SA 200.

[8] SA 610, "Using the Work of Internal Auditors.

[9] SA 560, "Subsequent Events", paragraph 13.

[10] SA 220, paragraph 16.

[11] Refer para 74 of SQC 1.

[12] Refer para 75 of SQC 1.

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they are administrative in nature. Examples of such changes include:

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

A23. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation.[13] The retention period for audit engagements ordinarily is no shorter than seven years[14] from the date of the auditor's report, or, if later, the date of the group auditor's report.[15]

A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

Ownership of Audit Documentation

A25. Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Material Modifications to ISA 230, "Audit Documentation"

Addition

1. Paragraph A23 of ISA 230 prescribes the minimum period of engagement documentation as five years. The SA 230 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, and regulations made there under, prescribe the minimum period of retention of working papers as seven years.

2. An additional paragraph A25 has been added from SQC 1, giving provisions regarding Ownership of Audit Documentation.

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[13] Refer para 82 of SQC 1.

[14] The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, 'Audit Documentation', issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph 'C', "Announcements/Clarifications" of Section 1, "Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India", included in Volume I.A of the Handbook.

[15] Refer para 83 of SQC 1.

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SA 240*
The Auditor's Responsibilities Relating to Fraud In An Audit of Financial Statements
(Effective for audits of financial statements for periods beginning on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," and SA 330, "The Auditor's Responses to Assessed Risks," are to be applied in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

3. Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor–misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly

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planned and performed in accordance with the SAs.[1]

6. As described in SA 200[2], the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

8. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

Objectives

10. The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.

Definitions

11. For purposes of the SAs, the following terms have the meanings attributed below:

(a) *Fraud* - An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

(b) *Fraud risk factors* - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

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[1] SA 200, paragraph A51.

[2] SA 200, paragraph A51.

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Requirements

Professional Skepticism

12. In accordance with SA 200[3], the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion Among the Engagement Team

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion[4]. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by SA 315[5], the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

(a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)

(b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)

(c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

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[3] SA 200, paragraph 15.

[4] SA 315, paragraph 10.

[5] SA 315, paragraphs 5-24.

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19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity[6], the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

Unusual or Unexpected Relationships Identified

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Other Information

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures[7].

26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)

27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

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[6] SA 260, "Communication with Those Charged with Governance", paragraph 12 (c).

[7] SA 315, Paragraph 25.

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Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

28. In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.[8] (Ref: Para. A33)

29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

(a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)

(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

30. In accordance with SA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.[9] (Ref: Para. A37-A40)

Audit Procedures Responsive to Risks Related to Management Override of Controls

31. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

32. Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

  (i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

  (ii) Select journal entries and other adjustments made at the end of a reporting period; and

  (iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)

(b) Review accounting estimates[10] for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor

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[8] SA 330, paragraph 5.

[9] SA 330, paragraph 6.

[10] Reference may be made to SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures".

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shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year11. (Ref: Para. A45-A46)

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A47)

33. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).

Evaluation of Audit Evidence (Ref: Para. A48)

34. The auditor shall evaluate whether analytical procedures[12] that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49)

35. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A50)

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51)

37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)

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11 Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires the adjustment of the prior period estimates, which may affect both the period of change in the Accounting Estimates and subsequent periods, in subsequent years.

12 Reference may be made to SA 520, "Analytical Procedures".

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Auditor Unable to Continue the Engagement

38. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

  (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

  (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A53-A56)

Management Representations

39. The auditor shall obtain written representations from management and, where applicable, those charged with governance that:

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:

  (i) Management;

  (ii) Employees who have significant roles in internal control; or

  (iii) Others where the fraud could have a material effect on the financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

(a) Management;

(b) Employees who have significant roles in internal control; or

(c) Others where the fraud results in a material misstatement in the financial statements.

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The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A60-A62)

42. In accordance with SA 260, Communication with Those Charged with Governance[13], the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A63)

Communications to Regulatory and Enforcement Authorities

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

Documentation

44. The auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315[14] shall include:

(a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and

(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

45. The auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330[15] shall include:

(a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and

(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

46. The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

47. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

Application and Other Explanatory Material

Characteristics of Fraud (Ref: Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under

[13] Reference may be made to SA 260, "Communication with Those Charged with Governance".

[14] SA 315, paragraph 32.

[15] SA 330, paragraph 28.

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pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are

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usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

A6. The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/by the entity in his report. For example, Clause (xxi) of Paragraph 4 of the Companies (Auditor's Report) Order, 2003 requires the auditor to specifically report "whether any fraud on or by the entity has been noticed or reported during the year; if yes, the nature and amount involved is to be indicated". Similarly, in case of audit of banks, the auditors, in terms of the circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref: Para. 12-14)

A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. As explained in SA 200, an audit performed in accordance with SAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication.[16] However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

[16] SA 200, paragraph A47.

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Discussion among the Engagement Team (Ref: Para. 15)

A10. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

A11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud *[Ref: Para. 17(a)]*

A12. Management accepts responsibility for the entity's internal control and for the preparation of the entity's

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financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. SA 315 and SA 610, establishes requirements and provides guidance in audits of those entities that have an internal audit function.[17] In carrying out the requirement of those SAs in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.

[17] SA 315, paragraph 23 and SA 610, "Using the Work of Internal Auditors".

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- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an Understanding of Oversight Exercised by Those Charged With Governance (Ref: Para. 20)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many entities, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.[18]

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and

[18] SA 260, "Communication with Those Charged with Governance", paragraphs A1-A8, discusses with whom the auditor communicates when the entity's governance structure is not well defined.

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whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A26. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

Risks of Fraud in Revenue Recognition (Ref: Para. 26)

A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

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A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 27)

A31. As explained in SA 315 management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.[19] In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A35. The extent of supervision reflects the auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

A36. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

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[19] SA 315, paragraph A48.

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- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

A37. The auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:
  - Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
  - The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.
- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A38. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity's inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.

A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts

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and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor's assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 32(a))

A41. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A42. Further, the auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- The assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor's assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.
- Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.
- The entity's financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
- The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or

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other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.

- The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.
- Journal entries or other adjustments processed outside the normal course of business – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 32(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 32(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

Accounting Estimates *(Ref: Para. 32(b))*

A45. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions *(Ref: Para. 32(c))*

A47. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.

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- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref: Para. 34-37)

A48. SA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.[20] This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review of the Financial Statements (Ref: Para. 34)

A49. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 35-37)

A50. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A52. SA 450, "Evaluation of Misstatements Identified during the Audit[21]", and SA 700, "Forming an Opinion and Reporting on Financial Statements", establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement *(Ref: Para. 38)*

A53. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

(a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

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[20] SA 330, paragraph 25.

[21] SA 450, "Evaluation of Misstatements Identified during the Audit", paragraphs 12-19.

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(b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A54. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary under different legislations and regulations and, accordingly, the clients. Under some legislations/ regulations, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others[22].

A56. In some cases, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the terms of appointment or public interest considerations.

Management Representations (Ref: Para. 39)

A57. SA 580, "Written Representations[23]", establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A58. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

(a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

A59. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a

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[22] The Code of Ethics issued by the Institute of Chartered Accountants of India contains guidance on communication between the outgoing and incoming auditor.

[23] SA 580, "Written Representations".

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matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication with Those Charged with Governance (Ref: Para. 41)

A60. The auditor's communication with those charged with governance may be made orally or in writing. SA 260 identifies factors the auditor considers in determining whether to communicate orally or in writing.[24] Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A61. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor's communications in this regard.

A62. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

Other Matters Related to Fraud (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's selection and application of accounting policies that may be indicative of management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Communications to Regulatory and Enforcement Authorities (Ref: Para. 43)

A64. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by law & statute and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some entities, for example, in case of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e., the Reserve Bank of India, in terms of the latter's circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with

[24] SA 260, Paragraph A42.

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governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

A66. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

Material Modifications to ISA 240, The Auditor's Responsibility relating to Fraud in an Audit of Financial Statements

Addition

In paragraph A64, the guidance has been made more entity specific, in the context of Indian legal requirement, by way of an example.

Deletions

1. Paragraph A6 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A6, highlighting the fact that in some cases, the auditors may be required by the legislature or the regulator to specifically report on the instances of actual/suspected fraud in the client entity, has been retained and examples of such situations have also been added.

2. Paragraph A56 of the Application Section of ISA 240 dealt with the considerations specific to public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that option of withdrawal may not be available in case of non public sector entities pursuant to a requirement under the statute or terms of appointment of the auditor. Accordingly, the spirit of erstwhile A56, highlighting that in some cases, the auditors may not be having an option to withdraw from the engagement has been retained.

3. Paragraph A66 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of A66 as given in ISA 240, highlighting the fact that in some cases, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation, has been retained.

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Appendix 1

(Ref: Para. A25)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with

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governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.25
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

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25 Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

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Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
    - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
    - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships

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may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

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Appendix 2

(Ref: Para. A40)

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for

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example, an allowance for sales returns, were resolved with the benefit of hindsight.

- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.

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- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

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Appendix 3

(Ref: Para. A48)

Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.

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- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's Code of Conduct.

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SA 250*
Consideration of Laws and Regulations in an Audit of Financial Statements
(Effective for all audits commencing on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. This SA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Effect of Laws and Regulations

2. The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

Responsibility of Management for Compliance with Laws and Regulations

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. *(Ref: Para. A1-A2)*

Responsibility of the Auditor (Ref: Para. A3-A6)

4. The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.[2] In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in

* Published in December, 2008 issue of the Journal.

[2] SA 200, paragraph 5.

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accordance with the SAs.[3] In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

6. This SA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. (see paragraph 13); and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

7. In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by SA 200,[4] is important in this context, given the extent of laws and regulations that affect the entity.

Effective Date

9. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objectives

10. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws

[3] SA 200, paragraph 52.

[4] SA 200, paragraph 15.

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and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Definition

11. For the purposes of this SA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Requirements

The Auditor's Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with SA 315,[5] the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework. *(Ref: Para. A7)*

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. *(Ref: Para. A8)*

14. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. *(Ref: Para. A9-A10)*

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. *(Ref: Para. A11)*

16. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. *(Ref: Para. A12)*

17. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 12-16.

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[5] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 11.

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Audit Procedures When Non-Compliance is Identified or Suspected

18. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: *(Ref: Para. A13)*

(a) An understanding of the nature of the act and the circumstances in which it has occurred; and

(b) Further information to evaluate the possible effect on the financial statements. *(Ref: Para. A14)*

19. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. *(Ref: Para. A15-A16)*

20. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

21. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. *(Ref: Para. A17-A18)*

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Those Charged with Governance

22. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,[6] the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

23. If, in the auditor's judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

24. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705[7], express a qualified or adverse opinion on the financial statements.

26. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

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[6] SA 260, "Communication with Those Charged with Governance", paragraph 9.

[7] SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 7-8.

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27. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. *(Ref: Para. A19-A20)*

Documentation

29. The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.[8] *(Ref: Para. A21)*

Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations

Responsibility of Management for Compliance with Laws and Regulations (Ref: Para. 3)

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework[9]. They may also establish certain legal rights and obligations of the entity, some of which will be recognised in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.

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[8] SA 230, "Audit Documentation", paragraphs 8-11, and paragraph A6.

[9] SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", paragraph 13 (a).

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- A compliance function.

Responsibility of the Auditor (Ref: Para. 4-8)

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, Revised SA 700[10] or SA 800[11] deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

A6. In some audit engagements, specially those relating to audit of government ventures and undertakings, etc., there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

The Auditor's Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 12)

A7. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

Laws and Regulations Generally Recognised to have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements (Ref: Para. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

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[10] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements"; paragraph 38.

[11] SA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", paragraph 11.

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- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations (Ref: Para. 14)

A9. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

A10. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 14 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

Non-Compliance brought to the Auditor's Attention by Other Audit Procedures (Ref: Para. 15)

A11. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:

- Reading minutes;
- Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 16)

A12. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the

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auditor.[12]

Audit Procedures When Non-Compliance is Identified or Suspected

Indications of Non-Compliance with Laws and Regulations (Ref: Para. 18)

A13. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Matters Relevant to the Auditor's Evaluation (Ref: Para. 18(b))

A14. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- The potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures (Ref: Para. 19)

A15. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

A16. If management or, as appropriate, those charged with governance do not provide sufficient information

[12] SA 580, "Written Representations", paragraph 3.

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to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity's legal counsel or when the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult the auditor's own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A18. In exceptional cases, the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter(s) paragraph in the auditor's report.[13]

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary under different laws and regulations and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. Under the present legal and regulatory framework for financial institutions in India, their auditor has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. For example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

A20. In case of certain entities, such as national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises), the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report.

Documentation (Ref: Para. 29)

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[13] SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", paragraph 8.

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A21. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

Material Modifications to ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"

Deletions

1. Paragraph A6 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the additional audit responsibilities with respect to the consideration of laws and regulations. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations. Accordingly, the spirit of erstwhile A6, highlighting the fact that in case of certain entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations, has been retained.

2. Paragraph A20 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the obligation to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor's report. Accordingly, the spirit of erstwhile A20, highlighting the fact that in case of certain entities, there may be instances of reporting non-compliance to governing authorities or to report them in the auditor's report, has been retained.

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Standard on Auditing (SA) 260 (Revised), Communication with Those Charged with Governance

(Effective for all audits commencing on or after April 1, 2017)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. Although this SA applies irrespective of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

2. This SA is written in the context of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation of the other historical financial information.

3. Recognizing the importance of effective two-way communication in an audit of financial statements, this SA provides an overarching framework for the auditor's communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs (see Appendix 1). In addition, SA 265[1] establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other SAs, may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A33–A36)

The Role of Communication

4. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:

a. The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity;

b. The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

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[1] SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.*

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c. Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

5. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility.

Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor's communication with those charged with governance.

6. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

7. Law or regulation may restrict the auditor's communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

9. The objectives of the auditor are:

(a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

(b) To obtain from those charged with governance information relevant to the audit;

(c) To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and

(d) To promote effective two-way communication between the auditor and those charged with governance.

Definitions

10. For purposes of the SAs, the following terms have the meanings attributed below:

(a) **Those charged with governance** – The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1–A8.

(b) **Management** – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

Requirements

Those Charged with Governance

11. The auditor shall determine the appropriate person(s) within the entity's governance structure with

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whom to communicate. (Ref: Para. A1–A4)

Communication with a Subgroup of Those Charged with Governance

12. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5–A7)

When All of Those Charged with Governance Are Involved in Managing the Entity

13. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A8)

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit

14. The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9–A10)

Planned Scope and Timing of the Audit

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: Para. A11–A16)

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)

(b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)

(c) Unless all of those charged with governance are involved in managing the entity:

  i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)

  ii. Written representations the auditor is requesting;

(d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)

(e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process. (Ref: Para. A26– A28)

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Auditor Independence

17. In the case of listed entities, the auditor shall communicate with those charged with governance:

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and

i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and

ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level. (Ref: Para. A29–A32)

The Communication Process

Establishing the Communication Process

18. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A37–A45)

Forms of Communication

19. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A46–A48)

20. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

Timing of Communications

21. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A49–A50)

Adequacy of the Communication Process

22. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A51–A53)

Documentation

23. Where matters required by this SA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.[2] (Ref: Para. A54)

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[2] SA 230, *Audit Documentation*, paragraphs 8–11, and A6.

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Application and Other Explanatory Material

Those Charged with Governance (Ref: Para. 11)

A1. Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some entities, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a "two-tier board" structure). In other entities, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a "one-tier board" structure).
- In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.
- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In some cases, those charged with governance are responsible for approving[3] the entity's financial statements (in other cases management has this responsibility).

A2. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A3. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315[4] is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A4. SA 600 includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

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[3] As described in paragraph A60 of SA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

[4] SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

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Communication with a Subgroup of Those Charged with Governance (Ref: Para. 12)

A5. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A6. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prohibited by law or regulation, the auditor retains the right to communicate directly with the governing body.

A7. Audit committees (or similar subgroups with different names) exist in many entities. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance Are Involved in Managing the Entity (Ref: Para.13)

A8. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

Matters to Be Communicated

The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 14)

A9. The auditor's responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement.[5] Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor's responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising during the audit of the financial statements

[5] See paragraph 10 of SA 210, *Agreeing the Terms of Audit Engagements*.

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that are relevant to those charged with governance in overseeing the financial reporting process.

- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
- When SA 7016 applies, the auditor's responsibilities to determine and communicate key audit matters in the auditor's report.
- When applicable, the auditor's responsibility for communicating particular matters required by law or regulation, by agreement with the entity or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body.

A10. Law or regulation, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor's attention as a result of other work, such as performance audits.

Planned Scope and Timing of the Audit (Ref: Para. 15)

A11. Communication regarding the planned scope and timing of the audit may:

- Assist those charged with governance to understand better the consequences of the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and
- Assist the auditor to understand better the entity and its environment.

A12. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

A13. Matters communicated may include:

(a) How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.

(b) How the auditor plans to address areas of higher assessed risks of material misstatement.

(c) The auditor's approach to internal control relevant to the audit.

(d) The application of the concept of materiality in the context of an audit.[7]

(e) The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.[8]

(f) When SA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work

[6] SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report.*

[7] SA 320, *Materiality in Planning and Performing an Audit.*

[8] See SA 620, 'Using the Work of an Auditor's Expert'.

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together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.[9]

- The views of those charged with governance of:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - Significant communications with regulators.
  - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A15. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

A16. Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

Significant Findings from the Audit (Ref: Para. 16)

A17. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

A18. When SA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor's determination of matters that required significant auditor attention and which therefore may be key audit matters.[10]

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

[9] SA 610 (Revised), 'Using the Work of Internal Auditors', paragraph 31.

[10] SA 701, paragraphs 9–10.

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A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices. Appendix 2 identifies matters that may be included in this communication.

Significant Difficulties Encountered during the Audit (Ref: Para. 16(b))

A21. Significant difficulties encountered during the audit may include such matters as:

(i) Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor's procedures.

(ii) An unreasonably brief time within which to complete the audit.

(iii) Extensive unexpected effort required to obtain sufficient appropriate audit evidence.

(iv) The unavailability of expected information.

(v) Restrictions imposed on the auditor by management.

(vi) Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.[11]

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(c)(i))

A22. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Significant events or transactions that occurred during the year.
- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Concerns about management's consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.
- Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.

[11] SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report.*

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Circumstances that Affect the Form and Content of the Auditor's Report (Ref: Para 16(d))

A23. SA 210 requires the auditor to agree the terms of the audit engagement with management or those charged with governance, as appropriate.[12] The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor's report.[13] As explained in paragraph A9, if the terms of engagement are not agreed with those charged with governance, the auditor may provide those charged with governance with a copy of the engagement letter to communicate about matters relevant to the audit. The communication required by paragraph 16(d) is intended to inform those charged with governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.

A24. Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the SAs, and for which communication with those charged with governance is required, include when:

- The auditor expects to modify the opinion in the auditor's report in accordance with SA 705 (Revised).[14]
- A material uncertainty related to going concern is reported in accordance with SA 570 (Revised).[15]
- Key audit matters are communicated in accordance with SA 701.[16]
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matters paragraph in accordance with SA 706 (Revised)[17] or is required to do so by other SAs.

In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

A25. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report in accordance with SA 700 (Revised), the auditor is required to discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat. The auditor also may communicate with those charged with governance in circumstances when the auditor elects not to include the description of the auditor's responsibilities in the body of the auditor's report as permitted by SA 700 (Revised).[18]

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

A26. SA 300[19] notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. The auditor may communicate with those charged with governance about such matters, for example, as an update to initial discussions about the planned scope

[12] SA 210, paragraph 9.

[13] SA 210, paragraph 10.

[14] SA 705 (Revised), paragraph 30.

[15] SA 570 (Revised), 'Going Concern', paragraph 25(d).

[16] SA 701, paragraph 17.

[17] SA 706 (Revised), 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', paragraph 12.

[18] SA 700 (Revised), paragraph 40.

[19] SA 300, 'Planning an Audit of Financial Statements', paragraph A14.

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and timing of the audit.

A27. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, in accordance with SA 220.[20]

Auditor Independence (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.[21]

A30. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

(a) Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

A31. Relevant ethical requirements or law or regulation may also specify particular communications to those charged with governance in circumstances where breaches of independence requirements have been identified. For example, the Code of Ethics issued by ICAI requires the auditor to communicate with those charged with governance in writing about any breach and the action the firm has taken or proposes to take.

A32. The communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A33. The oversight of management by those charged with governance includes ensuring that the entity designs, implements and maintains appropriate internal control with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A34. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity's obligations related to accountability. Such matters may include, for example, significant issues

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[20] See paragraphs 19–21 and A23–A31 of SA 220, *Quality Control for an Audit of Financial Statements*.

[21] SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing*, paragraph 14.

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regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.

A35. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind of which the auditor has become aware with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A36. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

(a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

(b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and

(c) No procedures were carried out to determine whether other such matters exist.

The Communication Process

Establishing the Communication Process (Ref: Para. 18)

A37. Clear communication of the auditor's responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A38. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the engagement team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A39. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A52).

Considerations Specific to Smaller Entities

A40. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A41. Many matters may be discussed with management in the ordinary course of an audit, including

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matters required by this SA to be communicated with those charged with governance. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the preparation of the financial statements.

A42. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognizing management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

Communication with Third Parties

A43. Those charged with governance may be required by law or regulation, or may wish, to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

- That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;
- That no responsibility is assumed by the auditor to third parties; and
- Any restrictions on disclosure or distribution to third parties.

A44. In some entities, the auditor may be required by law or regulation to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as a central authority in the case of some public sector entities; or
- Make reports prepared for those charged with governance publicly available.

A45. Unless required by law or regulation to provide a third party with a copy of the auditor's written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

Forms of Communication **(Ref: Para. 19)**

A46. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 19–20 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A47. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

(a) Whether a discussion of the matter will be included in the auditor's report. For example, when key audit matters are communicated in the auditor's report, the auditor may consider it necessary to

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communicate in writing about the matters determined to be key audit matters.

(b) Whether the matter has been satisfactorily resolved.

(c) Whether management has previously communicated the matter.

(d) The size, operating structure, control environment, and legal structure of the entity.

(e) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

(f) Legal requirements. In some entities, a written communication with those charged with governance is required in a prescribed form by local law.

(g) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(h) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(i) Whether there have been significant changes in the membership of a governing body.

A48. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

Timing of Communications **(Ref: Para. 21)**

A49. Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between those charged with governance and the auditor. However, the appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

(a) Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.

(b) It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified, prior to communicating these in writing as required by SA 265.[22]

- When SA 701 applies, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit (see paragraph A13), and the auditor also may have more frequent communications to further discuss such matters when communicating about significant audit findings.
- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion.
- Communications regarding findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices, may also be made as part of the concluding discussion.
- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

[22] SA 265, paragraphs 9 and A14.

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A50. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process **(Ref: Para. 22)**

A51. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A52. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.[23] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A53. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.

[23] SA 315, paragraph A70.

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- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Documentation (Ref: Para. 23)

A54. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

Appendix 1

(Ref: Para. 3)

Specific Requirements in SQC 1 and Other SAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in SQC 1[1] and other SAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* – paragraph 42(a).
- SA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 21, 38(c)(i) and 40-42.
- SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 14, 19 and 22–24.
- SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9.
- SA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12-13.
- SA 505, *External Confirmations* – paragraph 9.
- SA 510, *Initial Audit Engagements—Opening Balances* – paragraph 7.
- SA 550, *Related Parties* – paragraph 27.
- SA 560, *Subsequent Events*– paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17.
- SA 570 (Revised), *Going Concern* – paragraph 25.
- SA 610 (Revised), *Using the Work of Internal Auditors* – paragraphs 20 and 31.
- SA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17.
- SA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30.
- SA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12.

[1] SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

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- SA 710*, Comparative Information—Corresponding Figures and Comparative Financial Statements* - paragraph 18.
- SA 720, *The Auditor's Responsibilities in Relation to Other Information in Documents Containing Audited Financial Statements* – paragraphs 10, 13 and 16.

Appendix 2

(Ref: Para. 16(a), A19–A20)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in SA 540,[1] including, for example:
  - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
  - Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
  - Whether management's decision to recognize, or to not recognize, the accounting estimates in the financial statements is in accordance with the applicable financial reporting framework.
  - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the outcome of accounting estimates in prior periods.
  - Management's process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.
  - Whether the significant assumptions used by management in developing the accounting estimate

[1] SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.

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are reasonable.

- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
- Risks of material misstatement.
- Indicators of possible management bias.
- How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- The adequacy of disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. This communication may highlight:
  - The non-recurring amounts recognized during the period.
  - The extent to which such transactions are separately disclosed in the financial statements.
  - Whether such transactions appear to have been designed to achieve a particular accounting or tax treatment, or a particular legal or regulatory objective.
  - Whether the form of such transactions appears overly complex or where extensive advice regarding the structuring of the transaction has been taken.
  - Where management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

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SA 265*
Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control[24] that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330[25]. SA 260[26] establishes further requirements and provides guidance regarding the auditor's responsibility to communicate with those charged with governance in relation to the audit.

2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement[27]. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

3. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

Effective Date

4. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

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* Published in September, 2009 issue of the Journal.

[24] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraphs 4 and 12.

[25] SA 330, "The Auditor's Responses to Assessed Risks".

[26] SA 260, "Communication with Those Charged with Governance".

[27] SA 315, paragraph 12.

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Definitions

6. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Deficiency in internal control – This exists when:

(i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or

(ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

Requirements

7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)

8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)

9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12- A18, A27)

10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)

(a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21)

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22- A26)

11. The auditor shall include in the written communication of significant deficiencies in internal control:

(a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)

(i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

(iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Application and Other Explanatory Material

Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para. 7)

A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level

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of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).

A2. In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
- A preliminary indication from management of its response to the findings.

Considerations Specific to Smaller Entities

A3. While the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A4. Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

Significant Deficiencies in Internal Control (Ref: Para. 6(b), 8)

A5. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit.

A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:

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- General monitoring controls (such as oversight of management).
- Controls over the prevention and detection of fraud.
- Controls over the selection and application of significant accounting policies.
- Controls over significant transactions with related parties.
- Controls over significant transactions outside the entity's normal course of business.
- Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

A7. Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss[28].
- Evidence of management's inability to oversee the preparation of the financial statements.

A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements[29]. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure,

[28] Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

[29] SA 315, paragraph A66.

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relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this SA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this SA to be communicated to those charged with governance.

A11. The requirements of this SA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.[30]

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, in case of listed entities, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement[31] for the auditor to complete the assembly of the final audit file on a timely basis. SA 230 states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report[32].

A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this SA requires.

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[30] SA 260, paragraph 9.

[31] SA 230, "Audit Documentation", paragraph 14.

[32] SA 230, paragraph A21.

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A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature of the entity. For instance, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For instance, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.
- The entity's governance composition. For instance, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

Communication of Deficiencies in Internal Control to Management (Ref: Para. 10)

A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

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A21. SA 250 establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance[33]. SA 240 establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management[34].

Communication of Other Deficiencies in Internal Control to Management (Ref: Para. 10(b))

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

A23. The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor's findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as internal auditors or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor's judgment in the circumstances.

A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

A26. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity[35] .

A27. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this SA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Law, regulation or other authority may also mandate that the auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require the auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this SA, for example, controls related

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[33] SA 250, Consideration of Laws and Regulations in an Audit of Financial Statements, paragraphs 22-28.

[34] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 41.

[35] SA 260, paragraph 9.

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to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

Content of Written Communication of Significant Deficiencies in Internal Control (Ref: Para. 11)

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

A29. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.
- An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation may require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor's written communication may identify such regulatory authorities.

Material Modifications to ISA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"

Deletions

1 Paragraph A7 of ISA 265 provides the examples of the indicators of significant deficiencies in internal control which may include restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud. Since in India Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year's Statement of Profit & Loss.

2. Paragraph A27 of ISA 265 deals with the additional responsibilities of the public sector auditors to communicate/report deficiencies in internal control to the legislature or governing body. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such additional responsibilities may also be imposed on the auditor in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A22, highlighting the fact, has been retained though a specific reference to public sector entities has been deleted.

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SA 299
Joint Audit of Financial Statements
(Effective for all audits relating to accounting periods beginning on or after April 1, 2018)

Introduction

Scope of this SA

1. The practice of appointing more than one auditor to conduct the audit of large entities has been in vogue for a longtime, sometimes voluntarily by the shareholders or sometimes due to the requirements of laws or regulations. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing". This Standard deals with the special considerations in carrying out audit by joint auditors. Accordingly, in addition to the requirements enunciated in this Standard, the joint auditors also need to comply with all the relevant requirements of other applicable Standards on Auditing.

2. This Standard does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more component (divisions, branches, subsidiary, joint venture, associates, other entity) included in the financial statements of the entity.

Effective Date

3. This Standard on Auditing is effective for audits of financial statements for periods beginning on or after April 1, 2018.

Objectives

4 The objectives of this Standard are:

(a) To lay down broad principles for the joint auditors in conducting the joint audit.

(b) To provide a uniform approach to the process of joint audit.

(c) To identify the distinct areas of work and coverage thereof by each joint auditor.

(d) To identify individual responsibility and joint responsibility of the joint auditors in relation to audit.

Definitions

5. For purposes of the SAs, the following terms have the meaning attributed below:

'Joint Audit' and 'Joint Auditors'

A joint audit is an audit of financial statements of an entity by two or more auditors appointed with the objective of issuing the audit report. Such auditors are described as joint auditors.

Requirements

Audit Planning, Risk Assessment and Allocation of Work

6. The engagement partner and other key members of the engagement team from each of the joint auditors shall be involved in planning the audit.

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7. The joint auditors shall jointly establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

8. Prior to the commencement of the audit, the joint auditors shall discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors shall:

a. Identify division of audit areas and common audit areas amongst the joint auditors that define the scope of the work of each joint auditor; **(Ref: Para A1)**

b. Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

c. Consider and communicate among all joint auditors the factors that, in their professional judgment, are significant in directing the engagement team's efforts;

d. Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other or similar engagements performed earlier by the respective engagement partner(s) for the entity is relevant.

e. Ascertain the nature, timing and extent of resources necessary to perform the engagement.

9. At this stage, risks of material misstatement need to be considered and assessed by each of the joint auditors and shall be communicated to other joint auditors, and documented, whether pertaining to the overall financial statements level or to the area of allocation among the other joint auditors.

10. The joint auditors shall discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed by each of the joint auditors and the same shall be communicated to those charged with governance.

11. The joint auditors shall obtain common engagement letter and common management representation letter.

12. After identification and allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to those charged with governance of the entity. **(Ref: Para. A2)**

Responsibility and Co-ordination among Joint Auditors

13. In respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures.**(Ref: Para. A3)**

14. All the joint auditors shall be jointly and severally responsible for: **(Ref: Para. A3)**

a. the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

b. decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors. **(Ref: Para. A4)**

c. matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

d. examining that the financial statements of the entity comply with the requirements of the relevant statutes;

e. presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

f. ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

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15. Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

16. It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

Audit Conclusion and Reporting

17. The joint auditors are required to issue common audit report, however, where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per Revised SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". **(Ref: Para. A5)**

18. Each joint auditor is entitled to assume that:

a. The other joint auditors have carried out their part of the audit work and the work has actually been performed in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.

b. The other joint auditors have brought to said joint auditor's notice any departure from applicable financial reporting framework or significant observations that are relevant to their responsibilities noticed in the course of the audit.

19. Where financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and regulatory requirements and present a true and fair view of the state of affairs and of the results of operations of the division/branch concerned. **(Ref: Para. A6)**

20. Before finalizing their audit report, the joint auditors shall discuss and communicate with each other their respective conclusions that would form the content of the audit report.

Communication with Those Charged with Governance

21. When the joint auditors expect to modify the opinion in the auditor's report, the joint auditors shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification to ensure compliance with Revised SA 705, "Modifications to the Opinion in the Independent Auditor's Report". If the joint auditors expect to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the joint auditors shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph to ensure compliance with Revised SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report".

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Application and Other Explanatory Material

Audit Planning, Risk Assessment and Allocation of Work

A1. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors**. (Ref: Para. 8(a))**

A2. The documentation of allocation of work helps in avoiding any dispute or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them. Further, the communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity and the joint auditors. **(Ref: Para. 12)**

Responsibility and Co-ordination among Joint Auditors

A3. The audit process involves obtaining and evaluating information and explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required. **(Ref: Para. 13 and 14)**

A4. All the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned. **(Ref: Para. 14(b))**

Audit Conclusion and Reporting

A5. In a situation where there is more than one opinion to be expressed by the joint auditors due to disagreement among them, it is important to note that each joint auditor with a differing opinion would be required to issue a separate audit report and the reference to the other joint auditors report would be required to be made by each such joint auditor in their respective audit report. For example, where an entity has three joint auditors and all of them have disagreements and this leads to three different sets of opinion, then each of them needs to issue a separate audit report. Further, each of them needs to include an 'Other Matter' paragraph in their respective audit report wherein they would make a reference to the separate audit reports issued by other joint auditors. **(Ref: Para. 17)**

A6. In the case of audit of a large entity with several branches, including unaudited branches and those required to be audited by branch auditors, the branch audit reports/returns may be required to be reviewed by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to said joint auditor and to ensure that they are properly incorporated into the accounts of the entity. It is also the separate and specific responsibility of each joint auditor to exercise judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to said joint auditor. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch audit report/returns. **(Ref: Para. 19)**

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SA 300*
Planning an Audit of Financial Statements
(Effective for audits of financial statements for periods beginning on or after April 1, 2008)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified. (Ref: Para. A1-A4)

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after 1st April 2008.

Objective

3. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Requirements

Involvement of Key Engagement Team Members

4. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A5)

Preliminary Engagement Activities

5. The auditor shall undertake the following activities at the beginning of the current audit engagement:

(a) Performing procedures required by SA 220[1], "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement;

(b) Evaluating compliance with ethical requirements, including independence, as required by SA 220[2]; and

(c) Establishing an understanding of the terms of the engagement, as required by SA 210[3]. (Ref: Para. A6-A8)

Planning Activities

6. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

7. In establishing the overall audit strategy, the auditor shall:

(a) Identify the characteristics of the engagement that define its scope;

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*Published in December, 2007 issue of the Journal.

[1] SA 220, paragraph 12-13.

[2] SA 220, paragraph 9-11.

[3] SA 210, "Agreeing the Terms of Audit Engagements," paragraphs 9-13.

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(b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A9-A12)

8. The auditor shall develop an audit plan that shall include a description of:

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. (Ref: Para. A13)

9. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A14)

10. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A15-A16)

Documentation

11. The auditor shall document:

(a) The overall audit strategy;

(b) The audit plan; and

(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A17-A20)

Additional Considerations in Initial Audit Engagements

12. The auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement[4]; and

(b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A21)

Application and Other Explanatory Material

The Role and Timing of Planning *(Ref: Para. 1)*

A1. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.

[4] SA 220, paragraphs 12-13.

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- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

A2. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A3. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

A4. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

Involvement of Key Engagement Team Members (Ref: Para. 4)

A5. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process[5].

Preliminary Engagement Activities (Ref: Para. 5)

A6. Performing the preliminary engagement activities specified in paragraph 5 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A7. Performing these preliminary engagement activities enables the auditor to plan an audit engagement

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[5] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", paragraph 10, establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraph 15 provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

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for which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

A8. The auditor's consideration of client continuance and ethical requirements, including independence, occurs throughout the audit engagement as changes in conditions and circumstances occur. Performing initial procedures on both client continuance and evaluation of ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

Planning Activities

The Overall Audit Strategy (Ref: Para. 6-7)

A9. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
- When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

A10. The Appendix lists examples of considerations in establishing the overall audit strategy.

A11. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

Considerations Specific to Smaller Entities

A12. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 7.

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The Audit Plan (Ref: Para. 8*)*

A13. The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Changes to Planning Decisions During the Course of the Audit (Ref: Para. 9)

A14. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review (Ref: Para. 10)

A15. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- The capabilities and competence of the individual team members performing the audit work.

SA 220 contains further guidance on the direction, supervision and review of audit work[6].

Considerations Specific to Smaller Entities

A16. When an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. When particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body[7].

Documentation (Ref: Para. 11)

A17. The documentation of the overall audit strategy is a record of the key decisions considered necessary

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[6] SA 220, paragraphs 15-17.

[7] In India, the Institute of Chartered Accountants of India governs the accountancy profession to provide services of high quality in the public interest which are accepted worldwide.

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to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A18. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A19. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Considerations Specific to Smaller Entities

A20. As discussed in paragraph A12, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs and/or checklists (see paragraph A18) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

Additional Considerations in Initial Audit Engagements (Ref: Para. 12)

A21. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (see SA 510[8] "Initial Audit Engagements–Opening Balances").
- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Modifications to ISA 300, "Planning an Audit of Financial Statements"

SA 300, "Planning an Audit of Financial Statements" does not contain any modifications *vis a vis* ISA 300.

[8] SA 510, "Initial Audit Engagements—Opening Balances".

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Appendix

(Ref: Para. 6-7 and A9-A12)

Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other SAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

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- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of materiality in accordance with SA 320[9], and, where applicable:
  - Determination of materiality for components and communication thereof to component auditors.
  - Preliminary identification of significant components and material classes of transactions, account balances and disclosures
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

[9] SA 320, "Materiality in Planning and Performing an Audit".

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SA 315*
Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment
(Effective for audits of financial statements for periods beginning on or after April 1, 2008)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

(b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

(c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

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

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(e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1-A5)

6. The risk assessment procedures shall include the following:

(a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6)

(b) Analytical procedures. (Ref: Para. A7-A10)

(c) Observation and inspection. (Ref: Para. A11)

7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.

8. Where the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.

9. When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A12-A13)

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A14-A16)

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17-A22)

(b) The nature of the entity, including:

  (i) its operations;

  (ii) its ownership and governance structures;

  (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

  (iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A23-A27)

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto.

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The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A28)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29-A35)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A36-A41)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42-A65)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A66-A68)

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and

(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:

(a) Identifying business risks relevant to financial reporting objectives;

(b) Estimating the significance of the risks;

(c) Assessing the likelihood of their occurrence; and

(d) Deciding about actions to address those risks. (Ref: Para. A79)

16. If the entity has established such a process (referred to hereafter as the 'entity's risk assessment process'), the auditor shall obtain an understanding of it, and the results thereof. Where the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant

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deficiency in internal control. (Ref: Para. A80)

The information system, including the related business processes, relevant to financial reporting, and communication.

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

(a) The classes of transactions in the entity's operations that are significant to the financial statements;

(b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

(d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures;

(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A81-A85)

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

(a) Communications between management and those charged with governance; and

(b) External communications, such as those with regulatory authorities. (Ref: Para. A86-A87)

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. (Ref: Para. A88-A94)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A95-A97)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)

23. If the entity has an internal audit function,[1] the auditor shall obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

(a) The nature of the internal audit function's responsibilities and how the internal audit function fits in the

[1] SA 610, "Using the Work of Internal Auditors", paragraph 7(a).

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entity's organisational structure; and

(b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A101-A103)

24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A104)

Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:

(a) the financial statement level; and (Ref: Para. A105-A108)

(b) the assertion level for classes of transactions, account balances, and disclosures; (Ref: Para. A109-A113)

to provide a basis for designing and performing further audit procedures.

26. For this purpose, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114-A115)

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116-A118)

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

(a) Whether the risk is a risk of fraud;

(b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;

(c) The complexity of transactions;

(d) Whether the risk involves significant transactions with related parties;

(e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119-A123)

29. When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

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30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A127-A129)

Revision of Risk Assessment

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A130)

Documentation

32. The auditor shall document:

(a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;

(b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and

(d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320[2];
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;

[2] SA 320, "Materiality in Planning and Performing an Audit".

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- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this SA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this SA. However, the significance of fraud is such that further requirements and guidance are included in SA 240[3], "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.

A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11-24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:

- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management and Others Within the Entity (Ref: Para. 6(a))

A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain

[3] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", paragraphs 12-24.

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accounting policies.

- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

Analytical Procedures (Ref: Para. 6(b))

A7. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks*. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A8. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A9. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

A10. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection (Ref: Para. 6(c))

A11. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

A12. The auditor's previous experience with the entity and audit procedures performed in previous audits

* SA 520, "Analytical Procedures", paragraphs A1-A3 describe the nature of analytical procedures.

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may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A13. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion Among the Engagement Team (Ref: Para. 10)

A14. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

SA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.[4]

A15. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, specialists and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A16. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material

[4] SA 240, paragraph 15.

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misstatement due to fraud or error.

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

Industry factors

A17. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

A18. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience[5].

Regulatory factors

A19. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- Accounting principles and industry specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

A20. SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"[6], includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry.

A21. In case of the audits of certain entities, in addition to legislation or regulations, there may be government policy requirements and resolutions of the legislature that affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other external factors

A22. Examples of other external factors affecting the entity that the auditor may consider include the general

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[5] SA 220, "Quality Control for an Audit of Financial Statements", paragraph 14.

[6] SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", paragraph 10.

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economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity (Ref: Para.11(b))

A23. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately. SA 550, "Related Parties"7, establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A24. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations – such as:
  - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
  - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
  - Alliances, joint ventures, and outsourcing activities.
  - Geographic dispersion and industry segmentation.
  - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
  - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
  - Research and development activities and expenditures.
  - Transactions with related parties.
- Investments and investment activities – such as:
  - Planned or recently executed acquisitions or divestitures.
  - Investments and dispositions of securities and loans.
  - Capital investment activities.
  - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- Financing and financing activities – such as:
  - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.

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[7] SA 550, "Related Parties". Reference may also be made to the Accounting Standard (AS) 18, "Related Party Disclosures" for definition of related party and related party transactions.

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- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

- Financial reporting – such as:
  - Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition practices.
  - Accounting for fair values.
  - Foreign currency assets, liabilities and transactions.
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A25. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A26. A special-purpose entity (sometimes referred to as a special purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitisation of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (e.g., as part of a de-recognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As SA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.[8]

A27. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special- purpose entity.

The Entity's Selection and Application of Accounting Policies (Ref: Para.11(c))

A28. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref. Para.11(d))

[8] SA 550, 'Related Parties', paragraph A7.

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A29. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A30. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognise the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in liabilities and reputational risk.

A31. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A32. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A33. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in the

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Appendix 2.

A34. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A79-A80.

A35. In case of audits of certain entities, "management objectives" may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, and government directions.

Measurement and Review of the Entity's Financial Performance (Ref: Para. 11(e))

A36. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud – See SA 240 for requirements and guidance in relation to the risks of fraud.

A37. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A98-A104), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

A38. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

A39. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A40. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations specific to smaller entities

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A41. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control

A42. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures.

A43. The following application material on internal control is presented in four sections, as follows:

- General Nature and Characteristics of Internal Control.
- Controls Relevant to the Audit.
- Nature and Extent of the Understanding of Relevant Controls.
- Components of Internal Control.

General Nature and Characteristics of Internal Control (Ref: Para. 12)

Purpose of internal control

A44. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations;
- Its compliance with applicable laws and regulations; and
- Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

A45. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of internal control

A46. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A47. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

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A48. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A49. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager[9] may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A50. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of internal control into components

A51. The division of internal control into the following five components, for purposes of the SAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(a) The control environment;

(b) The entity's risk assessment process;

(c) The information system, including the related business processes, relevant to financial reporting, and communication;

(d) Control activities; and

(e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this SA, provided all the components described in this SA are addressed.

A52. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A69-A104 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of manual and automated elements of internal control relevant to the auditor's risk assessment

A53. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A54. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent

[9] Owner-manager refers to the proprietor of an entity who is involved in running the entity on a day-to-day basis.

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of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A55. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A56. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A57. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

A58. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

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- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

A59. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A60. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A61. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

A62. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor considers the accuracy of the price information and the completeness and accuracy of the sales volume data. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A63. Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

A64. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight

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schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

A65. In certain circumstances, the statute or the regulation governing the entity may require the auditor to report on compliance with certain specific aspects of internal controls as a result, the auditor's review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A66. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A67. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

A68. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A55), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in SA 330, "The Auditor's Responses to Assessed Risks".

Components of Internal Control—Control Environment (Ref: Para. 14)

A69. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A70. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) *Participation by those charged with governance* – Attributes of those charged with governance

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such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) Management's philosophy and operating style – Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) *Organisational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) *Assignment of authority and responsibility* - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit evidence for elements of the control environment

A71. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

Effect of the control environment on the assessment of the risks of material misstatement

A72. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.

A73. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

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A74. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures[10].

A75. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations specific to smaller entities

A76. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small business; it may, however, increase other risks, for example, the risk of override of controls.

A77. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

A78. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

A79. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations specific to smaller entities (Ref: Para. 17)

A80. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Components of Internal Control—The Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

The information system, including related business processes, relevant to financial reporting (Ref: Para. 18)

A81. The information system relevant to financial reporting objectives, which includes the accounting

[10] SA 330, paragraphs A2-A3.

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system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarised and appropriately reported in the financial statements.

Journal entries

A82. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A83. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

A84. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities

A85. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains

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important.

Communication (Ref: Para. 19)

A86. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A87. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities (Ref: Para. 20)

A88. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

- Authorization.
- Performance reviews.
- Information processing.
- Physical controls.
- Segregation of duties.

A89. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

A90. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A91. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A92. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations specific to smaller entities

A93. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of

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control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A94. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks arising from IT (Ref: Para. 21)

A95. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT-controls and application controls.

A96. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations.
- System software acquisition, change and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A56 above.

A97. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

A98. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A99. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations specific to smaller entities

A100. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Internal Audit Functions (Ref: Para 23)

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A101. The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. When the auditor determines that the internal audit function is likely to be relevant to the audit, SA 610 applies.

A102. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organisation, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting.

A103. If the nature of the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed, or to be performed by, the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

Sources of information (Ref: Para. 24)

A104. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- the sources of the information related to the entity's monitoring activities; and
- the basis upon which management considers the information to be sufficiently reliable for the purpose; is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25 (a))

A105. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A106. Risks at the financial statement level may derive in particular from deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A107. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is

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such that an audit cannot be conducted.

- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.

A108. SA 705, "Modifications to the Opinion in the Independent Auditor's Report" establishes requirements and provides guidance in determining whether there is a need for the auditor to consider a qualification or disclaimer of opinion or, as may be required in some cases, to withdraw from the engagement where this is legally possible.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A109. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A110. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

A111. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

(a) Assertions about classes of transactions and events for the period under audit:

  (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

  (ii) Completeness—all transactions and events that should have been recorded have been recorded.

  (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

  (iv) Cut-off—transactions and events have been recorded in the correct accounting period.

  (v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

  (i) Existence—assets, liabilities, and equity interests exist.

  (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

  (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

  (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

  (i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have

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occurred and pertain to the entity.

(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

A112. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

A113. When making assertions about the financial statements of certain entities, especially, for example, where the Government is a major stakeholder, in addition to those assertions set out in paragraph A111, management may often assert that transactions and events have been carried out in accordance with legislation or proper authority. Such assertions may fall within the scope of the financial statement audit.

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A114. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

A115. **Appendix 2** provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions [Ref: Para. 26(c)]

A116. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A117. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A118. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A119. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine

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transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A120. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A121. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A122. SA 330 describes the consequences for further audit procedures of identifying a risk as significant.[11]

Significant risks relating to the risks of material misstatement due to fraud

A123. SA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.[12]

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A124. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Control activities such as a review of assumptions by senior management or experts.
- Documented processes for estimations.
- Approval by those charged with governance.

A125. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A126. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to

[11] SA 330, paragraphs 15 and 21.

[12] SA 240, paragraph 25-27.

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implement such controls is an indicator of a significant deficiency in internal control.[13]

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 30)

A127. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A128. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

A129. The consequences for further audit procedures of identifying such risks are described in SA 330.[14]

Revision of Risk Assessment (Ref: Para. 31)

A130. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See SA 330 for further guidance.

Documentation (Ref: Para. 32)

A131. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan that is required by SA 300, "Planning an Audit of Financial Statements"[15]. Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures (see SA 330)[16]. The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A132. For entities that have uncomplicated businesses and processes relevant to financial reporting, the

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[13] SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Paragraph A7.

[14] SA 330, paragraph 8.

[15] SA 300, paragraphs 7 and 9.

[16] SA 330, paragraph 8.

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documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A133. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of SA 230, "Audit Documentation" are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A134. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

Material Modifications to ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

Deletions

1. Paragraph A21 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the effect of ministerial directives, government policy requirements and resolutions of the legislature on the operations of the entity. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that even in case of non public sector entities, the operation of the entity may be affected by government policy requirements and resolutions of the legislature. Accordingly, the spirit of erstwhile A21, highlighting the fact that in some cases, the entity's operations may be affected by such requirements/resolutions, has been retained.

2. Paragraph A35 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the influence of concerns relating to public accountability, including objectives having source in legislation, regulations, government ordinances, etc., on 'management objectives'. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that even in case of non public sector entities, the management's objectives are influenced by such aspects. Accordingly, the spirit of erstwhile A35, highlighting the fact that in some cases, the management objectives may be influenced by the concerns relating to public accountability, including objectives having source in legislation, regulations, government directions, has been retained.

3. Paragraph A65 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the additional reporting responsibilities of the auditor with respect to internal control because of any code of practice or compliance with legislative authorities. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

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Further, it is also possible that even in case of non public sector entities, the statute or regulations may require the auditor to report on compliance with certain specific aspects of internal control. Accordingly, the spirit of erstwhile A65, highlighting such additional reporting responsibilities of the auditor, has been retained.

4. Paragraph A113 of the Application Section of ISA 315 deals with the application of the requirements of ISA 315 to the audits of public sector entities regarding the relevance of management's assertions that transactions and events have been carried out in accordance with legislation or proper authority, for the financial statement audit. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that even in case of non public sector entities, there may be similar assertions made by the management that may fall within the scope of the financial statement audit. Accordingly, the spirit of erstwhile A113, highlighting such fact, has been retained and an example has been added.

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Appendix 1

(Ref: Paras. 4(c), 14-23 and A65-A97)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14-24 and A69-A104, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:

(a) *Communication and enforcement of integrity and ethical values*. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

(b) *Commitment to competence*. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

(c) *Participation by those charged with governance*. An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognised in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

(d) *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

(e) *Organizational structure*. Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.

(f) *Assignment of authority and responsibility*. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.

(g) *Human resource policies and practices*. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars

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illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements.

4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

   - *Changes in operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
   - *New personnel*. New personnel may have a different focus on or understanding of internal control.
   - *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control.
   - *Rapid growth*. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
   - *New technology*. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
   - *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
   - *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
   - *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
   - *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant To Financial Reporting, And Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

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6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
   - Identify and record all valid transactions.
   - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
   - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
   - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
   - Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:
   - *Performance reviews*. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
   - *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT-controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.
   - *Physical controls.* Controls that encompass:
     - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
     - The authorisation for access to computer programs and data files.
     - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting

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records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

- *Segregation of duties.* Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as, investment criteria set by those charged with governance; alternatively, non-routine transactions such as, major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as, management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A29 and A108)

Conditions and Events that May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency

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devaluation or highly inflationary economies.

- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganisations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

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SA 320*

Materiality in Planning and Performing an Audit

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450[1], explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
   - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
   - Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
   - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.
4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

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[1] SA 450, "Evaluation of Misstatements Identified during the Audit".

[2] For example, paragraph 10 of the "Framework for the Preparation and Presentation of Financial Statements," issued by the Institute of Chartered Accountants of India (ICAI) in July 2000, indicates for a profit-oriented entity that "as providers of risk capital to the enterprise, investor need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy".

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(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

6. In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

(a) Determining the nature, timing and extent of risk assessment procedures;

(b) Identifying and assessing the risks of material misstatement; and

(c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although, it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.[3]

Effective Date

7. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

9. For purposes of the SAs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Requirements

Determining Materiality and Performance Materiality when Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence

[3] SA 450, paragraph A16.

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the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)

13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The audit documentation shall include the following amounts and the factors considered in their determination:

    (a) Materiality for the financial statements as a whole (see paragraph 10);

    (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);

    (c) Performance materiality (see paragraph 11); and

    (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.[4] The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level[5]. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk[6]. Materiality and audit risk are considered throughout the audit, in particular, when:

    (a) Identifying and assessing the risks of material misstatement[7];

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[4] SA 200, paragraph 11.

[5] SA 200, paragraph 17.

[6] SA 200, paragraph 13(c)

[7] SA 315, "Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment".

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(b) Determining the nature, timing and extent of further audit procedures[8]; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report[9].

Determining Materiality and Performance Materiality when Planning the Audit (Ref: Para. 10)

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole

A2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

A3. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A4. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, the materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that the materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A5. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A6. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional

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[8] SA 330, "The Auditor's Responses to Assessed Risks".

[9] SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements".

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judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in different circumstances.

Considerations Specific to Small Entities

A7. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

A8. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of those entities may therefore be influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public utility programs/projects, such as, Accelerated Irrigation Benefit Programme (AIBP), Pradhan Mantri Gram Sadak Yojana (PMGSY) undertaken by the Central/State governments or related government entities .

A9. In an audit of the entities doing public utility programs/projects, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A10. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulations or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

A11. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

A12. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which,

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as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

A13. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

Material Modifications to ISA 320, "Materiality in Planning and Performing an Audit"

Deletions

1. Paragraph A2 of ISA 320 dealt with the determination of materiality for the financial statements as a whole or for particular assertion in an audit of financial statements of a public sector entity, which is influenced by legislative and regulatory requirements, and by the financial information needs of legislators and the public in relation to public sector programs. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A2, highlighting such fact, has been retained and the paragraph has been re-numbered as A8.

2. Paragraph A9 of ISA 320 states that in an audit of the public sector entities, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program/project activities. Where a public sector entity has custody of assets, assets may be an appropriate benchmark. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, or programs/projects launched by them, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A9, highlighting such fact, has been retained.

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SA 330*
The Auditor's Responses to Assessed Risks
(Effective for audits of financial statements for periods beginning on or after April 1, 2008)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315, "Identifying and Assessing Risks of Material Misstatement Through Understanding the Entity and Its Environment" in a financial statement audit.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:

(a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

  (i) Tests of details (of classes of transactions, account balances, and disclosures), and

  (ii) Substantive analytical procedures.

(b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Requirements

Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

7. In designing the further audit procedures to be performed, the auditor shall:

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(a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

(i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk); and

(ii) Whether the risk assessment takes into account the relevant controls (i.e., the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9-A18)

(b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

Tests of Controls

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

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20-A24)

9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

Nature and Extent of Tests of Controls

10. In designing and performing tests of controls, the auditor shall:

(a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

(i) How the controls were applied at relevant times during the period under audit.

(ii) The consistency with which they were applied.

(iii) By whom or by what means they were applied. (Ref: Para. A26-A29)

(b) Determine whether the controls to be tested depend upon other controls (indirect controls), and if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30-A31)

Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

Using audit evidence obtained during an interim period

12. When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

(b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of

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

(a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

(b) The risks arising from the characteristics of the control, including whether it is manual or automated;

(c) The effectiveness of general IT-controls;

(d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;

(e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

(f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)

14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

(a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-A39)

Controls over significant risks

15. When the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)

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

(a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures. (Ref: Para. A41)

Substantive Procedures

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42-A47)

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19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48-A51)

Substantive Procedures Related to the Financial Statement Closing Process

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

(a) Agreeing or reconciling the financial statements with the underlying accounting records; and

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

Substantive Procedures Responsive to Significant Risks

21. When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

Timing of Substantive Procedures (Ref: Para.A54)

22. When substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

(a) substantive procedures, combined with tests of controls for the intervening period; or

(b) if the auditor determines that it is sufficient, further substantive procedures only;

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A55-A57)

23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

Adequacy of Presentation and Disclosure

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60-A61)

26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)

27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or a disclaimer of opinion.

Documentation

28. The auditor shall document:

(a) The overall responses to address the assessed risks of material misstatement at the financial

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statement level, and the nature, timing and extent of the further audit procedures performed;

(b) The linkage of those procedures with the assessed risks at the assertion level; and

(c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)

29. If the auditor plans to use audit evidences about the operating effectiveness of controls obtained in previous audits, the auditor shall document the conclusions reached about relying on such controls that were tested in a previous audit.

30. The auditors' documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

Application and Other Explanatory Material

Overall Responses (Ref: Para. 5)

A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, (as

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appropriate and notwithstanding the requirements of this SA)[1], the auditor may determine that:

(a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;

(b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or

(c) A combined approach using both tests of controls and substantive procedures is an effective approach.

A5. The nature of an audit procedure refers to its purpose (i.e., test of controls or substantive procedure) and its type (i.e., inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditors' further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

Timing

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may

[1] For example, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each significant class of transactions, account balance, and disclosure.

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decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing the financial statements to the accounting records;
- Examining adjustments made during the course of preparing the financial statements; and
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalised.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A17. In certain circumstances, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity

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may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para 7(b))

A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, e.g., by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

Tests of Controls

Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, as discussed in SA 315, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level[2]. This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

[2] SA 315, paragraph 30.

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Audit Evidence and Intended Reliance (Ref: Para. 9)

A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 10(a))

A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

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

SA 530, "Audit Sampling" contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorised version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the

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case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorised access has not occurred during the period.

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT-controls) are described as "indirect" controls.

A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using audit evidence obtained during an interim period (Ref: Para. 12)

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.
- The degree to which audit evidence about the operating effectiveness of those controls was obtained.
- The length of the remaining period.
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.
- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para.13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

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Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) Have not changed since they were last tested; and

(b) Are not controls that mitigate a significant risk;

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT-controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para.16-17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognises that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that: (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (ii) there are inherent limitations to internal control, including management override.

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Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See SA 500[3].

Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.

[3] SA 500, "Audit Evidence", paragraph 10.

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- Accounts payable balances and terms.

A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
  - o May not accept responsibility for responding to a confirmation request;
  - o May consider responding too costly or time consuming;
  - o May have concerns about the potential legal liability resulting from responding;
  - o May account for transactions in different currencies; or
  - o May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

  In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.
- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20(b))

A52. The nature, and also the extent, of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 21)

A53. Paragraph 21 of this SA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognising revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In

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addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures (Ref: Para. 22-23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, e.g., a legal opinion obtained in a previous audit related to the structure of a securitisation to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

(a) Identify amounts that appear unusual;

(b) Investigate any such amounts; and

(c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other relevant controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analysing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:
  - (a) Significant unusual transactions or entries (including those at or near the period end);
  - (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and
  - (c) Changes in the composition of the classes of transactions or account balances.

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Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

Adequacy of Presentation and Disclosure (Ref: Para. 24)

A59. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25-27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example,

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.
- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.
- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognised risk of material misstatement.

In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. SA 315 contains further guidance on revising the auditor's risk assessment[4].

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.

[4] SA 315, paragraph 31.

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- Understanding of the entity and its environment, including the entity's internal control.

Documentation (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

Material Modifications to ISA 330, The Auditor's Responses to Assessed Risks

Deletion

1. Paragraph A17 of the Application Section of ISA 330 dealt with the application of the requirements of ISA 330 to the audits of public sector entities regarding the auditor's consideration of the nature, timing and extent of further audit procedures. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non-public sector entities the auditor may be required to give special considerations regarding the nature, timing and extent as a result of the terms of appointment of the auditor or any other special reporting requirement under the statute or regulation under which the entity operates. Accordingly, the spirit of erstwhile A17, highlighting the fact that in some cases, the auditor's consideration of the nature, timing and extent of further audit procedures may be affected by the audit mandate or any other special auditing requirements, has been retained.

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SA 402*
Audit Considerations relating to an Entity Using a Service Organisation
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations. Specifically, it expands on how the user auditor applies SA 315[1] and SA 330[2] in obtaining an understanding of the user entity, including internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and in designing and performing further audit procedures responsive to those risks.

2. Many entities outsource aspects of their business to organisations that provide services ranging from performing a specific task under the direction of an entity to replacing an entity's entire business units or functions, such as the tax compliance function. Many of the services provided by such organisations are integral to the entity's business operations; however, not all those services are relevant to the audit.

3. Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting. Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

(a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;

(b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;

(d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;

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* Published in August, 2009 issue of the Journal.

[1] SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment".

[2] SA 330, "The Auditor's Responses to Assessed Risks".

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(e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and

(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

4. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit.

5. This SA does not apply to services provided by financial institutions that are limited to processing, for an entity's account held at the financial institution, transactions that are specifically authorised by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, this SA does not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

Effective Date

6. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

7. The objectives of the user auditor, when the user entity uses the services of a service organisation, are:

(a) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and

(b) To design and perform audit procedures responsive to those risks.

Definitions

8. For purposes of the SAs, the following terms have the meanings attributed below:

(a) *Complementary user entity controls* – Controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

(b) *Report on the description and design of controls at a service organisation (referred to in this SA as a Type 1 report)* – A report that comprises:

  (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and

  (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

(c) *Report on the description, design, and operating effectiveness of controls at a service organisation (referred to in this SA as a Type 2 report)* – A report that comprises:

  (i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

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(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:

a. The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and

b. A description of the service auditor's tests of the controls and the results thereof.

(d) *Service auditor* – An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

(e) *Service organisation* – A third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

(f) *Service organisation's system* – The policies and procedures designed, implemented and maintained by the service organisation to provide user entities with the services covered by the service auditor's report.

(g) *Subservice organisation* – A service organisation used by another service organisation to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

(h) *User auditor* – An auditor who audits and reports on the financial statements of a user entity.

(i) *User entity* – An entity that uses a service organisation and whose financial statements are being audited.

Requirements

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

9. When obtaining an understanding of the user entity in accordance with SA 315,[3] the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including: (Ref: Para. A1-A2)

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control; (Ref: Para. A3-A5)

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation; (Ref: Para. A6)

(c) The degree of interaction between the activities of the service organisation and those of the user entity; and (Ref: Para. A7)

(d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation. (Ref: Para. A8-A11)

10. When obtaining an understanding of internal control relevant to the audit in accordance with SA 315,[4] the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. (Ref: Para. A12-A14)

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[3] SA 315, paragraph 11.

[4] SA 315, paragraph 12.

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11. The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

12. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: (Ref: Para. A15-A20)

    (a) Obtaining a Type 1 or Type 2 report, if available;

    (b) Contacting the service organisation, through the user entity, to obtain specific information;

    (c) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or

    (d) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation

13. In determining the sufficiency and appropriateness of the audit evidence provided by a Type 1 or Type 2 report, the user auditor shall be satisfied as to: (Ref: Para. A21)

    (a) The service auditor's professional competence (except where the service auditor is a member of the Institute of Chartered Accountants of India) and independence from the service organisation; and

    (b) The adequacy of the standards under which the Type 1 or Type 2 report was issued.

14. If the user auditor plans to use a Type 1 or Type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall: (Ref: Para. A22-A23)

    (a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

    (b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and

    (c) Determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Responding to the Assessed Risks of Material Misstatement

15. In responding to assessed risks in accordance with SA 330 , the user auditor shall: (Ref: Para. A24-A28)

    (a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,

    (b) Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Tests of Controls

16. When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating

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effectiveness of those controls from one or more of the following procedures: (Ref: Para. A29-A30)

(a) Obtaining a Type 2 report, if available;

(b) Performing appropriate tests of controls at the service organisation; or

(c) Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively

17. If, in accordance with paragraph 16(a), the user auditor plans to use a Type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by: (Ref: Para. A31-A39)

(a) Evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;

(b) Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;

(c) Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and

(d) Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation

18. If the user auditor plans to use a Type 1 or a Type 2 report that excludes the services provided by a subservice organisation and those services are relevant to the audit of the user entity's financial statements, the user auditor shall apply the requirements of this SA with respect to the services provided by the subservice organisation. (Ref: Para. A40)

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation

19. The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: Para. A41)

Reporting by the User Auditor

20. The user auditor shall modify the opinion in the user auditor's report in accordance with SA 705[5] if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements. (Ref: Para. A42)

21. The user auditor shall not refer to the work of a service auditor in the user auditor's report

[5] SA 705, "Modifications to the Opinion in the Independent Auditor's Report", paragraph 6.

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containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A43)

22. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A44)

Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

Sources of Information (Ref: Para. 9)

A1. Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as:

- User manuals.
- System overviews.
- Technical manuals.
- The contract or service level agreement between the user entity and the service organisation.
- Reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation.
- Reports by the service auditor, including management letters, if available.

A2. Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardised.

Nature of the Services Provided by the Service Organisation (Ref: Para. 9(a))

A3. A user entity may use a service organisation such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organisations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

A4. Examples of service organisation services that are relevant to the audit include:

- Maintenance of the user entity's accounting records.
- Management of assets.
- Initiating, recording or processing transactions as agent of the user entity.

Considerations Specific to Smaller Entities

A5. Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (e.g., payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organisation for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial

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statements.[6]

Nature and Materiality of Transactions Processed by the Service Organisation (Ref: Para. 9(b))

A6. A service organisation may establish policies and procedures that affect the user entity's internal control. These policies and procedures are at least in part physically and operationally separate from the user entity. The significance of the controls of the service organisation to those of the user entity depends on the nature of the services provided by the service organisation, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

The Degree of Interaction between the Activities of the Service Organisation and the User Entity (Ref: Para. 9(c))

A7. The significance of the controls of the service organisation to those of the user entity also depends on the degree of interaction between its activities and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation. For example, a high degree of interaction exists between the activities of the user entity and those at the service organisation when the user entity authorises transactions and the service organisation processes and does the accounting for those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions. On the other hand, when the service organisation initiates or initially records, processes, and does the accounting for the user entity's transactions, there is a lower degree of interaction between the two organisations. In these circumstances, the user entity may be unable to, or may elect not to, implement effective controls over these transactions at the user entity and may rely on controls at the service organisation.

Nature of the Relationship between the User Entity and the Service Organisation (Ref: Para. 9(d))

A8. The contract or service level agreement between the user entity and the service organisation may provide for matters such as:

- The information to be provided to the user entity and responsibilities for initiating transactions relating to the activities undertaken by the service organisation;
- The application of requirements of regulatory bodies concerning the form of records to be maintained, or access to them;
- The indemnification, if any, to be provided to the user entity in the event of a performance failure;
- Whether the service organisation will provide a report on its controls and, if so, whether such report would be a Type 1 or Type 2 report;
- Whether the user auditor has rights of access to the accounting records of the user entity maintained by the service organisation and other information necessary for the conduct of the audit; and
- Whether the agreement allows for direct communication between the user auditor and the service auditor.

[6] SA 200, paragraph 4 and A2-A3.

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A9. There is a direct relationship between the service organisation and the user entity and between the service organisation and the service auditor. These relationships do not necessarily create a direct relationship between the user auditor and the service auditor. When there is no direct relationship between the user auditor and the service auditor, communications between the user auditor and the service auditor are usually conducted through the user entity and the service organisation. A direct relationship may also be created between a user auditor and a service auditor, taking into account the relevant ethical and confidentiality considerations. A user auditor, for example, may use a service auditor to perform procedures on the user auditor's behalf, such as:

(a) Tests of controls at the service organisation; or

(b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organisation.

A10. Auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example when the service organisation is located in a different jurisdiction. In such situations, the auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained. In such cases, the auditor may also obtain or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organisation.

A11. In the above context, the auditors may also use another auditor to perform tests of controls or substantive procedures in relation to compliance with law, regulation or other authority.

Understanding the Controls relating to Services provided by the Service Organisation (Ref: Para. 10)

A12. The user entity may establish controls over the service organisation's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organisation. If a user entity, for example, uses a service organisation to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. These controls may include:

- Comparing the data submitted to the service organisation with reports of information received from the service organisation after the data has been processed.
- Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.

A13. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.

A14. As noted in SA 315,7 in respect of some risks, the user auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organisations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of

[7] SA 315, paragraph 30.

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this SA.

Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity (Ref: Para. 12)

A15. The user auditor's decision as to which procedure, individually or in combination, in paragraph 12 to undertake, in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement in relation to the user entity's use of the service organisation, may be influenced by such matters as:

- The size of both the user entity and the service organisation;
- The complexity of the transactions at the user entity and the complexity of the services provided by the service organisation;
- The location of the service organisation (for example, the user auditor may decide to use another auditor to perform procedures at the service organisation on the user auditor's behalf if the service organisation is in a remote location);
- Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence; and
- The nature of the relationship between the user entity and the service organisation.

A16. A service organisation may engage a service auditor to report on the description and design of its controls (Type 1 report) or on the description and design of its controls and their operating effectiveness (Type 2 report). Type 1 or Type 2 reports may be issued under Standard on Assurance Engagements (SAE) 3402[8] or under standards established by an authorised or recognised standards setting organisation (which may identify them by different names, such as Type A or Type B reports).

A17. The availability of a Type 1 or Type 2 report will generally depend on whether the contract between a service organisation and a user entity includes the provision of such a report by the service organisation. A service organisation may also elect, for practical reasons, to make a Type 1 or Type 2 report available to the user entities. However, in some cases, a Type 1 or Type 2 report may not be available to user entities.

A18. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organisations. As a report on controls at the service organisation may not be available in these circumstances, visiting the service organisation may be the most effective procedure for the user auditor to gain an understanding of controls at the service organisation, as there is likely to be direct interaction of management of the user entity with management at the service organisation.

A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organisation. If a Type 1 or Type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organisation. The user auditor using the work of another auditor may find the guidance in SA 600[9] useful as it relates to understanding another auditor

[8] SAE 3402, Assurance Reports on Controls at a Service Organisation.

[9] SA 600, Using the Work of Another Auditor.

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(including that auditor's independence and professional competence[10]), involvement in the work of another auditor in planning the nature, extent and timing of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.

A20. A user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation. A user auditor may need to consider controls at the sub-service organisation. In situations where one or more sub-service organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the sub-service organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the sub-service organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation's and sub-service organisation's controls to the user entity's controls.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation (Ref: Para. 13-14)

A21. The user auditor may make inquiries about the service auditor to the service auditor's professional organisation or other practitioners and inquire whether the service auditor is subject to regulatory oversight. The service auditor may be practicing in a jurisdiction where different standards are followed in respect of reports on controls at a service organisation, and the user auditor may obtain information about the standards used by the service auditor from the standard setting organisation.

A22. A Type 1 or Type 2 report, along with information about the user entity, may assist the user auditor in obtaining an understanding of:

(a) The aspects of controls at the service organisation that may affect the processing of the user entity's transactions, including the use of subservice organisations;

(b) The flow of significant transactions through the service organisation to determine the points in the transaction flow where material misstatements in the user entity's financial statements could occur;

(c) The control objectives at the service organisation that are relevant to the user entity's financial statement assertions; and

(d) Whether controls at the service organisation are suitably designed and implemented to prevent or detect processing errors that could result in material misstatements in the user entity's financial statements.

A Type 1 or Type 2 report may assist the user auditor in obtaining a sufficient understanding to identify and assess the risks of material misstatement. A type 1 report, however, does not provide any evidence of the operating effectiveness of the relevant controls.

A23. A Type 1 or Type 2 report that is as of a date or for a period that is outside of the reporting period of a user entity may assist the user auditor in obtaining a preliminary understanding of the controls implemented at the service organisation if the report is supplemented by additional current information from other sources. If the service organisation's description of controls is as of

[10] Except where such other auditor is a member of the Institute of Chartered Accountants of India.

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a date or for a period that precedes the beginning of the period under audit, the user auditor may perform procedures to update the information in a Type 1 or Type 2 report, such as:

- Discussing the changes at the service organisation with user entity personnel who would be in a position to know of such changes;
- Reviewing current documentation and correspondence issued by the service organisation; or
- Discussing the changes with service organisation personnel.

Responding to the Assessed Risks of Material Misstatement (Ref: Para. 15)

A24. Whether the use of a service organisation increases a user entity's risk of material misstatement depends on the nature of the services provided and the controls over these services; in some cases, the use of a service organisation may decrease a user entity's risk of material misstatement, particularly if the user entity itself does not possess the expertise necessary to undertake particular activities, such as initiating, processing, and recording transactions, or does not have adequate resources (e.g., an IT system).

A25. When the service organisation maintains material elements of the accounting records of the user entity, direct access to those records may be necessary in order for the user auditor to obtain sufficient appropriate audit evidence relating to the operations of controls over those records or to substantiate transactions and balances recorded in them, or both. Such access may involve either physical inspection of records at the service organisation's premises or interrogation of records maintained electronically from the user entity or another location, or both. Where direct access is achieved electronically, the user auditor may thereby obtain evidence as to the adequacy of controls operated by the service organisation over the completeness and integrity of the user entity's data for which the service organisation is responsible.

A26. In determining the nature and extent of audit evidence to be obtained in relation to balances representing assets held or transactions undertaken by a service organisation on behalf of the user entity, the following procedures may be considered by the user auditor:

(a) Inspecting records and documents held by the user entity: the reliability of this source of evidence is determined by the nature and extent of the accounting records and supporting documentation retained by the user entity. In some cases, the user entity may not maintain independent detailed records or documentation of specific transactions undertaken on its behalf.

(b) Inspecting records and documents held by the service organisation: the user auditor's access to the records of the service organisation may be established as part of the contractual arrangements between the user entity and the service organisation. The user auditor may also use another auditor, on its behalf, to gain access to the user entity's records maintained by the service organisation.

(c) Obtaining confirmations of balances and transactions from the service organisation: where the user entity maintains independent records of balances and transactions, confirmation from the service organisation corroborating the user entity's records may constitute reliable audit evidence concerning the existence of the transactions and assets concerned. For example, when multiple service organisations are used, such as an investment manager and a custodian, and these service organisations maintain independent records, the user auditor may confirm balances with these organisations in order to compare this information with the independent records of the user entity.

If the user entity does not maintain independent records, information obtained in confirmations from the service organisation is merely a statement of what is reflected in the records maintained by the service organisation. Therefore, such confirmations do not, taken alone, constitute reliable

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audit evidence. In these circumstances, the user auditor may consider whether an alternative source of independent evidence can be identified.

(d) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organisation: the effectiveness of analytical procedures is likely to vary by assertion and will be affected by the extent and detail of information available.

A27. Another auditor may perform procedures that are substantive in nature for the benefit of user auditors. Such an engagement may involve the performance, by another auditor, of procedures agreed upon by the user entity and its user auditor and by the service organisation and its service auditor. The findings resulting from the procedures performed by another auditor are reviewed by the user auditor to determine whether they constitute sufficient appropriate audit evidence. In addition, there may be requirements imposed by governmental authorities or through contractual arrangements whereby a service auditor performs designated procedures that are substantive in nature. The results of the application of the required procedures to balances and transactions processed by the service organisation may be used by user auditors as part of the evidence necessary to support their audit opinions. In these circumstances, it may be useful for the user auditor and the service auditor to agree, prior to the performance of the procedures, to the audit documentation or access to audit documentation that will be provided to the user auditor.

A28. In certain circumstances, in particular when a user entity outsources some or all of its finance function to a service organisation, the user auditor may face a situation where a significant portion of the audit evidence resides at the service organisation. Substantive procedures may need to be performed at the service organisation by the user auditor or another auditor on its behalf. A service auditor may provide a Type 2 report and, in addition, may perform substantive procedures on behalf of the user auditor. The involvement of another auditor does not alter the user auditor's responsibility to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Accordingly, the user auditor's consideration of whether sufficient appropriate audit evidence has been obtained and whether the user auditor needs to perform further substantive procedures includes the user auditor's involvement with, or evidence of, the direction, supervision and performance of the substantive procedures performed by another auditor.

Tests of Controls (Ref: Para. 16)

A29. The user auditor is required by SA 330[11] to design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls in certain circumstances. In the context of a service organisation, this requirement applies when:

(a) The user auditor's assessment of risks of material misstatement includes an expectation that the controls at the service organisation are operating effectively (i.e., the user auditor intends to rely on the operating effectiveness of controls at the service organisation in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone, or in combination with tests of the operating effectiveness of controls at the user entity, cannot provide sufficient appropriate audit evidence at the assertion level.

A30. If a Type 2 report is not available, a user auditor may contact the service organisation, through the user entity, to request that a service auditor be engaged to provide a Type 2 report that includes tests of the operating effectiveness of the relevant controls or the user auditor may use another auditor to perform procedures at the service organisation that test the operating effectiveness of those controls. A user

[11] SA 330, paragraph 8.

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auditor may also visit the service organisation and perform tests of relevant controls if the service organisation agrees to it. The user auditor's risk assessments are based on the combined evidence provided by the work of another auditor and the user auditor's own procedures.

Using a Type 2 Report as Audit Evidence that Controls at the Service Organisation Are Operating Effectively (Ref: Para. 17)

A31. A Type 2 report may be intended to satisfy the needs of several different user auditors; therefore tests of controls and results described in the service auditor's report may not be relevant to assertions that are significant in the user entity's financial statements. The relevant tests of controls and results are evaluated to determine that the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment. In doing so, the user auditor may consider the following factors:

(a) The time period covered by the tests of controls and the time elapsed since the performance of the tests of controls;

(b) The scope of the service auditor's work and the services and processes covered, the controls tested and tests that were performed, and the way in which tested controls relate to the user entity's controls; and

(c) The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

A32. For certain assertions, the shorter the period covered by a specific test and the longer the time elapsed since the performance of the test, the less audit evidence the test may provide. In comparing the period covered by the Type 2 report to the user entity's financial reporting period, the user auditor may conclude that the Type 2 report offers less audit evidence if there is little overlap between the period covered by the Type 2 report and the period for which the user auditor intends to rely on the report. When this is the case, a Type 2 report covering a preceding or subsequent period may provide additional audit evidence. In other cases, the user auditor may determine it is necessary to perform, or use another auditor to perform, tests of controls at the service organisation in order to obtain sufficient appropriate audit evidence about the operating effectiveness of those controls.

A33. It may also be necessary for the user auditor to obtain additional evidence about significant changes to the relevant controls at the service organisation outside of the period covered by the Type 2 report or determine additional audit procedures to be performed. Relevant factors in determining what additional audit evidence to obtain about controls at the service organisation that were operating outside of the period covered by the service auditor's report may include:

- The significance of the assessed risks of material misstatement at the assertion level;
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel;
- The degree to which audit evidence about the operating effectiveness of those controls was obtained;
- The length of the remaining period;
- The extent to which the user auditor intends to reduce further substantive procedures based on the reliance on controls; and
- The effectiveness of the control environment and monitoring of controls at the user entity.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the

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remaining period or testing the user entity's monitoring of controls.

A35. If the service auditor's testing period is completely outside the user entity's financial reporting period, the user auditor will be unable to rely on such tests for the user auditor to conclude that the user entity's controls are operating effectively because they do not provide current audit period evidence of the effectiveness of the controls, unless other procedures are performed.

A36. In certain circumstances, a service provided by the service organisation may be designed with the assumption that certain controls will be implemented by the user entity. For example, the service may be designed with the assumption that the user entity will have controls in place for authorising transactions before they are sent to the service organisation for processing. In such a situation, the service organisation's description of controls may include a description of those complementary user entity controls. The user auditor considers whether those complementary user entity controls are relevant to the service provided to the user entity.

A37. If the user auditor believes that the service auditor's report may not provide sufficient appropriate audit evidence, for example, if a service auditor's report does not contain a description of the service auditor's tests of controls and results thereon, the user auditor may supplement the understanding of the service auditor's procedures and conclusions by contacting the service organisation, through the user entity, to request a discussion with the service auditor about the scope and results of the service auditor's work. Also, if the user auditor believes it is necessary, the user auditor may contact the service organisation, through the user entity, to request that the service auditor perform procedures at the service organisation. Alternatively, the user auditor, or another auditor at the request of the user auditor, may perform such procedures.

A38. The service auditor's Type 2 report identifies results of tests, including exceptions and other information that could affect the user auditor's conclusions. Exceptions noted by the service auditor or a modified opinion in the service auditor's Type 2 report do not automatically mean that the service auditor's Type 2 report will not be useful for the audit of the user entity's financial statements in assessing the risks of material misstatement. Rather, the exceptions and the matter giving rise to a modified opinion in the service auditor's Type 2 report are considered in the user auditor's assessment of the testing of controls performed by the service auditor. In considering the exceptions and matters giving rise to a modified opinion, the user auditor may discuss such matters with the service auditor. Such communication is dependent upon the user entity contacting the service organisation, and obtaining the service organisation's approval for the communication to take place.

Communication of Deficiencies in Internal Control identified during the Audit

A39. The user auditor is required to communicate in writing significant deficiencies identified during the audit to both management and those charged with governance on a timely basis.[12] The user auditor is also required to communicate to management at an appropriate level of responsibility on a timely basis other deficiencies in internal control identified during the audit that, in the user auditor's professional judgment, are of sufficient importance to merit management's attention.[13] Matters that the user auditor may identify during the audit and may communicate to management and those charged with governance of the user entity include:

- Any monitoring of controls that could be implemented by the user entity, including those identified as a result of obtaining a Type 1 or Type 2 report;

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[12] SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", paragraph 9 and 10.

[13] SA 265, paragraph 9.

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- Instances where complementary user entity controls are noted in the Type 1 or Type 2 report and are not implemented at the user entity; and
- Controls that may be needed at the service organisation that do not appear to have been implemented or that are not specifically covered by a Type 2 report.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organisation (Ref: Para. 18)

A40. If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method, respectively. If the Type 1 or Type 2 report excludes the controls at a subservice organisation, and the services provided by the subservice organisation are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this SA in respect of the subservice organisation. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organisation depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph 9 assists the user auditor in determining the effect of the subservice organisation and the nature and extent of work to be performed.

Fraud, Non-Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation (Ref: Para. 19)

A41. A service organisation may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organisation's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organisation has reported any such matters and evaluates whether any matters reported by the service organisation affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may request the user entity to contact the service organisation to obtain the necessary information.

Reporting by the User Auditor (Ref: Para. 20)

A42. When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when:

- The user auditor is unable to obtain a sufficient understanding of the services provided by the service organisation and does not have a basis for the identification and assessment of the risks of material misstatement;
- A user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- Sufficient appropriate audit evidence is only available from records held at the service organisation, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or

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pervasive.

Reference to the Work of a Service Auditor (Ref: Para. 21-22)

A43. In some cases, law or regulation may require a reference to the work of a service auditor in the user auditor's report, for example, for the purposes of transparency in the public sector. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

A44. The fact that a user entity uses a service organisation does not alter the user auditor's responsibility under SAs to obtain sufficient appropriate audit evidence to afford a reasonable basis to support the user auditor's opinion. Therefore, the user auditor does not make reference to the service auditor's report as a basis, in part, for the user auditor's opinion on the user entity's financial statements. However, when the user auditor expresses a modified opinion because of a modified opinion in a service auditor's report, the user auditor is not precluded from referring to the service auditor's report if such reference assists in explaining the reason for the user auditor's modified opinion. In such circumstances, the user auditor may need the consent of the service auditor before making such a reference.

Material Modifications to ISA 402, "Audit Considerations Relating to an Entity Using a Service Organisation"

1. Paragraphs A10 and A11 of ISA 402 deal with the application of the requirements of ISA 402 to public sector auditors who have broad rights of access established by legislation. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

   However, since the situation envisaged in paragraphs A10 and A11 may be possible even in case of auditors of non-public sector entities, the spirit of paragraphs A10 and A11 has been retained and made generic.

2. Paragraph 13 (a) and paragraph A19 of ISA 402 deal with assessment of the service auditor's professional competence and independence from the service organisation for obtaining sufficient and appropriate audit evidence and for reporting purposes. The corresponding paragraphs of SA 402 also require such assessment of professional competence except where the service auditor is also a member of the Institute of Chartered Accountants of India.

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SA 450*

Evaluation of Misstatements Identified during the Audit

(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 700 (Revised)[1] deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by SA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this SA. SA 320[2] deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Effective Date

2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective

3. The objective of the auditor is to evaluate:
   (a) The effect of identified misstatements on the audit; and
   (b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

4. For purposes of the SAs, the following terms have the meanings attributed below:
   (a) Misstatement – A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

   When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects.

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* Published in August, 2009 issue of the Journal.

[1] 700, "Forming an Opinion and Reporting on Financial Statements", paragraphs 10-11.

[2] SA 320, "Materiality in Planning and Performing an Audit".

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(b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)

Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

   (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4)

   (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320. (Ref: Para. A5)

7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)

Communication and Correction of Misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation3.The auditor shall request management to correct those misstatements .(Ref: Para. A7-A9)

9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A 10)

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

   (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20)

   (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)

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[3] SA 260, "Communication with Those Charged with Governance", paragraph A4.

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Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance[4] uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representation

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The audit documentation shall include: (Ref: Para. A25)

    (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);

    (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5,8 and 12); and

    (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion. (paragraph 11)

Application and Other Explanatory Material

Misstatements (Ref: Para. 4(a))

A1. Misstatements may result from:

    (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

    (b) An omission of an amount or disclosure;

    (c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts; and

    (d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

    Examples of misstatements arising from fraud are provided in SA 240.[5]

Accumulation of Identified Misstatements (Ref: Para. 5)

A2. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. "Clearly trivial" is not another

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[4] In accordance with the paragraph 9 of SA 260, "Communication with Those Charged with Governance," if this matter has been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

[5] SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraphs A1-A6.

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expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

A3. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in SA 530[6].

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

A4. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

A5. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320, there may be a greater than an acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed the materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.7

A6. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

A7. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

A8. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of

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[6] SA 530, "Audit Sampling", paragraphs 14-15.

[7] SA 530, paragraphs 5(c) and (d).

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confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

A9. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

A10. SA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments[8], which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

A11. The auditor's determination of the materiality in accordance with SA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with SA 320 based on the actual financial results.

A12. SA 320 explains that, as the audit progresses, the materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially[9]. Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with SA 320 (see paragraph 10 of this SA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures, are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A13. Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A14. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate[10].

A15. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels

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[8] Revised SA 700, "Forming an Opinion and Reporting on Financial Statements", paragraph 12.

[9] SA 320, paragraph 12.

[10] The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to re-assess the risk of material misstatement for that account balance or class of transactions.

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applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

A16. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Makes a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information that will be communicated in documents containing the audited financial statements (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. SA 720[11] deals with the auditor's consideration of other information, on which the auditor has no obligation to report, in documents containing audited financial statements.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

[11] SA 720, "The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements".

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A17. SA 240[12], explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

A18. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

A19. In the case of an audit of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud.

A20. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with regulation, legislation or other authority.

Communication with Those Charged with Governance (Ref: Para. 12)

A21. If uncorrected misstatements have been communicated with person(s) with management responsibilities and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.[13]

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A23. SA 260 requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this SA).[14] The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representation (Ref: Para. 14)

A24. Because management and, where appropriate, those charged with governance are responsible for adjusting the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We do not agree that items ……and ……. constitute misstatements because [*description of reasons*]." Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A25. The auditor's documentation of uncorrected misstatements may take into account:

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[12] SA 240, paragraph 35.

[13] SA 260, paragraph 9.

[14] SA 260, paragraph 12(c)(iii).

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(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

Material Modifications to ISA 450, "Evaluation of Misstatements Identified during the Audit"

Deletions

Paragraph A19 of ISA 450 states that in the case of an audit of public sector entities, the evaluation whether a misstatement is material may also be affected by legislation or regulation and additional responsibilities for the auditor to report other matters, including, for example, fraud. Since as mentioned in the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services", the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A19, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.

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