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 315¹ and SA 330² 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;

* 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".
(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, 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, 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
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 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.

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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
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.

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6 SA 200, paragraph 4 and A2-A3.
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 SA 315, paragraph 30.

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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 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 useful as it relates to understanding another auditor.

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8 SAE 3402, Assurance Reports on Controls at a Service Organisation.
9 SA 600, Using the Work of Another Auditor.
(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.
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\textsuperscript{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

\textsuperscript{11} SA 330, paragraph 8.
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
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. 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. 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.
• 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
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.
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) 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 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.

* Published in August, 2009 issue of the Journal.
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 regulation. 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. A10)

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.
Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance 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.

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 5306.

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

7 SA 530, paragraphs 5(c) and (d).
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, 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. 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.

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.
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\(^\text{11}\) 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”. 
A17. SA 24012, 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:

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.
Part I: Engagement and Quality Control Standards

SA 500*
Audit Evidence
(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) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor’s responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.

2. This SA is applicable to all the audit evidence obtained during the course of the audit. Other SAs deal with specific aspects of the audit (for example, SA 3151), the audit evidence to be obtained in relation to a particular topic (for example, SA 5702), specific procedures to obtain audit evidence (for example, SA 5203), and the evaluation of whether sufficient appropriate audit evidence has been obtained (SA 200 and SA 3304).

Effective Date
3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective
4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.

Definitions
5. For purposes of the SAs, the following terms have the meanings attributed below:

(a) 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.

(b) 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.

(c) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based.

* Published in April, 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 570, “Going Concern”.
3 SA 520, “Analytical Procedures”.
4 SA 330, “The Auditor’s Responses to Assessed Risks”.

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opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

(d) Management’s expert — An individual or organisation 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.

(e) 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.

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)

8. When information to be used as audit evidence has been prepared using the work of a management’s expert, the auditor shall, to the extent necessary, having regard to the significance of that expert’s work for the auditor’s purposes,:

(a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A34-A36)

(b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)

(c) Evaluate the appropriateness of that expert’s work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor’s purposes, including as necessary in the circumstances:

(a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)

(b) Evaluating whether the information is sufficiently precise and detailed for the auditor’s purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

Inconsistency in, or Doubts over Reliability of, Audit Evidence

11. If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence,

The auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

Application and Other Explanatory Material

Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A1. Audit evidence is necessary to support the auditor’s opinion and report. It is cumulative in nature and is
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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) 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 using the work of a management’s expert. Audit evidence comprises both information that supports and corroborates management’s assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management’s refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

A2. Most of the auditor’s work in forming the auditor’s opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

A3. As explained in SA 200, reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

A4. 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.

A5. 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.

A6. SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgment. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

A7. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

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A8. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

A9. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts’ reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

A10. As required by, and explained further in, SA 315 and SA 330, audit evidence to draw reasonable conclusions on which to base the auditor’s opinion is obtained by performing:

(a) Risk assessment procedures; and

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

A11. The audit procedures described in paragraphs A14-A25 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in SA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.

A12. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

A13. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity’s data retention policies to request retention of some information for the auditor’s review or to perform audit procedures at a time when the information is available.

Inspection

A14. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

A15. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity’s application of accounting policies, such as revenue recognition.

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A16. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity’s rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation
A17. 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. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See SA 501 for further guidance on observation of the counting of inventory.9

External Confirmation
A18. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition. See SA 505 for further guidance.10

Recalculation
A19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance
A20. Reperformance involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.

Analytical Procedures
A21. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See SA 520 for further guidance.

Inquiry
A22. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A23. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to

9 SA 501, “Audit Evidence—Specific Considerations for Selected Items”.
10 SA 505, “External Confirmations”.

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modify or perform additional audit procedures.

A24. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

A25. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See SA 580 for further guidance.11

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

A27. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A28. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

A29. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A30. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

11 SA 580, “Written Representations”.

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Reliability

A31. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management’s expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

A32. SA 520 provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.12

A33. SA 240 deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.13

Reliability of Information Produced by a Management’s Expert (Ref: Para. 8)

A34. The preparation of an entity’s financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

A35. When information to be used as audit evidence has been prepared using the work of a management’s expert, the requirement in paragraph 8 of this SA applies. For example, an individual or organisation may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organisation applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organisation is a management’s expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this SA, but is not the use

12 SA 520, paragraph 5 (a).
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of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this SA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. 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. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A38. Information regarding the competence, capabilities and objectivity of a management’s expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management’s expert.

A39. Matters relevant to evaluating the competence, capabilities and objectivity of a management’s expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.
A40. Other matters that may be relevant include:

- The relevance of the management’s expert’s competence to the matter for which that expert’s work will be used, including any areas of specialty within that expert’s field. For example, a particular actuary may specialise in property and casualty insurance, but have limited expertise regarding pension calculations.

- The management’s expert’s competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.

- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management’s expert as the audit progresses.

A41. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management’s expert’s profession, legislation or regulation), or by the management’s expert’s work environment (for example, quality control policies and procedures).

A42. Although safeguards cannot eliminate all threats to a management’s expert’s objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert’s objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management’s Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management’s expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor’s determination of whether the auditor has the expertise to evaluate the work of the management’s expert, or whether the auditor needs an auditor’s expert for this purpose.\(^1\)

A45. Aspects of the management’s expert’s field relevant to the auditor’s understanding may include:

- Whether that expert’s field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods are used by the management’s expert, and whether they are generally accepted within that expert’s field and appropriate for financial reporting purposes.

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- The nature of internal and external data or information the auditor’s expert uses.

A46. In the case of a management’s expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management’s expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:
  - The nature, scope and objectives of that expert’s work;
  - The respective roles and responsibilities of management and that expert; and
  - The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management’s expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

Evaluating the Appropriateness of the Management’s Expert’s Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:
  - The relevance and reasonableness of that expert’s findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
  - If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
  - If that expert’s work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Information Produced by the Entity and Used for the Auditor’s Purposes (Ref: Para. 9(a)-(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorisation), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

A51. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity’s performance measures for the purpose of analytical procedures, or to make use of the entity’s information produced for monitoring activities, such as internal auditor’s reports. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor’s purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.
Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor’s purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);
(b) Selecting specific items; and
(c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

A53. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

A54. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor’s understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- High value or key items. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount. The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

A55. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit Sampling

A56. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis
of testing a sample drawn from it. Audit sampling is discussed in SA 530.\textsuperscript{15}

\textbf{Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)}

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor’s final conclusion regarding a significant matter.\textsuperscript{16}

\textbf{Material Modifications vis à vis ISA 500, “Audit Evidence”}

SA 500, “Audit Evidence” does not contain any material modifications vis-a-vis ISA 500.

\textsuperscript{15} SA 530, “Audit Sampling”.

\textsuperscript{16} SA 230, “Audit Documentation”, paragraph 11.
SA 501*
Audit Evidence—Specific Considerations for Selected Items
(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 specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330¹, SA 500² and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in 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 obtain sufficient appropriate audit evidence regarding the:
   (a) Existence and condition of inventory;
   (b) Completeness of litigation and claims involving the entity; and
   (c) Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Requirements
Inventory
4. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
   (a) Attendance at physical inventory counting, unless impracticable, to: (Ref: Para. A1-A3)
      (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting; (Ref: Para. A4)
      (ii) Observe the performance of management’s count procedures; (Ref: Para. A5)
      (iii) Inspect the inventory; and (Ref: Para. A6)
      (iv) Perform test counts; and (Ref: Para. A7-A8)
   (b) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.

¹ Published in March, 2010 issue of the Journal.
² SA 330, “The Auditor’s Responses to Assessed Risks”.
³ SA 500, “Audit Evidence”.

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5. If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required by paragraph 4, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded. (Ref: Para. A9-A11)

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

7. If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705. (Ref: Para. A12-A14)

8. When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:
   (a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity. (Ref: Para. A15)
   (b) Perform inspection or other audit procedures appropriate in the circumstances. (Ref: Para. A16)

**Litigation and Claims**

9. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (Ref: Para. A17-A19)
   (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
   (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
   (c) Reviewing legal expense accounts. (Ref: Para. A20)

10. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity’s external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity’s external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits the entity’s external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. (Ref: Para. A21-A25)

11. If:
   (a) management refuses to give the auditor permission to communicate or meet with the entity’s external legal counsel, or the entity’s external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and
   (b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor’s report in accordance with SA 705.

3 SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.
Written Representations

12. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Segment Information

13. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by: (Ref: Para. A26)

(a) Obtaining an understanding of the methods used by management in determining segment information, and: (Ref: Para. A27)
   (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
   (ii) Where appropriate, testing the application of such methods; and
(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

Application and Other Explanatory Material

Inventory

Attendance at Physical Inventory Counting (Ref: Para. 4(a))

A1. Management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity’s perpetual inventory system.

A2. Attendance at physical inventory counting involves:

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

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

A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this SA) include, for example:

- Nature of inventory.
- Stages of completion of work in progress.
- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of
material misstatement at different locations, in deciding at which locations attendance is appropriate. SA 600, “Using the Work of Another Auditor” deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regards to attendance of physical inventory counting at a remote location.

- Whether the assistance of an auditor’s expert is needed. SA 620 deals with the use of an auditor’s expert to assist the auditor to obtain sufficient appropriate audit evidence.

**Evaluate Management’s Instructions and Procedures** (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management’s instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cut off date.

**Observe the Performance of Management’s Count Procedures** (Ref: Para. 4(a)(ii))

A5. Observing the performance of management’s count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management’s instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

**Inspect the Inventory** (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

**Perform Test Counts** (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example by tracing items selected from management’s count records to the physical inventory and tracing items selected from the physical inventory to management’s count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor’s test counts, obtaining copies of management’s completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity’s final inventory records accurately reflect actual inventory count results.

**Physical Inventory Counting Conducted Other than At the Date of the Financial Statements** (Ref: Para. 5)

A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In

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4 SA 620, “Using the Work of an Auditor’s Expert”.
either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.5

A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity’s perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity’s perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Attendance at Physical Inventory Counting Is Impracticable (Ref: Para. 7)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A13. In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation.

Inventory under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A15. SA 505 establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

A16. Depending on the circumstances, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures.

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5 SA 330, paragraphs 22-23.
7 SA 705, paragraph 13.
8 SA 505, “External Confirmations”.

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procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party’s physical counting of inventory, if practicable.
- Obtaining another auditor’s report, or a service auditor’s report, on the adequacy of the third party’s internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Litigation and Claims

Completeness of Litigations and Claims (Ref: Para. 9)

A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. SA 540⁹ establishes requirements and provides guidance relevant to the auditor’s consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Reviewing Legal Expense Accounts (Ref: Para. 9(c))

A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor’s review of legal expense accounts.

Communication with the Entity’s External Legal Counsel (Ref: Para. 10-11)

A21. Direct communication with the entity’s external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management’s estimates of the financial implications, including costs, are reasonable.

A22. In some cases, the auditor may seek direct communication with the entity’s external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity’s external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of each of the identified litigation and claims, and an estimate of the financial implications, including costs involved.

A23. If it is considered unlikely that the entity’s external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(a) A list of litigation and claims;
(b) Where available, management’s assessment of the outcome of each of the identified litigation and

⁹ SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”.
claims and its estimate of the financial implications, including costs involved; and

(c) A request that the entity’s external legal counsel confirm the reasonableness of management’s assessments and provide the auditor with further information if the list is considered by the entity’s external legal counsel to be incomplete or incorrect.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity’s external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

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

A25. In accordance with Revised SA 700, the auditor is required to date the auditor’s report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor’s report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity’s external legal counsel.

Segment Information (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor’s responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis.

Understanding of the Methods Used by Management (Ref: Para. 13(a))

A27. Depending on the circumstances, example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Modifications vis-a-vis ISA 501, “Audit Evidence—Specific Considerations for Selected Items”

SA 501, “Audit Evidence—Specific Considerations for Selected Items” does not contain any modifications vis-à-vis ISA 501.

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10 Revised SA 700, “Forming an Opinion and Reporting on Financial Statements”, paragraph 41.
SA 505*
External Confirmations
(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 use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330 and SA 500. It does not address inquiries regarding litigation and claims. SA 501 deals with obtaining sufficient appropriate audit evidence from such inquiries.

External Confirmation Procedures to Obtain Audit Evidence
2. SA 500 indicates that the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. That SA also includes the following generalisations applicable to audit evidence:
   • Audit evidence is more reliable when it is obtained from independent sources outside the entity.
   • Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
   • Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.

Accordingly, depending on the circumstances of the audit, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity. This SA is intended to assist the auditor in designing and performing external confirmations procedures to obtain relevant and reliable audit evidence.

3. Other SAs recognise the importance of external confirmations as audit evidence, for example:
   • SA 330 discusses the auditor’s responsibility to design and implement overall responses to address the assessed risks of material misstatement at the financial statement level, and to 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. In addition, SA 330 requires that,
irrespective of the assessed risks of material misstatement, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure. The auditor is also required to consider whether external confirmation procedures are to be performed as substantive audit procedures.  

- SA 330 requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both. For example, the auditor may place more emphasis on obtaining evidence directly from third parties or obtaining corroborating evidence from a number of independent sources. SA 330 also indicates that external confirmation procedures 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.  

- SA 240 indicates that the auditor may design confirmation requests to obtain additional corroborative information as a response to address the assessed risks of material misstatement, whether due to fraud at the assertion level.  

- SA 500 indicates that corroborating information obtained from a source independent of the entity, such as external confirmations, may increase the assurance the auditor obtains from evidence existing within the accounting records or from the representations made by the management.  

Effective Date  
4. This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.  

Objective  
5. The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.  

Definitions  
6. For purposes of the SAs, the following terms have the meanings attributed below:  

a) 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.  

b) 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.  

c) 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.  

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

e) 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.

7 SA 330, Paragraph 18 and 19.  
8 SA 330, paragraph 7(b).  
9 SA 330, paragraph A53.  
11 SA 500, paragraph A8.
Requirements

External Confirmation Procedures

7. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
   (a) Determining the information to be confirmed or requested; (Ref: Para. A1)
   (b) Selecting the appropriate confirming party; (Ref: Para. A2)
   (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and (Ref: Para. A3-A6)
   (d) Sending the requests, including follow-up requests when applicable, to the confirming party. (Ref: Para. A7)

Management’s Refusal to Allow the Auditor to Send a Confirmation Request

8. If management refuses to allow the auditor to send a confirmation request, the auditor shall:
   (a) Inquire as to management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness; (Ref: Para. A8)
   (b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and (Ref: Para. A9)
   (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Ref: Para. A10)

9. If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 26012. The auditor also shall determine the implications for the audit and the auditor’s opinion in accordance with SA 70513.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests

10. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts. (Ref: Para. A11-A16)

11. If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures. (Ref: Para. A17)

Non-Responses

12. In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence. (Ref: Para A18-A19)

12 SA 260, “Communication with Those Charged with Governance”, paragraph 12.
13 SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.

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When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence

13. If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion in accordance with SA 705. (Ref: Para A20)

Exceptions

14. The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements. (Ref: Para. A21-A22)

Negative Confirmations

15. Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present: (Ref: Para. A23)

(a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
(b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
(c) A very low exception rate is expected; and
(d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Evaluating the Evidence Obtained

16. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary. (Ref: Para A24-A25)

Application and Other Explanatory Material

External Confirmation Procedures

Determining the Information to be Confirmed or Requested (Ref: Para. 7(a))

A1. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a ‘side agreement’.

Selecting the Appropriate Confirming Party (Ref: Para. 7(b))

A2. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

Designing Confirmation Requests (Ref: Para. 7(c))

A3. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.
A4. Factors to consider when designing confirmation requests include:
   • The assertions being addressed.
   • Specific identified risks of material misstatement, including fraud risks.
   • The layout and presentation of the confirmation request.
   • Prior experience on the audit or similar engagements.
   • The method of communication (for example, in paper form, or by electronic or other medium).
   • Management’s authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorisation.
   • The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A5. A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party’s agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of “blank” confirmation request may result in lower response rates because additional effort is required of the confirming parties.

A6. Determining that requests are properly addressed includes testing the validity of some or all of the addresses on confirmation requests before they are sent out.

Follow-Up on Confirmation Requests (Ref: Para. 7(d))

A7. The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management’s Refusal to Allow the Auditor to Send a Confirmation Request

Reasonableness of Management’s Refusal (Ref: Para. 8(a))

A8. A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

Implications for the Assessment of Risks of Material Misstatement (Ref: Para. 8(b))

A9. The auditor may conclude from the evaluation in paragraph 8(b) that it would be appropriate to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit
Part I: Engagement and Quality Control Standards

I. Engagement and Quality Control Standards

307 procedures in accordance with SA 315\textsuperscript{14}. For example, if management’s request to not confirm is unreasonable, this may indicate a fraud risk factor that requires evaluation in accordance with SA 240\textsuperscript{15}.

Alternative Audit Procedures (Ref: Para. 8(c))

A10. The alternative audit procedures performed may be similar to those appropriate for a non-response as set out in paragraphs A18-A19 of this SA. Such procedures also would take account of the results of the auditor’s evaluation in paragraph 8(b) of this SA.

Results of the External Confirmation Procedures

Reliability of Responses to Confirmation Requests (Ref: Para. 10)

A11. SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability\textsuperscript{16}. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include that it:

- Was received by the auditor indirectly; or
- Appeared not to come from the originally intended confirming party.

A12. Responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. A process used by the auditor and the respondent that creates a secure environment for responses received electronically may mitigate these risks. If the auditor is satisfied that such a process is secure and properly controlled, the reliability of the related responses is enhanced. An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify website authenticity.

A13. If a confirming party uses a third party to coordinate and provide responses to confirmation requests, the auditor may perform procedures to address the risks that:

(a) The response may not be from the proper source;
(b) A respondent may not be authorised to respond; and
(c) The integrity of the transmission may have been compromised.

A14. The auditor is required by SA 500 to determine whether to modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence\textsuperscript{17}. The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response. When a response has been returned to the auditor indirectly (for example, because the confirming party incorrectly addressed it to the entity rather than to the auditor), the auditor may request the confirming party to respond in writing directly to the auditor.

A15. On its own, an oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor. However, upon obtaining an oral response to a confirmation request, the auditor may, depending on the circumstances, request the confirming

\textsuperscript{14} SA 315, paragraph 31.
\textsuperscript{15} SA 240, paragraph 24.
\textsuperscript{16} SA 500, paragraph A31.
\textsuperscript{17} SA 500, paragraph 11.
party to respond in writing directly to the auditor. If no such response is received, in accordance with paragraph 12, the auditor seeks other audit evidence to support the information in the oral response.

A16. A response to a confirmation request may contain restrictive language regarding its use. Such restrictions do not necessarily invalidate the reliability of the response as audit evidence.

**Unreliable Responses** (Ref: Para. 11)

A17. When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with SA 315\(^{18}\). For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with SA 240\(^{18}\).

**Non-Responses** (Ref: Para. 12)

A18. Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A19. The nature and extent of alternative audit procedures are affected by the account and assertion in question. A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315\(^{20}\). For example, fewer responses to confirmation requests than anticipated, or a greater number of responses than anticipated, may indicate a previously unidentified fraud risk factor that requires evaluation in accordance with SA 240\(^{21}\).

**When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence** (Ref: Para. 13)

A20. In certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include where:

- The information available to corroborate management’s assertion(s) is only available outside the entity.
- Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

**Exceptions** (Ref: Para. 14)

A21. Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required by SA 240 to evaluate whether such misstatement is indicative of fraud\(^{22}\). Exceptions may provide a guide to the

\(^{18}\) SA 315, paragraph 31.

\(^{19}\) SA 240, paragraph 24.

\(^{20}\) SA 315, paragraph 31.

\(^{21}\) SA 240, paragraph 24.

\(^{22}\) SA 240, paragraph 35.
quality of responses from similar confirming parties or for similar accounts. Exceptions also may indicate a
deficiency, or deficiencies, in the entity’s internal control over financial reporting.

A22. Some exceptions do not represent misstatements. For example, the auditor may conclude that
differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the
external confirmation procedures.

Negative Confirmations (Ref: Para. 15)

A23. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt
by the intended confirming party of the confirmation request or verification of the accuracy of the information
contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation
request provides significantly less persuasive audit evidence than does a response to a positive confirmation
request. Confirming parties also may be more likely to respond indicating their disagreement with a
confirmation request when the information in the request is not in their favour, and less likely to respond
otherwise. For example, holders of bank deposit accounts may be more likely to respond if they believe that
the balance in their account is understated in the confirmation request, but may be less likely to respond
when they believe the balance is overstated. Therefore, sending negative confirmation requests to holders of
bank deposit accounts may be a useful procedure in considering whether such balances may be
understated, but is unlikely to be effective if the auditor is seeking evidence regarding overstatement.

Evaluating the Evidence Obtained (Ref: Para. 16)

A24. When evaluating the results of individual external confirmation requests, the auditor may categorise
such results as follows:

(a) A response by the appropriate confirming party indicating agreement with the information provided in
the confirmation request, or providing requested information without exception;

(b) A response deemed unreliable;

(c) A non-response; or

(d) A response indicating an exception.

A25. The auditor’s evaluation, when taken into account with other audit procedures the auditor may have
performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been
obtained or whether performing further audit procedures is necessary, as required by SA 33023.

Modifications vis-à-vis ISA 505, “External Confirmations”

SA 505, “External Confirmations” does not contain any modifications vis-à-vis ISA 505.

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Introduction
Scope of this SA
1. This Standard on Auditing (SA) deals with the auditor’s responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in SA 7101 also apply. SA 3002 includes additional requirements and guidance regarding activities prior to starting an initial audit.

Effective Date
2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objective
3. In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:
   (a) Opening balances contain misstatements that materially affect the current period’s financial statements; and
   (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Definitions
4. For the purposes of the SAs, the following terms have the meanings attributed below:
   (a) Initial audit engagement – An engagement in which either:
      (i) The financial statements for the prior period were not audited; or
      (ii) The financial statements for the prior period were audited by a predecessor auditor.
   (b) 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.
   (c) 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.

1 Published in March, 2009 issue of the Journal.
1 SA 710, “Comparative Information- Corresponding Figures and Comparatives Financial Statements”.
2 SA 300, “Planning an Audit of Financial Statements”.

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Requirements
Audit Procedures

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

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

(a) Determining whether the prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year’s Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following: (Ref: Para. A1–A4)
   (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
   (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
   (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

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

Consistency of Accounting Policies
8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Relevant Information in the Predecessor Auditor’s Report
9. If the prior period’s financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period’s financial statements in accordance with SA 315.

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3 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.
4 SA 450, “Evaluation of Misstatements Identified During the Audit”, paragraphs 8 and 12.
5 SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”.

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Audit Conclusions and Reporting

Opening Balances

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.6 (Ref: Para. A5)

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

Consistency of Accounting Policies

12. If the auditor concludes that:

(a) the current period’s accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or

(b) a change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705.

Modification to the Opinion in the Predecessor Auditor’s Report

13. If the predecessor auditor’s opinion regarding the prior period’s financial statements included a modification to the auditor’s opinion that remains relevant and material to the current period’s financial statements, the auditor shall modify the auditor’s opinion on the current period’s financial statements in accordance with SA 705 and SA 710. (Ref: Para. A6)

Application and Other Explanatory Material

Audit Procedures (Ref: Para. 6)

Opening Balances (Ref: Para. 6(c))

A1. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period’s financial statements.
- The significance of the opening balances relative to the current period’s financial statements.
- Whether the prior period’s financial statements were audited and, if so, whether the predecessor auditor’s opinion was modified.

A2. If the prior period’s financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of

6 SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.

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misstatements in opening balances is indicated.

A3. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period’s audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period’s audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

A4. For non-current assets and liabilities, such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening Balances (Ref: Para. 10)

A5. SA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor’s opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor’s report when the auditor’s opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor’s report:

(a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or
(b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations*, and cash flows, where relevant, and unmodified regarding State of Affairs*.

The Appendix includes illustrative auditor’s reports.

Modification to the Opinion in the Predecessor Auditor’s Report (Ref: Para. 13)

A6. In some situations, a modification to the predecessor auditor’s opinion may not be relevant and material to the opinion on the current period’s financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

Material Modifications vis a vis ISA 510, “Initial Audit Engagements - Opening Balances”

Deletions

1. Paragraph 6 (a) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period’s financial statements by determining whether the prior period’s closing balances have been correctly brought forward

* Profit & Loss Account.
* Balance Sheet.
to the current period or, when appropriate, have been restated. 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 6 (c) (i) of ISA 510 dealt with the procedure for obtaining sufficient appropriate audit evidence about the opening balances which contain misstatements that materially affect the current period’s financial statements by reviewing the predecessor auditor’s working papers, where the prior year financial statements were audited. Since in India Clause 1 of Part I of the Second Schedule to the Code of Ethics provides that a Chartered Accountant in Practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, an auditor cannot provide access to his working paper to the another auditor. Therefore, keeping in view the requirements of Code of Ethics, the requirement of reviewing the predecessor auditor’s working papers has been replaced with the requirement of perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements. Corresponding change has also been made in the paragraph A4 of ISA 510 and Paragraphs A1 and A5 have been deleted.

3. Paragraph A2 of ISA 510 dealt with the outsourcing of an audit of a public sector entity by the statutorily appointe auditor to a private sector audit firm. Since in the Indian context such situation does not exist, the paragraph A2 of the application part has been deleted completely.

Appendix

Illustrations of Auditors’ Reports with Modified Opinions*

Illustration 1:

Circumstances described in paragraph A5 (a) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity’s results of operations and cash flows.⁷
- The State of Affairs at year end gives a true and fair view.
- In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs.

⁷ The Reporting Standards may give rise to conforming amendments to the illustrations of auditors’ reports.

⁷ If the possible effects, in the auditor’s judgment, are considered to be material and pervasive to the entity’s results of operations and cash flows, the auditor would disclaim an opinion on the results of operations and cash flows.
INDEPENDENT AUDITOR’S REPORT
[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of financial statements that give a true and fair view in accordance with applicable Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance 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. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of financial statements that give a true and fair view 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. 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.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

8 The sub-title “Report on the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.
9 Depending on the circumstances, this sentence may read: “Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards”.
10 Depending on the circumstances, this sentence may read: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation 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”.
11 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances”. In the case of footnote 13, this sentence may read: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances”.

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Basis for Qualified Opinion
We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion
In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1, and of its Results of Operations and its cash flows for the year then ended in accordance with applicable Accounting Standards.

Other Matters
The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements
[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities].

For ABC and Co.
Chartered Accountants
Firm’s Registration Number
Signature
(Name of the Member Signing the Audit Report)
(Designation12)
Membership Number

Place of Signature
Date

Illustration 2:
Circumstances described in paragraph A5 (b) include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity’s results of operations and cash flows.13
- The State of Affairs at year end gives a true and fair view.
- An opinion that is qualified regarding the results of operations and cash flows and unmodified regarding State of Affairs is considered appropriate in the circumstances.

12 Partner or Proprietor, as the case may be.
13 If the possible effects, in the auditor’s judgment, are considered to be material and pervasive to the entity’s results of operations and cash flows, the auditor would disclaim the opinion on the results of operations and cash flows.
INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at March 31, 20X1, and the Statement of Profit and Loss, and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and presentation of financial statements that give a true and fair view in accordance with applicable Accounting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance 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. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and presentation of financial statements that give a true and fair view 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. 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.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the State of Affairs and our qualified audit opinion on the results of operations and cash flows.

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14 The sub-title “Report on the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.

15 Depending on the circumstances, this sentence may read: “Management is responsible for the preparation and fair presentation of these financial statements in accordance with applicable accounting standards”.

16 Depending on the circumstances, this sentence may read: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation 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”.

17 In circumstances where the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances”. In the case of footnote 19, this sentence may read: “In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and presentation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances”.

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Basis for Qualified Opinion on the results of operations and Cash Flows
We were appointed as auditors of the company on June 30, 20X0 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at March 31, 20X0. Since opening inventories enter into the determination of the results of operations and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the Statement of Profit and Loss and the net cash flows from operating activities reported in the cash flow statement.

Qualified Opinion on the results of operations and Cash Flows
In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the Statement of Profit and Loss and Cash Flow Statement give a true and fair view of the results of operations and cash flows of ABC Company for the year ended March 31, 20X1 in accordance with applicable Accounting Standards.

Opinion on the State of Affairs
In our opinion, the balance sheet gives a true and fair view of the State of Affairs of ABC Company as of March 31, 20X1 in accordance with applicable Accounting Standards.

Other Matters
The financial statements of the Company for the year ended March 31, 20X0, were audited by another auditor whose report dated July 1, 20X0 expressed an unmodified opinion on those statements.

Report on Other Legal and Regulatory Requirements
[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

For ABC and Co.
Chartered Accountants
Firm's Registration Number

Signature
(Name of the Member Signing the Audit Report)
(Designation)
Membership Number

Place of Signature
Date

18 Partner or Proprietor, as the case may be.
SA 520*
Analytical Procedures
(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 use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. The use of analytical procedures as risk assessment procedures is dealt with in SA 315. SA 330 includes requirements and guidance regarding the nature, timing and extent of audit procedures in response to assessed risks; these audit procedures may include substantive analytical procedures.

Effective Date
2. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives
3. The objectives of the auditor are:
   (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
   (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Definition
4. For the purposes of the SAs, the term "analytical procedures" means 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. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.
(Ref: Para. A1-A3)

Requirements
Substantive Analytical Procedures
5. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall: (Ref: Para. A4-A5)
   (a) Determine the suitability of particular substantive analytical procedures for given assertions, taking

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account of the assessed risks of material misstatement and tests of details, if any, for these assertions; (Ref: Para. A6-A11)

(b) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation; (Ref: Para. A12-A14)

(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and (Ref: Para. A15)

(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required by paragraph 7. (Ref: Para. A16)

Analytical Procedures that Assist When Forming an Overall Conclusion

6. The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity. (Ref: Para. A17-A19)

Investigating Results of Analytical Procedures

7. If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(a) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and

(b) Performing other audit procedures as necessary in the circumstances. (Ref: Para. A20-A21)

Application and Other Explanatory Material

Nature of Analytical Procedures (Ref: Para. 4)

A1. Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

A2. Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

A3. Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.
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Substantive Analytical Procedures (Ref: Para. 5)

A4. The auditor’s substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor’s judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

A5. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Suitability of Particular Analytical Procedures for Given Assertions (Ref: Para. 5(a))

A6. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor’s assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

A7. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

A8. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

A9. The determination of the suitability of particular substantive analytical procedures is influenced by the nature of the assertion and the auditor’s assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

A10. Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers’ accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Considerations Specific to Public Sector Entities

A11. The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue
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and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalised, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

The Reliability of the Data (Ref: Para. 5(b))

A12. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

A13. The auditor may consider testing the operating effectiveness of controls, if any, over the entity’s preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

A14. The matters discussed in paragraphs A12(a)-A12(d) are relevant irrespective of whether the auditor performs substantive analytical procedures on the entity’s period end financial statements, or at an interim date and plans to perform substantive analytical procedures for the remaining period. SA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.

Evaluation of Whether the Expectation Is Sufficiently Precise (Ref: Para. 5(c))

A15. Matters relevant to the auditor’s evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one

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5 SA 500, paragraph 10.
6 SA 330, paragraphs 22-23.
period to another than in comparing discretionary expenses, such as research or advertising.

- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

- The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information as discussed in paragraphs A12 - A13 above.

Amount of Difference of Recorded Amounts from Expected Values that Is Acceptable (Ref: Para. 5(d))

A16. The auditor’s determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality\(^7\) and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. SA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor’s assessment of risk\(^1\). Accordingly, as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence\(^9\).

Analytical Procedures that Assist When Forming an Overall Conclusion (Ref: Para. 6)

A17. The conclusions drawn from the results of analytical procedures designed and performed in accordance with paragraph 6 are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the auditor’s opinion.

A18. The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, SA 315 requires the auditor to revise the auditor’s assessment of the risks of material misstatement and modify the further planned audit procedures accordingly\(^10\).

A19. The analytical procedures performed in accordance with paragraph 6 may be similar to those that would be used as risk assessment procedures.

Investigating Results of Analytical Procedures (Ref: Para. 7)

A20. Audit evidence relevant to management’s responses may be obtained by evaluating those responses taking into account the auditor’s understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

A21. The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management’s response, is not considered adequate.

Modifications vis-a-vis ISA 520, “Analytical Procedures”

SA 520, “Analytical Procedures” does not contain any modifications vis-à-vis ISA 520.

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\(^7\) SA 320, “Materiality in Planning and Performing an Audit”, paragraph A13.

\(^8\) SA 330, paragraph 7(b).

\(^9\) SA 330, paragraph A19.

\(^10\) SA 315, paragraph 31.
Analytical Procedures

Trends
Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

Reasonableness
Tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. Examples of accounts that may be reasonably tested are:

- Interest expense against interest bearing obligations
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises

Ratios
Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

Sources of information

- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Bank and cash records
- VAT returns
- Board minutes
- Discussion or correspondence with the client at the year-end
Part I: Engagement and Quality Control Standards

SA 530*
Audit Sampling
(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) applies when the auditor has decided to use audit sampling in performing audit procedures. It deals with the auditor’s use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample.
2. This SA complements SA 500¹, which deals with the auditor’s responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SA 500 provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

Effective Date
3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective
4. The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Definitions
5. For purposes of the SAs, the following terms have the meanings attributed below:
   (a) 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.
   (b) Population – The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
   (c) 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:
      (i) 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.

* Published in February, 2009 issue of the Journal.
¹ SA 500, “Audit Evidence”.

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(ii) 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.

(d) Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para A1)

(e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

(f) Sampling unit – The individual items constituting a population. (Ref: Para A2)

(g) Statistical sampling – An approach to sampling that has the following characteristics:
   (i) Random selection of the sample items; and
   (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

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

(h) 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).

(i) 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. (Ref: Para. A3)

(j) Tolerable 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.

Requirements

Sample Design, Size and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)

7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)

8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)

Performing Audit Procedures

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)

11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)
Nature and Cause of Deviations and Misstatements

12. The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)

13. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Projecting Misstatements

14. For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)

Evaluating Results of Audit Sampling

15. The auditor shall evaluate:
   (a) The results of the sample; and (Ref: Para. A21-A22)
   (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Application and Other Explanatory Material

Definitions

Non-Sampling Risk (Ref: Para. 5(d))

A1. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Sampling Unit (Ref: Para. 5(f))

A2. The sampling units might be physical items (for example, cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors’ balances) or monetary units.

Tolerable Misstatement (Ref: Para. 5(i))

A3. When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in SA 320, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Sample Design, Size and Selection of Items for Testing

Sample Design (Ref: Para. 6)

A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

2 SA 320, “Materiality in Planning and Performing an Audit”, paragraph 9.
A5. When designing an audit sample, the auditor’s consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 8 of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor’s consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor’s understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. Appendix 1 provides further discussion on stratification and value-weighted selection.

A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor’s judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample Size (Ref: Para. 7)

A10. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

A11. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. Appendices 2 and 3 indicate the influences that various factors typically have on the determination of sample size. When circumstances are similar, the effect on sample size of factors such as those identified in Appendices 2 and 3 will be similar regardless of whether a statistical or non-statistical approach is chosen.

Selection of Items for Testing (Ref: Para. 8)

A12. With statistical sampling, sample items are selected in a way that each sampling unit has a known probability of being selected. With non-statistical sampling, judgment is used to select sample items. Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative
sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

A13. The principal methods of selecting samples are the use of random selection, systematic selection and haphazard selection. Each of these methods is discussed in Appendix 4.

**Performing Audit Procedures** (Ref: Para. 10-11)

A14. An example of when it is necessary to perform the procedure on a replacement item is when a cancelled cheque is selected while testing for evidence of payment authorisation. If the auditor is satisfied that the cheque has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined.

A15. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost.

A16. An example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence of their source and the items they are intended to settle when no reply has been received in response to a positive confirmation request.

**Nature and Cause of Deviations and Misstatements** (Ref: Para. 12)

A17. In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

**Projecting Misstatements** (Ref: Para. 14)

A18. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

A19. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

A20. For tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole. SA 330 provides guidance when deviations from controls upon which the auditor intends to rely are detected.

**Evaluating Results of Audit Sampling** (Ref: Para. 15)

A21. For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

A22. In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor’s best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population.

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population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor’s expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

A23. If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Material Modifications vis a vis ISA 530, “Audit Sampling”
SA 530, “Audit Sampling” does not contain any material modifications vis à vis ISA 530.

Appendix 1
(Ref: Para. A8)

Stratification and Value-Weighted Selection

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. This Appendix provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.
Value-Weighted Selection
5. When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes. This approach may be used in conjunction with the systematic method of sample selection (described in Appendix 4) and is most efficient when selecting items using random selection.

Appendix 2
(Ref: Para. A11)

Examples of Factors Influencing Sample Size for Tests of Controls
The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

<table>
<thead>
<tr>
<th>FACTOR</th>
<th>EFFECT ON SAMPLE SIZE</th>
<th>EFFECT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. An increase in the extent to which the auditor’s risk assessment takes into account relevant controls</td>
<td>Increase</td>
<td>The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor’s assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor’s assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor’s tests of controls (and therefore, the sample size is increased).</td>
</tr>
<tr>
<td>2. An increase in the tolerable rate of deviation</td>
<td>Decrease</td>
<td>The lower the tolerable rate of deviation, the larger the sample size needs to be.</td>
</tr>
<tr>
<td>3. An increase in the expected rate of deviation of the population to be tested</td>
<td>Increase</td>
<td>The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor’s consideration of the expected rate of deviation include the auditor’s understanding of the business (in particular, risk assessment procedures</td>
</tr>
</tbody>
</table>
undertaken to obtain an understanding of internal control, changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

4. An increase in the auditor’s desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population

<table>
<thead>
<tr>
<th>EFFECT ON SAMPLE SIZE</th>
<th>FACTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase</td>
<td>1. An increase in the auditor’s assessment of the risk of material misstatement</td>
</tr>
</tbody>
</table>

The greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

5. An increase in the number of sampling units in the population

<table>
<thead>
<tr>
<th>EFFECT ON SAMPLE SIZE</th>
<th>FACTOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negligible effect</td>
<td>5. An increase in the number of sampling units in the population</td>
</tr>
</tbody>
</table>

For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence.

### Appendix 3

(Ref: Para. A11)

#### Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

<table>
<thead>
<tr>
<th>FACTOR</th>
<th>EFFECT ON SAMPLE SIZE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. An increase in the auditor’s assessment of</td>
<td>Increase</td>
</tr>
<tr>
<td>the risk of material misstatement</td>
<td></td>
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</tbody>
</table>

The higher the auditor’s assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor’s assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor’s risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
### Part I: Engagement and Quality Control Standards

<table>
<thead>
<tr>
<th>2. An increase in the use of other substantive procedures directed at the same assertion</th>
<th>Decrease</th>
<th>The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. An increase in the auditor’s desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population</td>
<td>Increase</td>
<td>The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.</td>
</tr>
<tr>
<td>4. An increase in tolerable misstatement</td>
<td>Decrease</td>
<td>The lower the tolerable misstatement, the larger the sample size needs to be.</td>
</tr>
<tr>
<td>5. An increase in the amount of misstatement the auditor expects to find in the population</td>
<td>Increase</td>
<td>The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population. Factors relevant to the auditor’s consideration of the expected misstatement amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.</td>
</tr>
<tr>
<td>6. Stratification of the population when appropriate</td>
<td>Decrease</td>
<td>When there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.</td>
</tr>
<tr>
<td>7. The number of sampling units in the population</td>
<td>Negligible effect</td>
<td>For large populations, the actual size of the population has little, if any, effect on sample size. Thus, for small populations, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence. (However, when using monetary unit sampling, an increase in the monetary value of the population increases sample size, unless this is offset by a proportional increase in materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures).</td>
</tr>
</tbody>
</table>
Appendix 4
(Ref: Para. A13)

Sample Selection Methods

There are many methods of selecting samples. The principal methods are as follows:

(a) Random selection (applied through random number generators, for example, random number tables).

(b) Systematic selection, 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 50\textsuperscript{th} sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

(c) Monetary Unit Sampling is a type of value-weighted selection (as described in Appendix 1) in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.
Part I: Engagement and Quality Control Standards

SA 540*

Auditing Accounting Estimates, Including Fair
Value Accounting Estimates, and Related
Disclosures
(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 regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 3151 and SA 3302 and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: Para. A1-A11)

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as “marketplace participants” or equivalent) in an arm’s length transaction, rather than the settlement of a transaction at some past or future date.3

4. A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is

1 Published in February, 2009 issue of the Journal.
2 SA 330, “The Auditor’s Responses to Assessed Risks”.
3 Different definitions of fair value may exist among financial reporting frameworks.
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invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Effective Date
5. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

Objective
6. The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:
   (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
   (b) related disclosures in the financial statements are adequate.

Definitions
7. For purposes of the SAs, the following terms have the meanings attributed below:
   (a) 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 this SA addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.
   (b) 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.
   (c) Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
   (d) Management bias – A lack of neutrality by management in the preparation and presentation of information.
   (e) Management’s point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
   (f) 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.

Requirements
Risk Assessment Procedures and Related Activities
8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity’s internal control, as required by SA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)
   (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13-A15)
   (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that

4 SA 315, paragraphs 5-6 and 11-12.
may give rise to new, or the need to revise existing, accounting estimates. *(Ref: Para. A16-A21)*

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: *(Ref: Para. A22-A23)*

(i) The method, including where applicable the model, used in making the accounting estimate; *(Ref: Para. A24-A26)*

(ii) Relevant controls; *(Ref: Para. A27-A28)*

(iii) Whether management has used an expert; *(Ref: Para. A29-A30)*

(iv) The assumptions underlying the accounting estimates; *(Ref: Para. A31-A36)*

(v) 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; and *(Ref: Para. A37)*

(vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. *(Ref: Para. A38)*

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor’s review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. *(Ref: Para. A39-A44)*

**Identifying and Assessing the Risks of Material Misstatement**

10. In identifying and assessing the risks of material misstatement, as required by SA 315, the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. *(Ref: Para. A45-A46)*

11. The auditor shall determine whether, in the auditor’s judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. *(Ref: Para. A47-A51)*

**Responses to the Assessed Risks of Material Misstatement**

12. Based on the assessed risks of material misstatement, the auditor shall determine: *(Ref: Para. A52)*

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and *(Ref: Para. A53-A56)*

(b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. *(Ref: Para. A57-A58)*

13. In responding to the assessed risks of material misstatement, as required by SA 330, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: *(Ref: Para. A59-A61)*

(a) Determine whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate. *(Ref: Para. A62-A67)*

(b) Test how management made the accounting estimate and the data on which it is based. In doing so,

5 SA 315, paragraph 25.

6 SA 330, paragraph 5.
the auditor shall evaluate whether: (Ref: Para. A68-A70)

(i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71-A76)

(ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77-A83)

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84- A86)

(d) Develop a point estimate or a range to evaluate management’s point estimate. For this purpose: (Ref: Para. A87-A91)

(i) When the auditor uses assumptions or methods that differ from management’s, the auditor shall obtain an understanding of management’s assumptions or methods sufficient to establish that the auditor’s point estimate or range takes into account relevant variables and to evaluate any significant differences from management’s point estimate. (Ref: Para. A92)

(ii) When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93-A95)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialised skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96-A101)

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, the auditor shall evaluate the following: (Ref: Para. A102)

(a) 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. (Ref: Para. A103-A106)

(b) Whether the significant assumptions used by management are reasonable. (Ref: Para A107-A109)

(c) 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. (Ref: Para. A110)

16. If, in the auditor’s judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:

(a) management’s decision to recognise, or to not recognise, the accounting estimates in the financial

7 SA 330, paragraph 18.
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(b) the selected measurement basis for the accounting estimates. (Ref: Para. A115)

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable. (Ref: Para. A126-A127)

Documentation

23. The audit documentation shall include:

(a) The basis for the auditor’s conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and

(b) Indicators of possible management bias, if any. (Ref: Para. A128)

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this SA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
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- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as “observable” in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
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- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A11. Certain entities such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Often specialised assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this SA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:
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- Prescribes certain conditions for the recognition, or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability.
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome. Others may require, for example, use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting estimate to be recognised in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: Para. 8(b))

A16. In preparing the financial statements, management has the responsibility to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:
- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting

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8 Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognise such items, including accounting estimates.

9 Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.
estimates as necessary. The completeness of accounting estimates is often an important consideration for the auditor particularly accounting estimates relating to liabilities.

A18. The auditor’s understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:
- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity’s risk assessment processes.10

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly.

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. Management is responsible for establishing financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:
- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:
- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).

10 SA 315, paragraph 16.
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- Whether and, if so, how management has used recognised measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management selects a particular method considering the nature of the asset or liability being estimated.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular industry or environment.

Relevant Controls (Ref: Para. 8(c)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity’s proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model.
- The maintenance and periodic validation of the integrity of the model.
Management’s Use of Experts (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialised nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.
- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

Considerations Specific to Smaller Entities

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset’s useful life), and how they conform to the entity’s business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management’s assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what
knowledgeable, willing arm’s length parties (sometimes referred to as “marketplace participants” or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

(a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as “observable inputs” or equivalent).

(b) Those that reflect the entity’s own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as “unobservable inputs” or equivalent). In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor’s assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management’s assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:
Information regarding the effectiveness of management’s prior period estimation process, from which the auditor can judge the likely effectiveness of management’s current process.

Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.

Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor’s professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by SA 240.11 That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this SA may be carried out in conjunction with the review required by SA 240.

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognised in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor’s consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management’s prior estimation process, that is, management’s track record, from which the auditor can judge the likely effectiveness of management’s current process.

A44. A difference between the outcome of an accounting estimate and the amount recognised in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period’s financial statements were finalised, or that could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Identifying and Assessing the Risks of Material Misstatement

**Estimation Uncertainty** (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate’s susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management’s point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

**High Estimation Uncertainty and Significant Risks** (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor’s review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognised or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognised, or whether it should be measured at fair
value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. Where the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity’s controls, including control activities.\(^{12}\)

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity’s ability to continue as a going concern. SA 570 \(^{13}\) establishes requirements and provides guidance in such circumstances.

**Responses to the Assessed Risks of Material Misstatement** (Ref: Para. 12)

A52. SA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.\(^{14}\) Paragraphs A53-A115 focus on specific responses at the assertion level only.

**Application of the Requirements of the Applicable Financial Reporting Framework** (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor’s attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor’s understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

**Consistency in Methods and Basis for Changes** (Ref: Para. 12(b))

A57. The auditor’s consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management’s contention that there has been

\(^{12}\) SA 315, paragraph 29.

\(^{13}\) SA 570, “Going Concern”.

\(^{14}\) SA 330, paragraphs 5-6.
a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

**Responses to the Assessed Risks of Material Misstatements** (Ref: Para. 13)

A59. The auditor’s decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non-routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

**Events Occurring Up to the Date of the Auditor’s Report** (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor’s report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realisable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor’s report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with SA 560\(^{15}\). The auditor is required to perform audit

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\(^{15}\) Standard on Auditing (SA) 560, “Subsequent Events”.
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procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified\(^{16}\) and appropriately reflected in the financial statements.\(^{17}\) Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor’s work under SA 560 is particularly relevant.

Considerations Specific to Smaller Entities

A67. When there is a longer period between the balance sheet date and the date of the auditor’s report, the auditor’s review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner-managed entities, especially when management does not have formalised control procedures over accounting estimates.

Testing how Management made the Accounting Estimate (Ref: Para. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity’s accounting system.
- The auditor’s review of similar accounting estimates made in the prior period financial statements suggests that management’s current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Re-calculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.
- Considering management’s review and approval processes.

Considerations Specific to Smaller Entities

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the Method of Measurement (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a

\(^{16}\) SA 560, paragraph 6.
\(^{17}\) SA 560, paragraph 7.
A72. For this purpose, matters that the auditor may consider include, for example, whether:

- Management’s rationale for the method selected is reasonable.
- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.
- The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.
- The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

**Evaluating the use of Models**

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity’s validation process may include evaluation of:
  - The model’s theoretical soundness and mathematical integrity, including the appropriateness of model parameters.
  - The consistency and completeness of the model’s inputs with market practices.
  - The model’s output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented; including the model’s intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

**Assumptions Used by Management** (Ref: Para. 13(b)(ii))

A77. The auditor’s evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context of the audit of the entity’s financial statements, and not for the purpose of providing
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an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity’s economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management’s intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management’s intent and ability is a matter of professional judgment, the auditor’s procedures may include the following:

- Review of management’s history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorisations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor’s report.
- Evaluation of the entity’s ability to carry out a particular course of action given the entity’s economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management’s intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market specific inputs into the development of assumptions.
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- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:
- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.
- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor’s evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management’s process has been well-designed, implemented and maintained, for example:
- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity’s accounting system.

A85. Testing the operating effectiveness of the controls is required when:
(a) The auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or
(b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.\(^{18}\)

Considerations Specific to Smaller Entities

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the

\(^{18}\) SA 330, paragraph 8.
formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor’s response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

*Developing a Point Estimate or Range (Ref: Para. 13(d))*

A87. Developing a point estimate or a range to evaluate management’s point estimate may be an appropriate response when, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor’s review of similar accounting estimates made in the prior period financial statements suggests that management’s current period process is unlikely to be effective.
- The entity’s controls within and over management’s processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor’s report contradict management’s point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in making a point estimate or a range.

A88. Even when the entity’s controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management’s point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to make a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management’s consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialised expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.
Understanding Management’s Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor’s development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management’s point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management’s point estimate (the auditor’s range), paragraph 13(d)(ii) requires that range to encompass all “reasonable outcomes” rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor’s range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management’s point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and

(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering whether Specialised Skills or Knowledge are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement. This may include, as necessary, the involvement of those with specialised skills or knowledge. In addition, SA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor’s external experts, collectively have the appropriate capabilities, competence and time to perform the audit engagement. During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialised skills or knowledge to be applied in relation to one or more aspects of

19 SA 300, “Planning an Audit of Financial Statements”, paragraph 7(e).
the accounting estimates.

A97. Matters that may affect the auditor’s consideration of whether specialised skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).
- A high degree of estimation uncertainty.
- Complex calculations or specialised models are involved, for example, when estimating fair values when there is no observable market.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialised skills or knowledge will be required. For example, it is unlikely that specialised skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialised skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. SA 620 establishes requirements and provides guidance in determining the need to employ or engage an auditor’s expert and the auditor’s responsibilities when using the work of an auditor’s expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialised skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor’s firm or engaged from an external organisation outside of the auditor’s firm. When such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in SA 220.

A101. Depending on the auditor’s understanding and experience of working with the auditor’s expert or those other individuals with specialised skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor’s further substantive procedures are focused on the evaluation of:

(a) How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and

(b) The adequacy of related disclosures.

Estimation Uncertainty

Management’s Consideration of Estimation Uncertainty (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies
with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterised as a range of outcomes by management, such as “pessimistic” and “optimistic” scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor’s attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management’s consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

**Considerations Specific to Smaller Entities**

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor’s review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation and presentation of the financial statements.

**Significant Assumptions** *(Ref: Para. 15(b))*

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management’s knowledge may be obtained from management’s continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor’s considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

**Management Intent and Ability** *(Ref: Para. 15(c))*

A110. The auditor’s considerations in relation to assumptions made by management and management’s intent and ability are described in paragraphs A13 and A80.

**Development of a Range** *(Ref: Para. 16)*

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor’s judgment:
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- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 17(a))

A113. Where management has recognised an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognised, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognised, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. The auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. SA 706 establishes requirements and provides guidance concerning such paragraphs.

Measurement Basis for the Accounting Estimates (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements (Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).


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A118. SA 450 provides guidance on distinguishing misstatements for purposes of the auditor’s evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management’s judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- 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 (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognised in the financial statements.

Disclosures Related to Accounting Estimates

Disclosures in accordance with the Applicable Financial Reporting Framework (Ref: Para. 19)

A120. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognised or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates”.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the

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23 SA 450, “Evaluation of Misstatements Identified during the Audit”.
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entity's financial position and performance.

- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.

- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel, including credit risk, liquidity risk and market risk.

Disclosures of Estimation Uncertainty for Accounting Estimates that give Rise to Significant Risks

(Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor’s evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A95 & A94).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. SA 705 provides guidance on the implications for the auditor’s report when the auditor believes that management’s disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

Indicators of Possible Management Bias

(Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor’s conclusion as to whether the auditor’s risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor’s evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in Revised SA 700.

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.

- Use of an entity’s own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.

- Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.

- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Written Representations

(Ref: Para. 22)

A126. SA 580 discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models,
used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

- That the assumptions appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity’s applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor’s risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

Material Modifications vis a vis ISA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”

Deletions

1. Paragraph A11 of the Application Section of ISA 540 deals with the application of the requirements of ISA 540 to the audits of public sector entities regarding significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. 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 non-public sector entities, may have significant holdings of specialised assets for which there are no readily available and reliable sources of information for purposes of measurement. Accordingly, the spirit of erstwhile A11, highlighting the fact that in case of certain entities, there may be a requirement of estimation at fair value in case of specialised assets, has been retained.
Appendix

(Ref: Para. A1)

Fair Value Measurements and Disclosures Under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Accounting Standard (AS) 30 defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as “entity-specific value,” “value in use,” or similar terms, but may still fall within the concept of fair value in this SA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management’s intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:
   - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;
   - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;
   - Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;
   - Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or
   - Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly “observable inputs” based on quoted prices and active markets and those “unobservable inputs” that involve an entity’s own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property’s condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management’s plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

**Prevalence of Fair Value Measurements**

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically “marked-to-market”.

- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.

- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.

- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting
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frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity’s or unit’s group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.

- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity’s applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.

- Information disclosed in notes to financial statements or presented as supplementary information, but not recognised in the financial statements.
Introduction

Scope of this SA
1. This Standard on Auditing (SA) deals with the auditor’s responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how SA 315, SA 330 and SA 240 are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

Nature of Related Party Relationships and Transactions
2. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:
   - Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
   - Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
   - Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Responsibilities of the Auditor
3. Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity’s failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework.
4. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity’s related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as

* Published in March, 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”.
3 SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”.

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they are affected by those relationships and transactions: (Ref: Para. A1)

(a) Achieve a true and fair presentation (for fair presentation frameworks); or (Ref: Para. A2)

(b) Are not misleading (for compliance frameworks). (Ref: Para. A3)

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

6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor’s ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

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

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

Objectives

9. The objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

(ii) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

a. Achieve a true and fair presentation (for fair presentation frameworks); or

b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements.

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4 SA 240, paragraph 24.
5 SA 200, paragraph A52.
6 SA 200, paragraph 15.
Definitions
10. For purposes of the SAs, the following terms have the meanings attributed below:
   (a) 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.
   (b) Related party – A party that is either: (Ref: Para. A4-A7)
      (i) A related party as defined in the applicable financial reporting framework; or
      (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
          a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
          b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
          c. Another entity that is under common control with the reporting entity through having:
             i. Common controlling ownership;
             ii. Owners who are close family members; or
             iii. Common key management.

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

Requirements
Risk Assessment Procedures and Related Activities
11. As part of the risk assessment procedures and related activities that SA 315 and SA 240 require the auditor to perform during the audit, the auditor shall perform the audit procedures and related activities set out in paragraphs 12-17 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (Ref: Para. A8)

Understanding the Entity’s Related Party Relationships and Transactions
12. The engagement team discussion that SA 315 and SA 240 require shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity’s related party relationships and transactions. (Ref: Para. A9-A10)
13. The auditor shall inquire of management regarding:
   (a) The identity of the entity’s related parties, including changes from the prior period; (Ref: Para. A11-A14)
   (b) The nature of the relationships between the entity and these related parties; and

7 In Indian context, definitions of “Related Party” and “Related Party Transactions” as given in Accounting Standard (AS) 18, “Related Party Disclosures”, issued by the Institute of Chartered Accountants of India, will be applicable for the purposes of this SA, and the said definitions also meet the tests laid down in paragraph 10(b)(ii) of this SA.
8 SA 315, paragraph 5; and SA 240, paragraph 16.
9 SA 315, paragraph 10; and SA 240, paragraph 15.
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(c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

14. The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to: (Ref: Para. A15-A20)

(a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;

(b) Authorise and approve significant transactions and arrangements with related parties; and (Ref: Para. A21)

(c) Authorise and approve significant transactions and arrangements outside the normal course of business.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

15. During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. (Ref: Para. A22-A23) In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank, legal and third party confirmations obtained as part of the auditor’s procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

16. If the auditor identifies significant transactions outside the entity’s normal course of business when performing the audit procedures required by paragraph 15 or through other audit procedures, the auditor shall inquire of management about: (Ref: Para. A24-A25)

(a) The nature of these transactions; and (Ref: Para. A26)

(b) Whether related parties could be involved. (Ref: Para. A27)

Sharing Related Party Information with the Engagement Team

17. The auditor shall share relevant information obtained about the entity’s related parties with the other members of the engagement team. (Ref: Para. A28)

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

18. In meeting the SA 315 requirement to identify and assess the risks of material misstatement, the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity’s normal course of business as giving rise to significant risks.

19. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing

10 SA 315, paragraph 25.
I.370  Auditing Pronouncements

the risks of material misstatement due to fraud in accordance with SA 240. (Ref: Para. A6 and A29-A30)

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

20. As part of the SA 330 requirement that the auditor respond to assessed risks, the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24. (Ref: Para. A31-A34)

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

21. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

22. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

(a) Promptly communicate the relevant information to the other members of the engagement team; (Ref: Para. A35)

(b) Where the applicable financial reporting framework establishes related party requirements:

(i) Request management to identify all transactions with the newly identified related parties for the auditor’s further evaluation; and

(ii) Inquire as to why the entity’s controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;

(c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions; (Ref: Para. A36)

(d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and

(e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. (Ref: Para. A37)

Identified Significant Related Party Transactions outside the Entity’s Normal Course of Business

23. For identified significant related party transactions outside the entity's normal course of business, the auditor shall:

(a) Inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) The business rationale (or 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. A38-A39)

(ii) The terms of the transactions are consistent with management’s explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the

11 SA 330, paragraphs 5-6.
12 SA 240, paragraph 32(c).
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applicable financial reporting framework; and
(b) Obtain audit evidence that the transactions have been appropriately authorised and approved. (Ref: Para. A40-A41)

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm’s Length Transaction

24. When management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm’s length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. A42-A45)

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

25. In forming an opinion on the financial statements in accordance with SA 700, the auditor shall evaluate: (Ref: Para. A46)
(a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and (Ref: Para. A47)
(b) Whether the effects of the related party relationships and transactions:
   (i) Prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or
   (ii) Cause the financial statements to be misleading (for compliance frameworks).

Written Representations

26. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48-A49)
(a) They have disclosed to the auditor the identity of the entity’s related parties and all the related party relationships and transactions of which they are aware; and
(b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Communication with Those Charged with Governance

27. Unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity’s related parties. (Ref: Para. A50)

Documentation

28. In meeting the documentation requirements of SA 230 and other SAs, the auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

14 SA 260, paragraph 12 (c).
15 SA 230, “Audit Documentation”.

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Application and Other Explanatory Material

Responsibilities of the Auditor

Financial Reporting Frameworks That Establish Minimal Related Party Requirements (Ref: Para. 4)

A1. An applicable financial reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but that definition has a substantially narrower scope than the definition set out in paragraph 10(b)(ii) of this SA, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions.

Fair Presentation Frameworks (Ref: Para. 4(a))

A2. In the context of a fair presentation framework, related party relationships and transactions may cause the financial statements to fail to achieve true and fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, true and fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend.

Compliance Frameworks (Ref: Para. 4(b))

A3. In the context of a compliance framework, whether related party relationships and transactions cause the financial statements to be misleading as discussed in SA 700 depends upon the particular circumstances of the engagement. For example, even if non-disclosure of related party transactions in the financial statements is in compliance with the framework and applicable law or regulation, the financial statements could be misleading if the entity derives a very substantial portion of its revenue from transactions with related parties, and that fact is not disclosed. However, it will be extremely rare for the auditor to consider financial statements that are prepared and presented in accordance with a compliance framework to be misleading if in accordance with SA 210 the auditor determined that the framework is acceptable.

Definition of a Related Party (Ref: Para. 10(b))

A4. Many financial reporting frameworks discuss the concepts of control and significant influence. Although they may discuss these concepts using different terms, they generally explain that:

(a) Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and

(b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies.

A5. The existence of the following relationships may indicate the presence of control or significant influence:

(a) Direct or indirect equity holdings or other financial interests in the entity.

(b) The entity’s holdings of direct or indirect equity or other financial interests in other entities.

(c) Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).

16 SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, paragraph 13 (a), defines the meaning of fair presentation and compliance frameworks.

17 SA 210, “Agreeing the Terms of Audit Engagements”, paragraph 4(a).

(d) Being a close family member of any person referred to in subparagraph (c).
(e) Having a significant business relationship with any person referred to in subparagraph (c).

**Related Parties with Dominant Influence**

A6. Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs A29-A30.

**Special-Purpose Entities as Related Parties**

A7. In some circumstances, a special-purpose entity\(^{19}\) may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity’s equity.

**Risk Assessment Procedures and Related Activities**

**Risks of Material Misstatement Associated with Related Party Relationships and Transactions** (Ref: Para. 11)

A8. In case of certain entities, auditor’s responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. Consequently, in such cases the auditor’s responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing such entities that lay down specific requirements in the conduct of business with related parties. Further, in such cases the auditor may need to have regard to any specific financial reporting requirements for related party relationships and transactions that may differ from other entities.

**Understanding the Entity’s Related Party Relationships and Transactions**

**Discussion among the Engagement Team** (Ref: Para. 12)

A9. Matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity’s relationships and transactions with related parties (using, for example, the auditor’s record of identified related parties updated after each audit).
- An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).
- The records or documents that may indicate the existence of related party relationships or transactions.
- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

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\(^{19}\) SA 315, paragraphs A26-A27, provides guidance regarding the nature of a special-purpose entity.
A10. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

- How special-purpose entities controlled by management might be used to facilitate earnings management.
- How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity’s assets.

The Identity of the Entity’s Related Parties (Ref: Para. 13(a))

A11. Where the applicable financial reporting framework establishes related party requirements, information regarding the identity of the entity’s related parties is likely to be readily available to management because the entity’s information systems will need to record, process and summarise related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of the framework. Management is therefore likely to have a comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the auditor’s record of related parties noted in previous audits.

A12. However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 still applies because management may be aware of parties that meet the related party definition set out in this SA.

In such a case, however, the auditor’s inquiries regarding the identity of the entity’s related parties are likely to form part of the auditor’s risk assessment procedures and related activities performed in accordance with SA 315 to obtain information regarding:

- The entity’s ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the auditor’s inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

A13. In the context of a group audit, SA 600 requires the group engagement team to provide each component auditor with a list of related parties prepared by group management and any other related parties of which the group engagement team is aware. Where the entity is a component within a group, this information provides a useful basis for the auditor’s inquiries of management regarding the identity of the entity’s related parties.

A14. The auditor may also obtain some information regarding the identity of the entity’s related parties through inquiries of management during the engagement acceptance or continuance process.

The Entity’s Controls over Related Party Relationships and Transactions (Ref: Para. 14)

A15. Others within the entity are those considered likely to have knowledge of the entity’s related party relationships and transactions, and the entity’s controls over such relationships and transactions. These may

20 Currently, SA 600, ‘Using the Work of Another Auditor’ is in force. The standard is being revised in light of the corresponding international standard.
include, to the extent that they do not form part of management:

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel;
- Internal auditors;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A16. The audit is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, and 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.\(^1\) Accordingly, where the framework establishes related party requirements, management, with oversight from those charged with governance, is responsible for the design, implementation and maintenance of adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance are responsible for monitoring how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in order to fulfill their oversight responsibilities, obtain information from management to enable them to understand the nature and business rationale of the entity’s related party relationships and transactions.

A17. In meeting the SA 315 requirement to obtain an understanding of the control environment,\(^2\) the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity’s personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarising, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity’s normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by internal auditors, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.

\(^1\) SA 200, paragraph A2.
\(^2\) SA 315, paragraph 14.
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- The existence of whistle-blowing policies and procedures, where applicable.

A18. Controls over related party relationships and transactions within some entities may be deficient or non-existent for a number of reasons, such as:
- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, for example, the existence of transactions involving family members of management.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case, the auditor would, in accordance with SA 705\textsuperscript{23}, consider the implications for the audit, including the auditor’s report.

A19. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.\textsuperscript{24} The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management’s financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions for the benefit of these parties, or (b) colluding with such parties or controlling their actions. Examples of possible fraud include:
- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

Considerations specific to smaller entities

A20. Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists. Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management’s oversight and review activities, and inspection of

\textsuperscript{23}SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.
\textsuperscript{24}SA 240, paragraphs 31 and A4.
A21. Authorisation involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity’s shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not. Approval involves those parties’ acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorisation was granted. Examples of controls the entity may have established to authorise and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include:

- Monitoring controls to identify such transactions and arrangements for authorisation and approval.
- Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance or, where applicable, shareholders.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

Records or Documents That the Auditor May Inspect (Ref: Para. 15)

A22. During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity’s principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity’s investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity’s ordinary course of business.
- Specific invoices and correspondence from the entity’s professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors’ reports.
- Documents associated with the entity’s filings with a securities regulator (e.g., prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions

A23. An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.
- The provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.
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- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity’s normal course of business.
- Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business (Ref: Para. 16)

A24. Obtaining further information on significant transactions outside the entity’s normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

A25. Examples of transactions outside the entity’s normal course of business may include:
- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business (Ref: Para. 16(a))

A26. Inquiring into the nature of the significant transactions outside the entity’s normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

Inquiring into whether related parties could be involved (Ref: Para. 16(b))

A27. A related party could be involved in a significant transaction outside the entity’s normal course of business not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

Sharing Related Party Information with the Engagement Team (Ref: Para. 17)

A28. Relevant related party information that may be shared among the engagement team members includes, for example:
- The identity of the entity’s related parties.
- The nature of the related party relationships and transactions.
- Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are financially involved.

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

Fraud Risk Factors Associated with a Related Party with Dominant Influence (Ref: Para. 19)

A29. Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor.25 Indicators of dominant influence exerted by a related party include:

25 SA 240, Appendix 1.

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The related party has vetoed significant business decisions taken by management or those charged with governance.

Significant transactions are referred to the related party for final approval.

There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.

Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence may also exist in some cases if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

A30. In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example:

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.
- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the related party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 20)

A31. The nature, timing and extent of the further audit procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.

A32. Examples of substantive audit procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.
- Confirming the purposes, specific terms or amounts of the transactions with the related parties (this audit procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).
- Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties’ accounting records.

A33. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements

26 SA 330 provides further guidance on considering the nature, timing and extent of further audit procedures. SA 240 establishes requirements and provides guidance on appropriate responses to assessed risks of material misstatement due to fraud.
of SA 240, perform audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

- Inquiries of, and discussion with, management and those charged with governance.
- Inquiries of the related party.
- Inspection of significant contracts with the related party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of employee whistle-blowing reports where these are retained.

Depending upon the results of the auditor’s risk assessment procedures, the auditor may consider it appropriate to obtain audit evidence without testing the entity’s controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the SA 330 requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, the auditor is required to test the entity’s controls over the completeness and accuracy of the recording of the related party relationships and transactions.

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

Communicating Newly Identified Related Party Information to the Engagement Team (Ref: Para. 22(a))

A35. Communicating promptly any newly identified related parties to the other members of the engagement team assists them in determining whether this information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: Para. 22(c))

A36. Examples of substantive audit procedures that the auditor may perform relating to newly identified related parties or significant related party transactions include:

- Making inquiries regarding the nature of the entity’s relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, guarantors, or other close business partners.
- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.
- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been appropriately accounted for and disclosed in accordance with the

27 SA 330, paragraph 8(b).
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applicable financial reporting framework.

Intentional Non-Disclosure by Management (Ref: Para. 22(e))

A37. The requirements and guidance in SA 240 regarding the auditor’s responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management’s responses to the auditor’s inquiries and management’s representations to the auditor.

Identified Significant Related Party Transactions outside the Entity’s Normal Course of Business

Evaluating the Business Rationale of Significant Related Party Transactions (Ref: Para. 23)

A38. In evaluating the business rationale of a significant related party transaction outside the entity’s normal course of business, the auditor may consider the following:

- Whether the transaction:
  - Is overly complex (e.g., it may involve multiple related parties within a consolidated group).
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
  - Lacks an apparent logical business reason for its occurrence.
  - Involves previously unidentified related parties.
  - Is processed in an unusual manner.

- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.

- Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction.

If management’s explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with SA 500, to consider the reliability of management’s explanations and representations on other significant matters.

A39. The auditor may also seek to understand the business rationale of such a transaction from the related party’s perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party’s perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Authorization and Approval of Significant Related Party Transactions (Ref: Para. 23(b))

A40. Authorisation and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity’s normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorisation and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to error or fraud. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorisation and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorisation and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to

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the dominant influence of a related party.

**Considerations specific to smaller entities**

A41. A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity’s normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager’s involvement with the transactions.

**Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm’s Length Transaction** (Ref: Para. 24)

A42. Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm’s length transaction, there are ordinarily practical difficulties that limit the auditor’s ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm’s length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management’s assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm’s length transaction may be materially misstated.

A43. Management is responsible for the substantiation of an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm’s length transaction. Management’s support for the assertion may include:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

A44. Evaluating management’s support for this assertion may involve one or more of the following:

- Considering the appropriateness of management’s process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

A45. Some financial reporting frameworks require the disclosure of related party transactions not conducted on terms equivalent to those prevailing in arm’s length transactions. In these circumstances, if management has not disclosed a related party transaction in the financial statements, there may be an implicit assertion that the transaction was conducted on terms equivalent to those prevailing in an arm’s length transaction.

**Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions**

**Materiality Considerations in Evaluating Misstatements** (Ref: Para. 25)

A46. SA 450 requires the auditor to consider both the size and the nature of a misstatement, and the
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I. Particular circumstances of its occurrence, when evaluating whether the misstatement is material. The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.

Evaluation of Related Party Disclosures (Ref: Para. 25(a))

A47. Evaluating the related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity’s related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

(a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or

(b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

Written Representations (Ref: Para. 26)

A48. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
- When they have made specific oral representations to the auditor on details of certain related party transactions.
- When they have financial or other interests in the related parties or the related party transactions.
- Management’s assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm’s length transaction.

A49. The auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

Communication with Those Charged with Governance (Ref: Para. 27)

A50. Communicating significant matters arising during the audit in connection with the entity’s related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include:

- Non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware.
- The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud.
- Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable financial reporting framework.

29 SA 450, “Evaluation of Misstatements Identified during the Audit,” paragraph 11(a). Paragraph A16 of SA 450 provides guidance on the circumstances that may affect the evaluation of a misstatement.

30 SA 230, “Audit Documentation”, paragraph A8 provides further guidance on the nature of significant matters arising during the audit.
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- Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions.
- Difficulties in identifying the party that ultimately controls the entity.

Material Modifications vis a vis ISA 550, “Related Parties”

Additions

1. In paragraph A20 of the Application Section, the lines, “Control environment in smaller entities is likely to be different from larger entities. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists” have been added so to explain the difference between the control environment in the larger entities and smaller entities.

2. In paragraph A48 of the Application Section, it has been added that a written representation may be obtained by the auditor regarding management’s assertion of responsibility that related party transactions were conducted on terms equivalent to those prevailing in an arm’s length transaction.

Deletions

1. Paragraph A8 of the Application Section of ISA 550 deals with the application of the requirement of ISA 550 to the audits of public sector entities regarding the effect of laws and regulations governing the public sector bodies on the auditor’s responsibilities with regard to related party relationships and transactions. 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 certain entities, the laws and regulations may also include a broader responsibility to address the risks of non-compliance with laws and regulations that lay down specific requirements in the conduct of business with related parties. Accordingly, the spirit of erstwhile A8, highlighting such additional responsibilities of the auditor, has been retained.
SA 560*
Subsequent Events
(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 subsequent events in an audit of financial statements. (Ref: Para. A1)
2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:
   (a) Those that provide evidence of conditions that existed at the date of the financial statements; and
   (b) Those that provide evidence of conditions that arose after the date of the financial statements.
SA 700 explains that the date of the auditor’s report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.2

Effective Date
3. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

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

Definitions
5. For purposes of the SAs, the following terms have the meanings attributed below:
   (a) Date of the financial statements – The date of the end of the latest period covered by the financial statements.
   (b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)

* Published in January, 2009 issue of the Journal.
1 SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing”, Paragraph 13 (a).
2 Revised SA 700, “Forming an Opinion and Reporting on Financial Statements”; paragraph A37.
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(c) Date of the auditor’s report – The date the auditor dates the report on the financial statements in accordance with SA 700. (Ref: Para. A3)

(d) Date the financial statements are issued – The date that the auditor’s report and audited financial statements are made available to third parties. (Ref: Para. A4-A5)

(e) 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.

Requirements

Events Occurring Between the Date of the Financial Statements and the Date of the Auditor’s Report

6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)

7. The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor’s report, or as near as practicable thereto. The auditor shall take into account the auditor’s risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7-A8)

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)

(c) Reading minutes, if any, of the meetings of the entity’s owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available. (Ref: Para. A10)

(d) Reading the entity’s latest subsequent interim financial statements, if any.

8. When, as a result of the procedures performed as required by paragraphs 6 and 7, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Written Representations

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, “Written Representations” that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Facts Which Become Known to the Auditor After the Date of the Auditor’s Report but Before the Date the Financial Statements are Issued

10. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor’s report. However, when, after the date of the auditor’s report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor’s report, may have caused the auditor to amend the auditor’s report, the auditor shall: (Ref: Para. A11)

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,
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(c) Inquire how management intends to address the matter in the financial statements.

11. If management amends the financial statements, the auditor shall:

(a) Carry out the audit procedures necessary in the circumstances on the amendment.

(b) Unless the circumstances in paragraph 12 apply:

(i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor’s report; and

(ii) Provide a new auditor’s report on the amended financial statements. The new auditor’s report shall not be dated earlier than the date of approval of the amended financial statements.

12. When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events or events causing that amendments and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases, the auditor shall either:

(a) Amend the auditor’s report to include an additional date restricted to that amendment that thereby indicates that the auditor’s procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or (Ref: Para. A12)

(b) Provide a new or amended auditor’s report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph that conveys that auditor’s procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor’s report. However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: (Ref: Para. A13-A14)

(a) If the auditor’s report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor’s report; or

(b) If the auditor’s report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor’s report. (Ref: Para. A15-A16)

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

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

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,


4 SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.
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(c) Inquire how management intends to address the matter in the financial statements.

15. If the management amends the financial statements, the auditor shall: (Ref: Para. A17)
   (a) Carry out the audit procedures necessary in the circumstances on the amendment.
   (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor’s report thereon is informed of the situation.
   (c) Unless the circumstances in paragraph 12 apply:
      (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor’s report, and the date the new auditor’s report no earlier than the date of approval of the amended financial statements; and
      (ii) Provide a new auditor’s report on the amended financial statements.
   (d) When the circumstances in paragraph 12 apply, amend the auditor’s report, or provide a new auditor’s report as required by paragraph 12.

16. The auditor shall include in the new or amended auditor’s report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance\(^5\) are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor’s report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor’s report. (Ref: Para. A18)

Application and Other Explanatory Material

Introduction (Ref: Para. 1)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.

Definitions

*Date of Approval of the Financial Statements* (Ref: Para. 5(b))

A2. In some entities, the applicable law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In some other entities, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalising its financial statements in view

\(^5\) SA 260, paragraph 12(c).
of its management and governance structures. In some cases, final approval of the financial statements by shareholders is required. In such cases, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor’s opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the SASs is the earlier date on which those with the recognised authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements.

**Date of the Auditor’s Report** (Ref: Para. 5(c))

A3. The auditor’s report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognised authority have asserted that they have taken responsibility for those financial statements. Consequently, the date of the auditor’s report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor’s report as defined in paragraph 5(c) and the date the auditor’s report is provided to the entity.

**Date the Financial Statements are Issued** (Ref: Para. 5(d))

A4. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor’s report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor’s report, but must also be at or later than the date the auditor’s report is provided to the entity.

A5. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the date the financial statements are issued may be the date the audited financial statements and the auditor’s report thereon are presented to the legislature or otherwise made public.

**Events Occurring Between the Date of the Financial Statements and the Date of the Auditor’s Report** (Ref: Para. 6-9)

A6. Depending on the auditor’s risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor’s report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cut-off procedures or procedures in relation to subsequent receipts of accounts receivable).

A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. When the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records,

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6 SA 700, paragraph 41.
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including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.

A8. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:

- Read the entity’s latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;
- Inquire, or extend previous oral or written inquiries, of the entity’s legal counsel concerning litigation and claims; or
- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

Inquiry (Ref: Para. 7(b))

A9. In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

Reading Minutes (Ref: Para. 7(c))

A10. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

Facts Which Become Known to the Auditor After the Date of the Auditor’s Report but Before the Date the Financial Statements are Issued

Management Responsibility Towards Auditor (Ref: Para. 10)

A11. As explained in SA 210, the terms of the audit engagement include 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.\(^7\)

**Dual Dating** (Ref: Para. 12(a))

A12. When, in the circumstances described in paragraph 12(a), the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor’s report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor’s report to inform users that the auditor’s procedures subsequent to that date were restricted to the subsequent amendment of the financial statements. The following is an illustration of such an additional date:

“(Date of auditor’s report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)”.

**No Amendment of Financial Statements by Management** (Ref: Para. 13)

A13. In some entities, management may not be required by the applicable law, regulation or the financial reporting framework to issue amended financial statements. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements.

A14. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the actions taken in accordance with paragraph 13 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor’s report.

**Auditor Action to Seek to Prevent Reliance on Auditor’s Report** (Ref: Para. 17(b))

A15. The auditor may need to fulfill additional legal obligations even when the auditor has notified management not to issue the financial statements and management has agreed to this request.

A16. When management has issued the financial statements despite the auditor’s notification not to issue the financial statements to third parties, the auditor’s course of action to prevent reliance on the auditor’s report on the financial statements depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

**Facts Which Become Known to the Auditor After the Financial Statements have been Issued**

**No Amendment of Financial Statements by Management** (Ref: Para. 15)

A17. In some circumstances, the entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions) may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body.

**Auditor Action to Seek to Prevent Reliance on Auditor’s Report** (Ref: Para. 17)

A18. When the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor’s report on financial statements previously issued by the entity despite the auditor’s prior notification that the auditor will take action to seek to prevent such reliance, the auditor’s course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

\(^7\) SA 210, “Agreeing the Terms of Audit Engagements”, paragraph A23.
Material Modifications to ISA 560, “Subsequent Events”

Deletion

1. Paragraph A5 of ISA 560 provides that in the case of public sector entities, the date the financial statements are issued may be the date the audited financial statements and the auditor’s report thereon are presented to the legislature or otherwise made public. Paragraph A10 of ISA 560 provides that in the case of public sector, the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available. Paragraph A14 of ISA 560 provides that in the case of public sector, the actions taken in accordance with paragraph 13 of ISA when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor’s report. Paragraph A17 of ISA 560 provides that in some circumstances, the entities in the public sector may be prevented from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory 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 situations may also exist in case of certain entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A5, A10, A14 and A17, highlighting such fact, has been retained though a specific reference to public sector entities has been deleted.
Introduction

Scope of this SA
1. This Standard on Auditing (SA) deals with the auditor’s responsibilities in the audit of financial statements relating to going concern and the implications for the auditor’s report. (Ref: Para. A1)

Going Concern Basis of Accounting
2. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis). When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (Ref: Para. A2)

Responsibility for Assessment of the Entity’s Ability to Continue as a Going Concern
3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. The detailed requirements regarding management’s responsibility to assess the entity’s ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern. Nevertheless, where the going concern basis of accounting is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, the preparation of the financial statements requires management to assess the entity’s ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

5. Management’s assessment of the entity’s ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.

* Published in October, 2008 issue of the Journal.
The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.

Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the Auditor

6. The auditor’s responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity’s ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern.

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

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 obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern; and

(c) To report in accordance with this SA.

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity’s ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity’s ability to continue as a going concern, and: (Ref: Para. A3–A6)

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern.

1 SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraphs A51–A52

2 SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, paragraph 5
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concern and, if so, management’s plans to address them; or

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern.

11. The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. (Ref: Para. A7)

Evaluating Management’s Assessment

12. The auditor shall evaluate management’s assessment of the entity’s ability to continue as a going concern. (Ref: Para. A8–A10, A12–A13)

13. In evaluating management’s assessment of the entity’s ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management’s assessment of the entity’s ability to continue as a going concern covers less than twelve months from the date of the financial statements as defined in SA 560, the auditor shall request management to extend its assessment period to at least twelve months from that date. (Ref: Para. A11–A13)

14. In evaluating management’s assessment, the auditor shall consider whether management’s assessment includes all relevant information of which the auditor is aware as a result of the audit.

Period beyond Management’s Assessment

15. The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management’s assessment that may cast significant doubt on the entity’s ability to continue as a going concern. (Ref: Para. A14–A15)

Additional Audit Procedures When Events or Conditions Are Identified

16. If events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern (hereinafter referred to as “material uncertainty”) through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: (Ref: Para. A16)

(a) Where management has not yet performed an assessment of the entity’s ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management’s plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management’s plans are feasible in the circumstances. (Ref: Para. A17)

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management’s plans for future actions: (Ref: Para. A18–A19)

(i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

(ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which

3 SA 560, Subsequent Events, paragraph 5(a)
management made its assessment.

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans. (Ref: Para. A20)

Auditor Conclusions

17. The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements.

18. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor’s judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor’s judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (Ref: Para. A21−A22)

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading.

Adequacy of Disclosures When Events or Conditions Have Been Identified and a Material Uncertainty Exists

19. If the auditor concludes that management’s use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: (Ref: Para. A22−A23)

(a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and management’s plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists

20. If events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. (Ref: Para. A24−A25)

Implications for the Auditor’s Report

Use of Going Concern Basis of Accounting Is Inappropriate

21. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor’s judgment, management’s use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion. (Ref: Para. A26−A27)

Use of Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements

22. If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor’s report shall include a separate section under the heading “Material Uncertainty Related to Going Concern” to: (Ref: Para. A28–A31, A34)
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(a) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19; and

(b) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity’s ability to continue as a going concern and that the auditor’s opinion is not modified in respect of the matter.

Adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements

23. If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall: (Ref: Para. A32–A34)

(a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised)⁴; and

(b) In the Basis for Qualified (Adverse) Opinion section of the auditor’s report, state that a material uncertainty exists that may cast significant doubt on the entity’s ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Management Unwilling to Make or Extend Its Assessment

24. If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor’s report. (Ref: Para. A35)

Communication with Those Charged with Governance

25. Unless all those charged with governance are involved in managing the entity,⁵ the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity’s ability to continue as a going concern. Such communication with those charged with governance shall include the following:

(a) Whether the events or conditions constitute a material uncertainty;

(b) Whether management’s use of the going concern basis of accounting is appropriate in the preparation of the financial statements;

(c) The adequacy of related disclosures in the financial statements; and

(d) Where applicable, the implications for the auditor’s report.

Significant Delay in the Approval of Financial Statements

26. If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as described in paragraph 16, as well as consider the effect on the auditor’s conclusion regarding the existence of a material uncertainty, as described in paragraph 18.

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Application and Other Explanatory Material

Scope of this SA (Ref: Para 1)

A1. SA 701⁶ deals with the auditor’s responsibility to communicate key audit matters in the auditor’s report.

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⁴ SA 705 (Revised), Modifications to the Opinion in the Independent Auditor’s Report.
⁵ SA 260 (Revised), Communication with Those Charged with Governance, paragraph 13.
⁶ SA 701, Communicating Key Audit Matters in the Independent Auditor’s Report.
I. Auditing Pronouncements

That SA acknowledges that, when SA 701 applies, matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern is, by its nature, a key audit matter.⁷

Going Concern Basis of Accounting (Ref: Para. 2)

Considerations Specific to Public Sector Entities

A2. Management's use of the going concern basis of accounting is also relevant to public sector entities. Going concern risks may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatization. Events or conditions that may cast significant doubt on an entity’s ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity.

Risk Assessment Procedures and Related Activities

Events or Conditions That May Cast Significant Doubt on the Entity’s Ability to Continue as a Going Concern (Ref: Para. 10)

A3. The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

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

⁷ See paragraphs 15 and A41 of SA 701.
Emergence of a highly successful competitor.

Other

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

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management’s plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

A4. The risk assessment procedures required by paragraph 10 help the auditor to determine whether management’s use of the going concern basis of accounting is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management’s plans and resolution of any identified going concern issues.

Considerations Specific to Smaller Entities (Ref: Para. 10)

A5. The size of an entity may affect its ability to withstand adverse conditions. Small entities may be able to respond quickly to exploit opportunities, but may lack reserves to sustain operations.

A6. Conditions of particular relevance to small entities include the risk that banks and other lenders may cease to support the entity, as well as the possible loss of a principal supplier, major customer, key employee, or the right to operate under a license, franchise or other legal agreement.

Remaining Alert throughout the Audit for Audit Evidence about Events or Conditions (Ref: Para. 11)

A7. SA 315 requires the auditor to revise the auditor’s risk assessment and modify the further planned audit procedures accordingly when additional audit evidence is obtained during the course of the audit that affects the auditor’s assessment of risk. If events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern are identified after the auditor’s risk assessments are made, in addition to performing the procedures in paragraph 16, the auditor’s assessment of the risks of material misstatement may need to be revised. The existence of such events or conditions may also affect the nature, timing and extent of the auditor’s further procedures in response to the assessed risks. SA 330 establishes requirements and provides guidance on this issue.

Evaluating Management’s Assessment

Management’s Assessment and Supporting Analysis and the Auditor’s Evaluation (Ref: Para. 12)

A8. Management’s assessment of the entity’s ability to continue as a going concern is a key part of the auditor’s consideration of management’s use of the going concern basis of accounting.

A9. It is not the auditor’s responsibility to rectify the lack of analysis by management. In some circumstances, however, the lack of detailed analysis by management to support its assessment may not prevent the auditor from concluding whether management’s use of the going concern basis of accounting is

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8 SA 315, paragraph 31
9 SA 330, The Auditor’s Responses to Assessed Risks
appropriate in the circumstances. For example, when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. In this case, the auditor’s evaluation of the appropriateness of management’s assessment may be made without performing detailed evaluation procedures if the auditor’s other audit procedures are sufficient to enable the auditor to conclude whether management’s use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances.

A10. In other circumstances, evaluating management’s assessment of the entity’s ability to continue as a going concern, as required by paragraph 12, may include an evaluation of the process management followed to make its assessment, the assumptions on which the assessment is based and management’s plans for future action and whether management’s plans are feasible in the circumstances.

The Period of Management’s Assessment (Ref: Para. 13)

A11. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information.

Considerations Specific to Smaller Entities (Ref: Para. 12–13)

A12. In many cases, the management of smaller entities may not have prepared a detailed assessment of the entity’s ability to continue as a going concern, but instead may rely on in-depth knowledge of the business and anticipated future prospects. Nevertheless, in accordance with the requirements of this SA, the auditor needs to evaluate management’s assessment of the entity’s ability to continue as a going concern.

For smaller entities, it may be appropriate to discuss the medium and long-term financing of the entity with management, provided that management’s contentions can be corroborated by sufficient documentary evidence and are not inconsistent with the auditor’s understanding of the entity. Therefore, the requirement in paragraph 13 for the auditor to request management to extend its assessment may, for example, be satisfied by discussion, inquiry and inspection of supporting documentation, for example, orders received for future supply, evaluated as to their feasibility or otherwise substantiated.

A13. Continued support by owner-managers is often important to smaller entities’ ability to continue as a going concern. Where a small entity is largely financed by a loan from the owner-manager, it may be important that these funds are not withdrawn. For example, the continuance of a small entity in financial difficulty may be dependent on the owner-manager subordinating a loan to the entity in favor of banks or other creditors, or the owner-manager supporting a loan for the entity by providing a guarantee with his or her personal assets as collateral. In such circumstances, the auditor may obtain appropriate documentary evidence of the subordination of the owner-manager’s loan or of the guarantee. Where an entity is dependent on additional support from the owner-manager, the auditor may evaluate the owner-manager’s ability to meet the obligation under the support arrangement. In addition, the auditor may request written confirmation of the terms and conditions attaching to such support and the owner-manager’s intention or understanding.

Period beyond Management’s Assessment (Ref: Para. 15)

A14. As required by paragraph 11, the auditor remains alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management’s use of the going concern basis of accounting in preparing the financial statements. Since the degree of uncertainty associated with the outcome of an event or condition increases as the event or condition is further into the future, in considering events or conditions further in the future, the indications of going concern issues need to be significant before the auditor needs to consider taking further action. If such events or conditions are identified, the auditor may need to request management to evaluate the potential significance of the event or condition on its assessment of the entity’s ability to continue as a going concern. In these circumstances, the procedures in
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paragraph 16 apply.

A15. Other than inquiry of management, the auditor does not have a responsibility to perform any other audit procedures to identify events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern beyond the period assessed by management, which, as discussed in paragraph 13, would be at least twelve months from the date of the financial statements.

**Additional Audit Procedures When Events or Conditions Are Identified (Ref: Para.16)**

A16. Audit procedures that are relevant to the requirement in paragraph 16 may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity’s latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity’s legal counsel regarding the existence of litigation and claims and the reasonableness of management’s assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity’s plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity’s ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Determining the adequacy of support for any planned disposals of assets.

**Evaluating Management’s Plans for Future Actions (Ref: Para. 16(b))**

A17. Evaluating management’s plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

**The Period of Management’s Assessment (Ref: Para. 16(c))**

A18. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A19. Where management’s assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity’s ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

**Written Representations (Ref: Para. 16(e))**

A20. The auditor may consider it appropriate to obtain specific written representations beyond those
required in paragraph 16 in support of audit evidence obtained regarding management’s plans for future actions in relation to its going concern assessment and the feasibility of those plans.

Auditor Conclusions

Material Uncertainty Related to Events or Conditions that May Cast Significant Doubt on the Entity’s Ability to Continue as a Going Concern (Ref: Para. 18-19)

A21. The phrase “material uncertainty” means the uncertainties related to events or conditions which may cast significant doubt on the entity’s ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase “significant uncertainty” is used in similar circumstances.

Adequacy of Disclosure when Events or Conditions Have Been Identified and a Material Uncertainty Exists

A22. Paragraph 18 explains that a material uncertainty exists when the magnitude of the potential impact of the events or conditions and the likelihood of occurrence is such that appropriate disclosure is necessary to achieve fair presentation (for fair presentation frameworks) or for the financial statements not to be misleading (for compliance frameworks). The auditor is required by paragraph 18 to conclude whether such a material uncertainty exists regardless of whether or how the applicable financial reporting framework defines a material uncertainty.

A23. Paragraph 19 requires the auditor to determine whether the financial statement disclosures address the matters set forth in that paragraph. This determination is in addition to the auditor determining whether disclosures about a material uncertainty, required by the applicable financial reporting framework, are adequate. Disclosures required by some financial reporting frameworks that are in addition to matters set forth in paragraph 19 may include disclosures about:

- Management’s evaluation of the significance of the events or conditions relating to the entity’s ability to meet its obligations; or
- Significant judgments made by management as part of its assessment of the entity’s ability to continue as a going concern.

Some financial reporting frameworks may provide additional guidance regarding management’s consideration of disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of their occurrence.

Adequacy of Disclosures When Events or Conditions Have Been Identified but No Material Uncertainty Exists (Ref: Para. 20)

A24. Even when no material uncertainty exists, paragraph 20 requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. Some financial reporting frameworks may address disclosures about:

- Principal events or conditions;
- Management’s evaluation of the significance of those events or conditions in relation to the entity’s ability to meet its obligations;
- Management’s plans that mitigate the effect of these events or conditions; or
- Significant judgments made by management as part of its assessment of the entity’s ability to continue as a going concern.

A25. When the financial statements are prepared in accordance with a fair presentation framework, the auditor’s evaluation as to whether the financial statements achieve fair presentation includes the
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consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation. Depending on the facts and circumstances, the auditor may determine that additional disclosures are necessary to achieve fair presentation. This may be the case, for example, when events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern but, based on the audit evidence obtained, the auditor concludes that no material uncertainty exists, and no disclosures are explicitly required by the applicable financial reporting framework regarding these circumstances.

Implications for the Auditor’s Report

Use of Going Concern Basis of Accounting is Inappropriate (Ref: Para. 21)

A26. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor’s judgment, management’s use of the going concern basis of accounting in the financial statements is inappropriate, the requirement in paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management’s use of the going concern basis of accounting.

A27. When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in accordance with SA 706 (Revised) in the auditor’s report to draw the user’s attention to that alternative basis of accounting and the reasons for its use.

Use of the Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists (Ref: Para. 22-23)

A28. The identification of a material uncertainty is a matter that is important to users’ understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.

A29. The Appendix to this SA provides illustrations of the statements that are required to be included in the auditor’s report on the financial statements when “the Accounting Principles generally accepted in India” is the applicable financial reporting framework. If an applicable financial reporting framework other than abovementioned framework is used, the illustrative statements presented in the Appendix to this SA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

A30. Paragraph 22 establishes the minimum information required to be presented in the auditor’s report in each of the circumstances described. The auditor may provide additional information to supplement the required statements, for example to explain:

- That the existence of a material uncertainty is fundamental to users’ understanding of the financial statements; or

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10 SA 700 (Revised), Forming an Opinion and Reporting on Financial Statements, paragraph 14
11 SA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report
12 SA 706(Revised), paragraph A2

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- How the matter was addressed in the audit. (Ref: Para. A1)

Adequate Disclosure of a Material Uncertainty Is Made in the Financial Statements (Ref: Para. 22)

A31. Illustration 1 of the Appendix to this SA is an example of an auditor’s report when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of management’s use of the going concern basis of accounting but a material uncertainty exists and disclosure is adequate in the financial statements. The Appendix of SA 700 (Revised) also includes illustrative wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements (Ref: Para. 23)

A32. Illustrations 2 and 3 of the Appendix to this SA are examples of auditor’s reports containing qualified and adverse opinions, respectively, when the auditor has obtained sufficient appropriate audit evidence regarding the appropriateness of the management’s use of the going concern basis of accounting but adequate disclosure of a material uncertainty is not made in the financial statements.

A33. In situations involving multiple uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of including the statements required by paragraph 22. SA 705 (Revised) provides guidance on this issue.13

Communication with Regulators (Ref: Para. 22–23)

A34. When the auditor of a regulated entity considers that it may be necessary to include a reference to going concern matters in the auditor’s report, the auditor may have a duty to communicate with the applicable regulatory, enforcement or supervisory authorities.

Management Unwilling to Make or Extend Its Assessment (Ref: Para. 24)

A35. In certain circumstances, the auditor may believe it necessary to request management to make or extend its assessment. If management is unwilling to do so, a qualified opinion or a disclaimer of opinion in the auditor’s report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management’s use of the going concern basis of accounting in the preparation of the financial statements, such as audit evidence regarding the existence of plans management has put in place or the existence of other mitigating factors.

Appendix

(Ref: Para. A29, A31–A32)

Illustrations of Auditor’s Reports Relating to Going Concern

- Illustration 1: An auditor’s report containing an unmodified opinion when the auditor has concluded that a material uncertainty exists and disclosure in the financial statements is adequate.

- Illustration 2: An auditor’s report containing a qualified opinion when the auditor has concluded that a material uncertainty exists and that the financial statements are materially misstated due to inadequate disclosure.

- Illustration 3: An auditor’s report containing an adverse opinion when the auditor has concluded that a material uncertainty exists and the financial statements omit the required disclosures relating to a material uncertainty.

13 SA 705(Revised), paragraph 10
Illustration 1 – Unmodified Opinion When a Material Uncertainty Exists and Disclosure in the Financial Statements Is Adequate

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.14
- The auditor has concluded an unmodified (i.e., “clean”) opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. The disclosure of the material uncertainty in the financial statements is adequate.
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR’S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

Opinion

We have audited the standalone financial statements of ABC Company Limited (“the Company”), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (statement of changes in equity) and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company’s branches located at (location of branches)].

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Basis for Opinion

14 SA 210, Agreeing the Terms of Audit Engagements
15 The sub-title “Report on the Audit of the Standalone Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.
16 Where applicable.
17 Where applicable.
18 Where applicable
We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note XX in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company’s current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note XX, indicate that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the Material Uncertainty Related to Going Concern section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with SA 701.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised). 19]

Auditor’s Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm’s Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation 20)
(Membership No.: XXXXX)

Place of Signature:
Date:

19 Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

20 Partner or Proprietor, as the case may be
Illustration 2 – Qualified Opinion When a Material Uncertainty Exists and the Financial Statements Are Mislabeled Due to Inadequate Disclosure

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed company using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern. Note YY to the financial statements discusses the magnitude of financing arrangements, the expiration and the total financing arrangements; however the financial statements do not include discussion on the impact or the availability of refinancing or characterize this situation as a material uncertainty.
- The financial statements are materially misstated due to the inadequate disclosure of the material uncertainty. A qualified opinion is being expressed because the auditor concluded that the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.
- Key audit matters have been communicated in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.

INDEPENDENT AUDITOR’S REPORT

To the Members of ABC Company Limited

Report on the Audit of the Standalone Financial Statements

Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited (“the Company”), which comprise the balance sheet as at 31st March 20XX, and the statement of Profit and Loss, (statement of changes in equity) and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information [in which are included the Returns for the year ended on that date audited by the branch auditors of the Company’s branches located at (location of branches)].

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India,

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21 The sub-title “Report on the Audit of the Standalone Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.
22 Where applicable.
23 Where applicable.
Auditing Pronouncements

of the state of affairs of the Company as at March 31, 20XX, and profit/loss, (changes in equity)\textsuperscript{24} and its cash flows for the year ended on that date.

**Basis for Qualified Opinion**

As discussed in Note YY, the Company’s financing arrangements expire and amounts outstanding are payable on April 30, 20X2. The Company has been unable to conclude re-negotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. The financial statements do not adequately disclose this matter.

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Key Audit Matters**

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the Basis for Qualified Opinion section, we have determined the matters described below to be the key audit matters to be communicated in our report.

\[\textit{Descriptions of each key audit matter in accordance with SA 701.}\]

**Responsibilities of Management and Those Charged with Governance for the Financial Statements**

\[\textit{Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).}\]

**Auditor’s Responsibilities for the Audit of the Financial Statements**

\[\textit{Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).}\]

**Report on Other Legal and Regulatory Requirements**

\[\textit{Reporting in accordance with SA 700 (Revised) – see Illustration 1 in SA 700 (Revised).}\]

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For XYZ & Co
Chartered Accountants
(Firm’s Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation\textsuperscript{26})
(Member’s Registration No. XXXXX)

Place of Signature:
Date:

\textsuperscript{24} Where applicable

\textsuperscript{25} Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

\textsuperscript{26} Partner or Proprietor, as the case may be

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Illustration 3 – Adverse Opinion When a Material Uncertainty Exists and Is Not Disclosed in the Financial Statements

For purposes of the illustrative auditor’s report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a non corporate entity using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.
- The terms of the audit engagement reflect the description of management’s responsibility for the financial statements in SA 210.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements omit the required disclosures relating to the material uncertainty. An adverse opinion is being expressed because the effects on the financial statements of such omission are material and pervasive.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR’S REPORT

To the Partners of ABC & Associates [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Adverse Opinion

We have audited the financial statements of ABC & Associates (the entity), which comprise the balance sheet at March 31st 20XX, and the profit and loss account, (and statement of cash flows) for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly (or do not give a true and fair view of), the financial position of the entity as at March 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The entity’s financing arrangements expired and the amount outstanding was payable on March 31, 20X1. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. The financial statements do not adequately disclose this fact.

27 The sub-title “Report on the Audit of the Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.
26 Where applicable.
I.410 Auditing Pronouncements

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) issued by ICAI. Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).]

Auditor’s Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with SA 700 (Revised) – see Illustration 4 in SA 700 (Revised).]

For XYZ & Co
Chartered Accountants
(Firm’s Registration No.)

Signature
(Name of the Member signing the Audit Report)
(Designation31)
(Membership No. XXXXX)

Place of Signature:
Date:

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29 Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction.
30 Paragraphs 33 and 38 of SA 700 (Revised) require wording to be included in the auditor’s report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.
31 Partner or Proprietor, as the case may be
Part I: Engagement and Quality Control Standards

SA 580*
Written Representations
(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 obtain written representations from management and, where appropriate, those charged with governance.

Written Representations as Audit Evidence
2. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. (Ref: Para. A1)

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

Effective Date
4. This SA is effective for audits of financial statements for periods beginning on or after 1st April, 2009.

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

Definition
6. For purposes of the SAs, the following term has the meaning attributed below:

* Published in October, 2008 issue of the Journal.
1 SA 500, “Audit Evidence”, paragraph 5 (c).
Written representations — 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.

7. For purposes of this SA, references to “management” should be read as “management and, where appropriate, those charged with governance.” Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the applicable financial reporting framework.

Requirements

Management from Whom Written Representations Requested

8. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2-A6)

Written Representations about Management’s Responsibilities

Preparation of the Financial Statements

9. The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.2 (Ref: Para. A7-A9, A14, A22)

Information Provided and Completeness of Transactions

10. The auditor shall request management to provide a written representation that:
    (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement,3 and
    (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)

Description of Management’s Responsibilities in the Written Representations

11. Management’s responsibilities shall be described in the written representations required by paragraphs 9 and 10 in the manner in which these responsibilities are described in the terms of the audit engagement.

Other Written Representations

12. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10-A13, A14, A22)

Date of and Period(s) Covered by Written Representations

13. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor’s report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor’s report. (Ref: Para. A15-A18)

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2 SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b)(i)
3 SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b)(ii).

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Form of Written Representations

14. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 9 or 10, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19-A21)

Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

Doubt as to the Reliability of Written Representations

15. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24-A25)

16. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A23)

17. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor’s report in accordance with SA 705, having regard to the requirement in paragraph 19 of this SA.

Requested Written Representations Not Provided

18. If management does not provide one or more of the requested written representations, the auditor shall:

   (a) Discuss the matter with management;
   (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
   (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor’s report in accordance with SA 705, having regard to the requirement in paragraph 19 of this SA.

Written Representations about Management’s Responsibilities

19. The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if: (Ref: Para. A26-A27)

   (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 9 and 10 are not reliable; or
   (b) Management does not provide the written representations required by paragraphs 9 and 10.

Application and Other Explanatory Material

Written Representations as Audit Evidence (Ref: Para. 2)

A1. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more

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4 SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”.

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significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Management from Whom Written Representations Requested (Ref: Para. 8)

A2. Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity’s chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

A3. Due to its responsibility for the preparation and presentation of the financial statements, and its responsibilities for the conduct of the entity’s business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

A4. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

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

A5. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

A6. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations, confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

Written Representations about Management’s Responsibilities (Ref: Para. 9-10)

A7. Audit evidence obtained during the audit that management has fulfilled the responsibilities referred to in paragraphs 10 and 11 is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

A8. The written representations required by paragraphs 9 and 10 draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by
Part I: Engagement and Quality Control Standards

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

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

Consistent with the requirement of SA 210, such reconfirmation of management’s acknowledgement and understanding of its responsibilities is not made subject to the best of management’s knowledge and belief (as discussed in paragraph A5 of this SA).

A9. The mandates for audits of the financial statements of certain entities 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 give rise to additional written representations. These may include written representations confirming that transactions and events have been carried out in accordance with legislation or proper authority.

Other Written Representations (Ref: Para. 12)

**Additional Written Representations about the Financial Statements**

A10. In addition to the written representation required by paragraph 9, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation required by paragraph 9. They may include representations about the following:

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - Liabilities, both actual and contingent;
  - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
  - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

**Additional Written Representations about Information Provided to the Auditor**

A11. In addition to the written representation required by paragraph 10, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

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5 SA 210, “Agreeing the Terms of Audit Engagements,” paragraph 6(b).
Written Representations about Specific Assertions

A12. When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity’s past history in carrying out its stated intentions.
- The entity’s reasons for choosing a particular course of action.
- The entity’s ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management’s judgment or intent.

A13. In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management’s judgment or intent in relation to, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

Communicating a Threshold Amount (Ref: Para. 9-10, 12)

A14. SA 450\(^6\) requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial. The auditor may determine a threshold above which misstatements cannot be regarded as clearly trivial. In the same way, the auditor may consider communicating to management a threshold for purposes of the requested written representations.

Date of and Period(s) Covered by Written Representations (Ref: Para. 13)

A15. Because written representations are necessary audit evidence, the auditor’s opinion cannot be expressed, and the auditor’s report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor’s report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor’s report on the financial statements.

A16. In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

A17. The written representations are for all periods referred to in the auditor’s report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

A18. Situations may arise where current management were not present during all periods referred to in the auditor’s report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons’ responsibilities for the financial statements as a whole. Accordingly, the

\(^6\) SA 450, “Evaluation of Misstatements Identified during the Audit”, paragraph 5.
requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Form of Written Representations (Ref: Para. 14)

A19. Written representations are required to be included in a representation letter addressed to the auditor. Some laws or regulations may, however, require management to make a written public statement about its responsibilities. Although such statement is a representation to the users of the financial statements, or to relevant authorities, the auditor may determine that it is an appropriate form of written representation in respect of some or all of the representations required by paragraph 9 or 10. Consequently, the relevant matters covered by such statement need not be included in the representation letter. Factors that may affect the auditor’s determination include:

- Whether the statement includes confirmation of the fulfillment of the responsibilities referred to in paragraphs 10 and 11.
- Whether the statement has been given or approved by those from whom the auditor requests the relevant written representations.
- Whether a copy of the statement is provided to the auditor as near as practicable to, but not after, the date of the auditor’s report on the financial statements (see paragraph 13).

A20. A formal statement of compliance with law or regulation, or of approval of the financial statements, would not contain sufficient information for the auditor to be satisfied that all necessary representations have been consciously made. The expression of management’s responsibilities in law or regulation is also not a substitute for the requested written representations.

A21. The Appendix to this Standard provides an illustrative example of a representation letter.

Communication with Those Charged with Governance (Ref: Para. 9-10, 12)

A22. SA 260\(^7\) requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.

Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

Doubt as to the Reliability of Written Representations (Ref: Para. 15-16)

A23. In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

A24. Concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider, where possible, withdrawing from the engagement, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

A25. SA 230\(^8\) requires the auditor to document significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. The

\(^7\) SA 260, “Communication with Those Charged with Governance”, paragraph 12(c)(ii).

\(^8\) SA 230, “Audit Documentation”, refer paragraph 8 and 10.
Auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with SA 230.

**Written Representations about Management’s Responsibilities** *(Ref: Para. 19)*

A26. As explained in paragraph A7, the auditor is not able to judge solely on other audit evidence whether management has fulfilled the responsibilities referred to in paragraphs 10 and 11. Therefore, if, as described in paragraph 19(a), the auditor concludes that the written representations about these matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. SA 705 requires the auditor to disclaim an opinion on the financial statements in such circumstances.  

A27. A written representation that has been modified from that requested by the auditor does not necessarily mean that management did not provide the written representation. However, the underlying reason for such modification may affect the opinion in the auditor’s report. For example:

- The written representation about management’s fulfillment of its responsibility for the preparation and presentation of the financial statements may state that management believes that, except for material non-compliance with a particular requirement of the applicable financial reporting framework, the financial statements are prepared and presented in accordance with that framework. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effect of the non-compliance on the opinion in the auditor’s report in accordance with SA 705.

- The written representation about the responsibility of management to provide the auditor with all relevant information agreed in the terms of the audit engagement may state that management believes that, except for information destroyed in a fire, it has provided the auditor with such information. The requirement in paragraph 19 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor’s report in accordance with SA 705.

**Material Modifications to ISA 580, “Written Representations”**

**Deletions**

Paragraph A9 of the Application Section of ISA 580 deals with the application of the requirements of ISA 580 to the audits of public sector entities regarding the premise, relating to management’s responsibilities which may give rise to additional written representations. 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. Since it is also possible that even in case of non public sector entities, management responsibilities may give rise to additional representations, accordingly, the spirit of erstwhile A9, highlighting the fact that in case of certain entities, the need of additional representations may arise, has been retained.

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9 SA 705, paragraph 9.
Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other SAs in effect for audits of financial statements for period beginning on or after as at [date]. It is assumed in this illustration that the applicable financial reporting framework is applicable accounting standards in India; the requirement of SA 570\(^\text{10}\) to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(To Auditor)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended March 31, 20XX\(^\text{11}\) for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or give a true and fair view) in accordance with the applicable accounting standards in India.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

**Financial Statements**

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with Financial Reporting Standards; in particular the financial statements are fairly presented (or give a true and fair view) in accordance with the applicable accounting standards in India.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (SA 540)
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)\(^\text{12}\)
- All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)
- [Any other matters that the auditor may consider appropriate (see paragraph A10 of this SA).]

**Information Provided**

- We have provided you with:

\(^{10}\) SA 570, “Going Concern”.

\(^{11}\) Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor’s report.

\(^{12}\) SA 550, “Related Parties”.

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- Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
- Additional information that you have requested from us for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (SA 240).
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements. (SA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity’s financial statements communicated by employees, former employees, analysts, regulators or others. (SA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (SA 250)\(^{13}\)
- We have disclosed to you the identity of the entity’s related parties and all the related party relationships and transactions of which we are aware. (SA 550)\(^{14}\)
- [Any other matters that the auditor may consider necessary (see paragraph A11 of this SA).]

Management Management

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\(^{13}\) SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”.

\(^{14}\) SA 550, “Related Parties”.

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