General Principles of Audit and Audit Evidence: An Overview and Analysis

Standards on Auditing (SA) are formulated by the Auditing & Assurance Standards Board (AASB) under the council of Institute of Chartered Accountants of India (ICAI) & are in line with the International standards issued by International Auditing & Assurance Board (IAASB). They apply when an independent verification of historical financial information is carried out for any entity whether profit oriented or not or irrespective of its size or legal form (unless specified otherwise) and are mandatorily to be followed as necessary in the circumstances, by practitioners in performance of their Assurance Engagement. All SAs are interlinked, cohesive and are to be applied consistently and not in isolation.

As per Section 143(9) of Companies Act-2013, every auditor shall comply with Auditing Standards. A CA shall be deemed to be guilty of Professional misconduct under clause 9 of Part I of Schedule-II of CA-Act, 1949 (as amended by CA (amendment) Act 2006) if he does not perform the audit in accordance with the standards and fails to invite attention to any material departures there from applicable to the circumstances;

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Each SA contains – Introduction i.e. the scope & the effective date of the SA, Objective, Definitions, Requirements and other applicable & explanatory material and Appendices if any. The Requirements part is the crux of the SA.

Each SA has to be read in context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance & Related Services which sets the authority for the SA's and SA 200 – "*Overall Objectives of the Independent Auditor and the conduct of an Audit in accordance with the Standards on Auditing*".

Some key auditing principles and a synopsis of a few important SAs are discussed as below:-

Audit Documentation –SA 230 (Revised)

- Provides (a) evidence of auditor's basis to conclude on achievements of overall objective of audit; and (b) evidence that audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.
- Refers to record of audit procedures performed, relevant audit evidence obtained, and conclusions reached.
- Preparing sufficient and appropriate audit documentation on a timely basis helps enhance audit quality, facilitates effective review and evaluation of audit evidence obtained and conclusions reached before finalising auditor's report.
- To document discussions of significant matters with management, those charged with governance, and others, including nature of significant matters discussed and when / with whom the discussions took place.
- Auditor may consider preparing and retaining a summary (Completion Memorandum), describing significant matters identified during the audit and how they were addressed. SA 220 requires auditor to review audit work performed through review of audit documentation.
- Standards on Quality Control (SQC) 1 requires, firms to establish policies and procedures for timely completion of assembly of audit files ordinarily be within 60 days from date of auditor's report. SQC 1 requires firms to establish policies and procedures for retention of engagement documentation.
- Retention period for audit engagements is 7 years from date of auditor's report, or date of group auditor's report.
- ICAI has issued an Implementation Guide to SA 230.

The Auditor's Responsibility to consider Fraud & error in an audit of Financial Statements– SA 240 (Revised)

- Auditor is concerned with fraud causing a material misstatement in financial statements.
- Two types of intentional misstatements are relevant — misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
- Management & Those charged with Governance are primarily responsible for prevention and detection of frauds and they should place a strong emphasis on fraud prevention to reduce opportunities for fraud to take place and also act as a deterrent.
- Auditor is responsible for obtaining reasonable assurance that financial statement taken as a whole are free from material misstatement, whether caused by fraud or error. While auditor may be able to identify potential opportunities for fraud perpetration, it is difficult to determine misstatements in judgment areas like accounting estimates.

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- Risk of auditor not detecting a material misstatement due to management fraud is greater than employee fraud, as management is frequently in position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. Auditor is

responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures, effective for detecting error may not be effective in detecting fraud.

- Auditor shall identify and assess risks of material misstatement due to fraud at financial statement level, and at assertion level for classes of transactions, account balances and disclosures. Auditor must make appropriate inquiries with management and discuss with those charged with governance as they have oversight responsibility for systems for accounting risk, financial control and compliance with laws.
- When auditor identifies a misstatement, s/he should consider indications of fraud and if there is such an indication, s/he should consider the implications of misstatement in relation to other aspects of the audit, particularly reliability of management representations.
- When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, s/he should communicate that information to management, those charged with governance and, in some circumstances, when so required by laws and regulations, to regulatory and enforcement authorities.
- To obtain written representations from management.
- To document the understanding of entity, its environment, assessment of risks of material misstatement, responses to assessed risks of material misstatement and communications about fraud made to management, those charged with governance, regulators and others.
- Section 143(12) of The Companies Act, 2013 requires the auditor to report Fraud caused by an employee or an officer of the Company and not by a 3rd party. A Guidance Note on Reporting of Fraud under Section 143(12) is also issued by ICAI.

Consideration of Laws & Regulations in the audit of Financial Statements – SA 250 (Revised)

- To recognise that non–compliance with laws and regulations may materially affect financial statements.
- Management is responsible to ensure that entity's operations are conducted in accordance with laws and regulations.
- Auditor is not responsible for preventing non–compliance but is responsible for obtaining reasonable assurance that financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error and to obtain a general understanding of legal and regulatory framework applicable to the entity and the framework compliance.

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- Risk of non-detection of material misstatements is higher as regards material misstatements resulting from non–compliance with laws and regulations due to various factors.
- After obtaining general understanding, auditor should perform procedures to identify instances of non–compliance with these laws and regulations. Auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations that would have an effect on determination of material amounts and disclosures in financial statements.
- To obtain written representations that management has disclosed all known actual or possible non–compliance with laws and regulations whose effects should be considered when preparing financial statements.
- This SA does not apply to other assurance engagements where auditor is specifically engaged to test and report separately

on compliance with specific laws and regulations. Whether an act constitutes a non–compliance can be determined only by a court of law.

- SA 250 envisages "*engaging a legal advisor to assist in monitoring legal requirements*" instead of "*establishing a legal department*" as a policy to ensure compliance with laws and regulations. In larger entities, it envisages existence of a separate "*compliance function*" in addition to internal audit function / audit committee to supplement policies and procedures for ensuring compliance with laws and regulations.

Audit Evidence – SA 500 (Revised) -

- Auditor is required to obtain sufficient appropriate audit evidence to enable drawing reasonable conclusions to base his opinion on financial information.
- Auditor normally relies on persuasive evidence rather than conclusive evidence. Auditor may obtain evidence on a selective basis by judgmental or statistical sampling procedures or through performance of compliance and substantive procedures.

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- Compliance procedures are tests designed to obtain reasonable assurance that internal controls on which audit reliance is placed are in effect. Substantive procedures are designed to obtain evidence as to completeness, accuracy and validity of data produced by accounting system.
- Obtaining audit evidence from compliance procedures gives reasonable assurance in respect of assertions of existence, effectiveness and continuity. Obtaining audit evidence from substantive procedures gives reasonable assurance on assertions of existence, rights and obligations, occurrence, completeness, valuation, measurement, presentation and disclosure.
- To test reliability, few generalisations are useful such as external evidence is more reliable than internal evidence, written evidence is more reliable than oral evidence and self obtained evidence is more reliable than obtained through the entity.
- Auditor gains increased assurance when audit evidence obtained from different sources is consistent. Methods for obtaining audit evidence include inspection, observation, inquiry and confirmation, computation and analytical review.
- Emphasis is to be laid on considering relevance and reliability of audit evidence obtained during course of audit, and focus should be on designing and performing audit procedures to obtain relevant and reliable audit evidence.

Audit Evidence – Additional Considerations for specific items – SA 501

- Deals with specific audit considerations in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 (Revised) and other relevant SAs, with respect to certain aspects of inventory, litigation, claims involving the entity, and segment information in an audit of financial statements.
- **Inventories**: Management ordinarily establishes procedures for physical count of inventory at least annually to serve as a basis for preparation of financial statements or to ascertain reliability of perpetual inventory system. When inventory is material to financial statements, auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable. If unable to attend physical inventory count on the date planned due to unforeseen circumstances, auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures

to assess whether changes in inventory between date of physical count and period end date are correctly recorded.

- **Litigation and Claims**: Auditor shall design and perform audit procedures to identify litigation and claims involving the entity giving rise to a risk of material misstatement, including: Inquiry of management or of others within the entity, including in–house legal counsel;
- Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel;
- Reviewing legal expense accounts.
- **Segment Information**: Auditor to consider segment information in relation to financial statements as a whole, and is not required to apply necessary auditing procedures to express an opinion on segment information standing alone. Such audit procedures to consist of obtaining an understanding of methods used by management in determining segment information, performing analytical procedures and other audit tests appropriate in the circumstances.

Audit Sampling –SA 530 (Revised)

- Auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results to provide sufficient appropriate audit evidence.
- Objective is to provide a reasonable basis to draw conclusions about the population from which the sample is selected.

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- When designing an audit sample, the objectives of the audit procedure and characteristics of the population, should be considered. To assist in efficient and effective design of sample, stratification (process of dividing a population into sub–populations) may be appropriate.
- When determining sample size, auditor should consider sampling risk, tolerable error, and expected error. Tolerable error is the maximum error in population that the auditor would be willing to accept and still conclude that the result from sample has achieved audit objective.
- If Auditor expects error to be present in the population, a larger sample needs to be examined to conclude that actual error in the population is not greater than planned tolerable error. Auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected. After having carried out audit procedures on each sample item, appropriate to particular audit objective, auditor should analyse errors detected in the sample, project the sampling errors to the population and reassess sampling risk.
- Auditor should investigate nature and cause of deviations or misstatements identified, and their possible effect on objective of the particular audit procedure or other areas of audit. In order to conclude that a misstatement or deviation is an anomaly, the auditor should obtain a high degree of certainty that misstatement or deviation is not representative of the population.

Subsequent Events –SA 560 (Revised)

- Subsequent events are significant events occurring between balance sheet date and date of auditor's report. Auditor should consider effect of subsequent events on financial statements and on auditor's report. Auditor should perform procedures to obtain sufficient appropriate audit evidence that all events up to date of auditor's report requiring adjustment of or disclosure in financial statements have been identified.
- Procedures to identify events requiring adjustment of, or disclosure in financial

statements would be performed as near as practicable to date of auditor's report.

- When Auditor becomes aware of events which materially affect financial statements, he/she should consider whether such events are properly accounted for in financial statements.
- When the management does not account for such events that auditor believes should be accounted for, auditor should express a qualified or adverse opinion, as appropriate.

Going Concern – SA 570 (Revised)

- Going concern assumption is a fundamental principle in preparation of financial statements. Management should assess entity's ability to continue as a going concern even if applicable financial reporting framework does not include an explicit requirement.
- Auditor should evaluate appropriateness of management's use of going concern assumption in preparation of financial statements and conclude whether there is a material uncertainty about entity's ability to continue as a going concern needing disclosure in financial statements.

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- In planning and performing audit procedures, and evaluating results thereof, auditor should perform further audit procedures when events or conditions are identified that cast significant doubt on entity's ability to continue as a going concern. Such risk indications that continuance as a going concern may be questionable could come from financial statements, operational activities or from other sources.
- If on the presence of such financial indicators, operating indicators or other indicators, a question arises regarding appropriateness of going concern assumption, auditor should gather sufficient appropriate audit evidence to attempt to resolve satisfactorily, the entity's ability to continue in operation for foreseeable future.
- After necessary procedures have been carried out, all information required is obtained, and effect of any management plans and other mitigating factors is considered, auditor should decide whether the question regarding going concern assumption is satisfactorily resolved.
- Auditor, on the basis of his/her judgement and audit evidence will report, as deemed appropriate. In case - where use of going concern assumption is appropriate but material uncertainty exists, then (i) if adequate disclosure is made in financial statements, auditor should express an unmodified opinion but include an Emphasis of Matter paragraph in the auditor's report; (ii) if adequate disclosure is not made in financial statements, auditor should express a qualified or adverse opinion, as appropriate. In case of entity's inability to continue as a going concern, auditor should express an adverse opinion if financial statement is prepared on a going concern basis.
- Auditor should communicate with those charged with governance when there are identified events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- ICAI has issued an Implementation Guide to SA 570.

Conclusion

Auditors play a key role in contributing to the credibility of the financial statements they audit. High quality audits promote financial stability. Auditing Standards provide a framework / guidance to the auditors and constitute a yardstick or criteria against which audit quality is evaluated.

SAs state and establish Performance, Evaluation, Documentation, Communication, Reporting responsibilities for an auditor. An audit conducted in accordance with the standards builds trust and gives a high level of confidence and assurance to the users of the financial statements. ■