Introduction

Scope of this SA

1. This Standard on Auditing (SA) establishes the independent auditor’s overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. The independent auditor is referred to as “the auditor” hereafter.

2. SAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)

4. The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. SAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in

* Published in March, 2010 issue of the Journal.
accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of those responsibilities. (Ref: Para. A2-A11)

5. As the basis for the auditor’s opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. (Ref: Para. A28-A52)

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor’s perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor’s opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The SAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity’s internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable laws or regulations. (Ref: Para. A12-A13)

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1 SA 320, “Materiality in Planning and Performing an Audit” and SA 450, “Evaluation of Misstatements Identified during the Audit”.

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9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the SAs or by applicable laws or regulations².

Effective Date

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

Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

   (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

   (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor’s findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor’s report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SAs require that the auditor disclaim an opinion or withdraw from the engagement, where withdrawal is legally permitted.

Definitions

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

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

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

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

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

       The term “compliance framework” is used to refer to a financial reporting framework that

² See, for example, SA 260, “Communication with Those Charged with Governance”; and paragraph 43 of SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”.

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Part I: Engagement and Quality Control Standards

requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

(b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:

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

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

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

(d) Auditor – “Auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an SA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term “engagement partner” rather than “auditor” is used. “Engagement partner” and “firm” are to be read as referring to their public sector equivalents where relevant.

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

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

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

(h) Management – The person(s) with executive responsibility for the conduct of the entity’s operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
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(i) Misstatement – A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

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

(j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have the following responsibilities that are fundamental to the conduct of an audit in accordance with SAs. That is, responsibility:

(i) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(ii) To provide the auditor with:
   a. All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
   b. Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and
   c. Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, the responsibility is for the preparation and fair presentation of the financial statements in accordance with the financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework. This applies to all references to “preparation and presentation of the financial statements” in the SAs.

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

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

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

(m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

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

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

(ii) Control risk – The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

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

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A14-A17)

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A18-A22)

Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A23-A27)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion. (Ref: Para. A28-A52)

Conduct of an Audit in Accordance with SAs

Complying with SAs Relevant to the Audit

18. The auditor shall comply with all SAs relevant to the audit. An SA is relevant to the audit
when the SA is in effect and the circumstances addressed by the SA exist. (Ref: Para. A53-A56)

19. The auditor shall have an understanding of the entire text of an SA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A57-A65)

20. The auditor shall not represent compliance with SAs in the auditor’s report unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit.

**Objectives Stated in Individual SAs**

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit, having regard to the interrelationships among the SAs, to: (Ref: Para. A66-A68)

(a) Determine whether any audit procedures in addition to those required by the SAs are necessary in pursuance of the objectives stated in the SAs; and (Ref: Para. A69)

(b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A70)

**Complying with Relevant Requirements**

22. Subject to paragraph 23, the auditor shall comply with each requirement of an SA unless, in the circumstances of the audit:

(a) The entire SA is not relevant; or

(b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A71-A72)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an SA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A73)

**Failure to Achieve an Objective**

24. If an objective in a relevant SA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the SAs, to modify the auditor’s opinion or withdraw from the engagement. Failure to achieve an objective represents a significant matter requiring documentation in accordance with SA 230.³ (Ref: Para. A74-A75)

**Application and Other Explanatory Material**

**An Audit of Financial Statements**

**Scope of the Audit** (Ref: Para. 3)

A1. The auditor’s opinion on the financial statements deals with whether the financial

³ SA 230, “Audit Documentation”, paragraph 8(c).
statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor’s opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some cases, however, the applicable laws and regulations may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the SAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

**Preparation of the Financial Statements** (Ref: Para. 4)

A2. An audit in accordance with SAs is conducted on the premise that management and, where appropriate, those charged with governance have responsibility:

(a) For the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) To provide the auditor with:

(i) All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;

(ii) Any additional information that the auditor may request from management and, where appropriate, those charged with governance; and

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

A3. As part of their responsibility for the preparation and presentation of the financial statements, management and, where appropriate, those charged with governance are responsible for:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation and presentation of the financial statements in accordance with that framework.
- An adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:
The common financial information needs of a wide range of users (i.e., “general purpose financial statements”); or

The financial information needs of specific users (i.e., “special purpose financial statements”).

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organisations;
- Published views of varying authority on emerging accounting issues issued by standards setting, professional or regulatory organisations;
- General and industry practices widely recognised and prevalent; and
- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organisation that is authorised or recognised to promulgate standards to be used by entities for preparing and presenting general purpose financial statements are often designed to achieve fair presentation.

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the state of affairs, results of operations and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; statement of profit and loss; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement
and the related notes might constitute a complete set of financial statements:

- For example, normally, in government departments and local bodies, the primary financial statement is a statement of cash receipts and payments.
- Other examples of a single financial statement, each of which would include related notes, are:
  - Balance sheet.
  - Statement of profit & loss.
  - Statement of cash flows.
  - Statement of operations by product lines.

A9. SA 210 establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework. SA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework.

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain agreement from management and, where appropriate, those charged with governance that they acknowledge and understand their responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement. The auditor is also required to obtain written representations about whether management and, where appropriate, those charged with governance have fulfilled those responsibilities.

Considerations Specific to Central/State Governments and Related Government Entities

A11. The mandates for audits of the financial statements of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may be broader than those of other entities. As a result, the premise, relating to management’s responsibilities, on which an audit of the financial statements of such an entity is conducted may include additional responsibilities, such as, the responsibility for the execution of transactions and events in accordance with legislation or proper authority.

Form of the Auditor’s Opinion (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor’s opinion, however, will depend upon the applicable financial reporting framework and any applicable laws or regulations. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the applicable financial reporting framework includes presentation.

4 SA 210, “Agreeing the Terms of Audit Engagements”, paragraph 6(a).
6 SA 210, paragraph 6(b).
A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the SAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the SAs to the auditor’s opinion cover both forms of opinion.

**Ethical Requirements Relating to an Audit of Financial Statements** (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India.

A15. The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

(a) Integrity;
(b) Objectivity;
(c) Professional competence and due care;
(d) Confidentiality; and
(e) Professional behavior.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor’s independence from the entity safeguards the auditor’s ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor’s ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A17. Standard on Quality Control (SQC) 18 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence9. SA 220 sets out the engagement partner’s responsibilities with respect to relevant ethical requirements. These include evaluating whether members of the engagement team have complied with relevant ethical requirements, determining the appropriate action if matters come to the engagement partner’s attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit.

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8 Standard on Quality Control (SQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”.
9 SQC 1, paragraphs 14-27.
engagement. SA 220 recognises that the engagement team is entitled to rely on a firm’s systems in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

**Professional Skepticism** (Ref: Para. 15)

A18. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity’s management and those charged with governance. Nevertheless, a

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12 SA 240, paragraph 13; SA 500, paragraph 11; and SA 505, paragraphs 10-11, and 16.
belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.

**Professional Judgment** (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- The evaluation of management’s judgments in applying the entity’s applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by SA 220¹³, assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor’s report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching

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¹³ SA 220, paragraph 18.
conclusions on significant matters arising during the audit. Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

**Sufficient Appropriate Audit Evidence and Audit Risk** (Ref: Para. 5 and 17)

**Sufficiency and Appropriateness of Audit Evidence**

A28. Audit evidence is necessary to support the auditor’s opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit) or a firm’s quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity’s accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management’s assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management’s refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor’s work in forming the auditor’s opinion consists of obtaining and evaluating audit evidence.

A29. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A30. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A31. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgment. SA 500 and other relevant SAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor’s considerations in obtaining sufficient appropriate audit evidence.

**Audit Risk**

A32. Audit risk is a function of the risks of material misstatement and detection risk. The
assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A33. For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A34. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial
statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed\(^\text{16}\).

A40. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

\textit{Detection Risk}

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing, and extent of the auditor’s procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. SA 300 \(^\text{17}\) and SA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor’s responses to assessed risks. Detection risk, however,

\(^{16}\) SA 330, “The Auditor’s Responses to Assessed Risks”, paragraphs 7-17.

\(^{17}\) SA 300, “Planning an Audit of Financial Statements”. 

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can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

**Inherent Limitations of an Audit**

A45. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

**The Nature of Financial Reporting**

A46. The preparation of financial statements involves judgment by management in applying the requirements of the entity’s applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the SAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgments\(^\text{18}\).

**The Nature of Audit Procedures**

A47. There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.

Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A48. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognised in certain financial reporting frameworks (see, for example, the “Framework for the Preparation and Presentation of Financial Statements” issued by the Institute of Chartered Accountants of India (ICAI)). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A49. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the SAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities; and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.

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19 SA 315, paragraphs 5-10.
20 SA 330; SA 500; SA 520, “Analytical Procedures”, and SA 530, “Audit Sampling”.

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Other Matters that Affect the Inherent Limitations of an Audit

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor’s ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See SA 240 for further discussion.
- The existence and completeness of related party relationships and transactions. See SA 550 \(^{21}\) for further discussion.
- The occurrence of non-compliance with laws and regulations. See SA 250 \(^{22}\) for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See SA 570 \(^{23}\) for further discussion.

Relevant SAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor’s report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with SAs

Nature of the SAs (Ref: Para. 18)

A53. The SAs, taken together, provide the standards for the auditor’s work in fulfilling the overall objectives of the auditor. The SAs deal with the general responsibilities of the auditor, as well as the auditor’s further considerations relevant to the application of those responsibilities to specific topics.

A54. The scope, effective date and any specific limitation of the applicability of a specific SA is made clear in the SA. Unless otherwise stated in the SA, the auditor is permitted to apply an SA before the effective date specified therein.

A55. In performing an audit, the auditor may be required to comply with legal or regulatory

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\(^{21}\) SA 550, “Related Parties”.
\(^{22}\) SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”.
\(^{23}\) SA 570, “Going Concern”.

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requirements in addition to the SAs. The SAs do not override laws and regulations that govern an audit of financial statements. In the event that those laws and regulations differ from the SAs, an audit conducted only in accordance with laws and regulations will not automatically comply with SAs.

A56. The SAs are also relevant to engagements in case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions). The auditor’s responsibilities of those entities, however, may be affected by the audit mandate, or by obligations on those entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature, which may encompass a broader scope than an audit of financial statements in accordance with the SAs. These additional responsibilities are not dealt with in the SAs. They may be dealt with in the relevant laws and regulations in which the entities are operating.

**Contents of the SAs** (Ref: Para. 19)

A57. In addition to objectives and requirements (requirements are expressed in the SAs using “shall”), an SA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the SA, and definitions. The entire text of an SA, therefore, is relevant to an understanding of the objectives stated in an SA and the proper application of the requirements of an SA.

A58. Where necessary, the application and other explanatory material provides further explanation of the requirements of an SA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an SA. The application and other explanatory material may also provide background information on matters addressed in an SA.

A59. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related SA or within the title and introduction of the appendix itself.

A60. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the SA, including how the SA relates to other SAs.
- The subject matter of the SA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the SA.
- The context in which the SA is set.

A61. An SA may include, in a separate section under the heading “Definitions”, a description of the meanings attributed to certain terms for purposes of the SAs. These are provided to
assist in the consistent application and interpretation of the SAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the SAs. The Glossary of Terms relating to Engagement and Quality Control Standards issued by the Auditing and Assurance Standards Board contains a complete listing of terms defined in the SAs. It also includes descriptions of other terms found in SAs to assist in common and consistent interpretation.

A62. When appropriate, additional considerations specific to audits of smaller entities and to certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), are included within the application and other explanatory material of an SA. These additional considerations assist in the application of the requirements of the SA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the SAs.

Considerations Specific to Smaller Entities

A63. For purposes of specifying additional considerations to audits of smaller entities, a “smaller entity” refers to an entity which typically possesses qualitative characteristics such as:

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

(b) One or more of the following:
   (i) Straightforward or uncomplicated transactions;
   (ii) Simple record-keeping;
   (iii) Few lines of business and few products within business lines;
   (iv) Few internal controls;
   (v) Few levels of management with responsibility for a broad range of controls; or
   (vi) Few personnel, many having a wide range of duties.

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

A64. The considerations specific to smaller entities included in the SAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A65. The SAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the “owner-manager”.

Objectives Stated in Individual SAs (Ref: Para. 21)

A66. Each SA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual SAs serve to focus the auditor on the desired outcome of the SA, while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate
means of doing so; and
• Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A67. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this SA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A68. In using the objectives, the auditor is required to have regard to the interrelationships among the SAs. This is because, as indicated in paragraph A53, the SAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this SA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. At a more detailed level, SA 315 and SA 330 contain, among other things, objectives and requirements that deal with the auditor’s responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An SA dealing with specific aspects of the audit (for example, SA 540 ) may expand on how the objectives and requirements of such SAs as SA 315 and SA 330 are to be applied in relation to the subject of the SA but does not repeat them. Thus, in achieving the objective stated in SA 540 , the auditor has regard to the objectives and requirements of other relevant SAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

A69. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the SAs by the auditor is therefore expected to provide a sufficient basis for the auditor’s achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the SAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the SAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the SAs to meet the objectives specified in the SAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

A70. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):
• Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other SAs;
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- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances. Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the SAs to determine the effect on the auditor’s report or on the auditor’s ability to complete the engagement.

Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

A71. In some cases, an SA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in SA 610 \(^{24}\) is not relevant.

A72. Within a relevant SA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor’s opinion if there is a limitation of scope \(^{25}\) represents an explicit conditional requirement.
- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance \(^{26}\), which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework \(^{27}\), which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

Departure from a Requirement (Ref: Para. 23)

A73. SA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement \(^{28}\). The SAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Failure to Achieve an Objective (Ref: Para. 24)

A74. Whether an objective has been achieved is a matter for the auditor’s professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the SAs, and the auditor’s evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done

\(^{24}\) SA 610, “Using the Work of Internal Auditors”.


\(^{26}\) SA 265, “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”, paragraph 9.


\(^{28}\) SA 230, paragraph 12.

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in the particular circumstances of the audit to achieve the objectives stated in the SAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an SA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example due to a limitation in the available audit evidence.

A75. Audit documentation that meets the requirements of SA 230 and the specific documentation requirements of other relevant SAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

**Modifications vis-à-vis ISA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing”**

**Deletion**

Paragraph A11 of ISA 200 deals with the additional responsibilities for the execution of transactions and events in accordance with legislation or proper authority in case of public sector entities. Further, paragraph A57 of ISA 200 (A56 of SA 200) deals with the auditor’s additional responsibility arising out of the mandatory or obligatory laws or regulations applicable to that public sector entity. These additional responsibilities are not dealt by the SAs but dealt by the laws or regulations under which the public sector entity operates. Also, paragraph A63 of ISA 200 (A62 of SA 200) deals with the inclusion of the paragraph specific to public sector entities in the application and explanatory material section. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific situation may exist in case of Central/State governments or related government entities, pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of paragraphs A11, A57 and A63 in ISA, highlighting such fact, has been retained.
Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. SA 220¹ deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

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

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

(a) Establishing whether the preconditions for an audit are present; and

(b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

4. For purposes of the SAs, the following term has the meaning attributed below:

Preconditions for an audit – The use by management of an acceptable financial reporting framework² in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise³ on which an audit is conducted.

¹Published in September, 2009 issue of the Journal.
²SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing”, paragraph 13 (a).
³SA 200, Paragraph 13 (j).
5. For the purposes of this SA, references to “management” should be read hereafter as “management and, where appropriate, those charged with governance”.

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A9)

(b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A10-A13, A19)

   (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A14)

   (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A15-A18)

   (iii) To provide the auditor with:

      a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

      b. Additional information that the auditor may request from management for the purpose of the audit; and

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

Limitation on Scope Prior to Audit Engagement Acceptance

7. If management or those charged with governance impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

(a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or

(b) If the agreement referred to in paragraph 6(b) has not been obtained.
Agreement on Audit Engagement Terms

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A20)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A21-A24)

(a) The objective and scope of the audit of the financial statements;
(b) The responsibilities of the auditor;
(c) The responsibilities of management;
(d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A21, A25-A26)

12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor’s judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A25)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A27)

Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A28-A30)

15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A31-A32)

16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under applicable law or regulation; and

(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation

18. If financial reporting standards established by an authorised or recognised standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:

(a) The additional requirements can be met through additional disclosures in the financial statements; or

(b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor’s opinion in accordance with SA 705. (Ref: Para. A33)

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A34)

(a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and

(b) It is recognised in the terms of the audit engagement that:

(i) The auditor’s report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users’ attention to the additional disclosures, in accordance with SA

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4 Accounting Standards issued by the ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies issued by the ICAI, as may be applicable.

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(ii) Unless the auditor is required by law or regulation to express the auditor’s opinion on the financial statements by using the phrases “present fairly, in all material respects”, or “give a true and fair view” in accordance with the applicable financial reporting framework, the auditor’s opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:

(a) Evaluate the effect of the misleading nature of the financial statements on the auditor’s report; and

(b) Include appropriate reference to this matter in the terms of the audit engagement.

Auditor’s Report Prescribed by Law or Regulation

21. In some cases, the law or regulation applicable to the entity prescribes the layout or wording of the auditor’s report in a form or in terms that are significantly different from the requirements of SAs. In these circumstances, the auditor shall evaluate:

(a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,

(b) Whether additional explanation in the auditor’s report can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor’s report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with SAs. Accordingly, the auditor shall not include any reference within the auditor’s report to the audit having been conducted in accordance with SAs. (Ref: Para. A35-A36)

Application and Other Explanatory Material

Scope of this SA (Ref: Para. 1)

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics. The auditor’s responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they are within the control of the auditor are dealt with in SA 220. This SA deals with those matters (or preconditions) that are

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7 SA 706.
8 SA 700, “Forming an Opinion and Reporting on Financial Statements”, paragraph 43.
within the control of the entity and upon which it is necessary for the auditor and the entity’s management to agree.

Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users11. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the SAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

A4. Factors that are relevant to the auditor’s determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, or a not for profit organization);
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.

A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such

financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. SA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users. 12

A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

A8. At present, there is no objective and authoritative basis that has been generally recognised globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorised or recognised to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and/or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, as may be applicable;
- Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI);
- International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board; and
- International Public Sector Accounting Standards (IPSASs) issued by the International Public Sector Accounting Standards Board.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. Appendix 2 contains guidance on determining the acceptability of the financial reporting framework. In case of some entities, law or regulation may prescribe the financial

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reporting framework to be used in the preparation of general purpose financial statements. In
the absence of indications to the contrary, such a financial reporting framework is presumed
to be acceptable for general purpose financial statements prepared by such entities. In the
event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

**Agreement of the Responsibilities of Management** (Ref: Para. 6(b))

A10. An audit in accordance with SAs is conducted on the premise that management has
acknowledged and understands that it has the responsibilities set out in paragraph 6(b)13. In
case of certain entities, such responsibilities may be specified in the applicable law or
regulation. In others, there may be little or no legal or regulatory definition of such
responsibilities. SAs do not override law or regulation in such matters. However, the concept
of an independent audit requires that the auditor’s role does not involve taking responsibility
for the preparation of the financial statements or for the entity’s related internal control, and
that the auditor has a reasonable expectation of obtaining the information necessary for the
audit in so far as management is able to provide or procure it. Accordingly, the premise is
fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement
is reached with management that it acknowledges and understands that it has such
responsibilities as part of agreeing and recording the terms of the audit engagement in
paragraphs 9-12.

A11. The way in which the responsibilities for financial reporting are divided between
management and those charged with governance will vary according to the resources and
structure of the entity and any relevant law or regulation, and the respective roles of
management and those charged with governance within the entity. In most cases,
management is responsible for execution while those charged with governance have
oversight of management. In some cases, those charged with governance will have, or will
assume, responsibility for approving the financial statements or monitoring the entity’s
internal control related to financial reporting. In larger or public entities, a subgroup of those
charged with governance, such as an audit committee, may be charged with certain oversight
responsibilities.

A12. SA 580 requires the auditor to request management to provide written representations
that it has fulfilled certain of its responsibilities14. It may therefore be appropriate to make
management aware that receipt of such written representations will be expected, together
with written representations required by other SAs and, where necessary, written
representations to support other audit evidence relevant to the financial statements or one or
more specific assertions in the financial statements.

A13. Where management will not acknowledge its responsibilities, or agree to provide the
written representations, the auditor will be unable to obtain sufficient appropriate audit
evidence15. In such circumstances, it would not be appropriate for the auditor to accept the

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13 SA 200, Paragraph A2.
15 SA 580, paragraph A26.
audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor’s report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

A14. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, preparation of the financial statements in accordance with the financial reporting framework includes presentation. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will “give a true and fair view” in accordance with the financial reporting framework.

Internal Control (Ref: Para. 6(b)(ii))

A15. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity’s financial reporting objectives due to the inherent limitations of internal control.

A16. An independent audit conducted in accordance with the SAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its purpose or will be free of deficiencies.

A17. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term “internal control” encompasses a wide range of activities within components that may be described as the control environment; the entity’s risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component. An entity’s internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

A18. In some cases, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some other cases, general practice may assume a distinction between accounting books and records or

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17 SA 315, paragraph A51 and Appendix 1.
accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A19. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

A20. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

Audit Engagement Letter or Other Form of Written Agreement 18 (Ref: Para. 10-11)

A21. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some entities, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A22. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor’s responsibilities may be based on SA 200 19. Paragraphs 6(b) and 12 of this SA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, SAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.

18 In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

19 SA 200, paragraph 3-9.
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- The form of any other communication of results of the audit engagement.
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations (see also paragraph A13).
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor’s report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- The fact that the audit process may be subjected to a peer review under the Chartered Accountants Act, 1949.

A23. When relevant, the following points could also be made in the audit engagement letter:

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

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A24. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;
• Whether a separate auditor’s report is to be issued on the component;
• Legal requirements in relation to audit appointments;
• Degree of ownership by parent; and
• Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A25. If, in the circumstances described in paragraphs A22 and A27, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b).

A26. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), law or regulation governing the operations of that entities generally mandate the appointment of the auditor and commonly set out the auditor’s responsibilities and powers, including the power to access an entity’s records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A27. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

• Any indication that the entity misunderstands the objective and scope of the audit.
• Any revised or special terms of the audit engagement.
• A recent change of senior management.
• A significant change in ownership.
• A significant change in nature or size of the entity’s business.
• A change in legal or regulatory requirements.
• A change in the financial reporting framework adopted in the preparation of the financial statements.
• A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

A28. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the
scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A29. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

A30. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

A31. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with SAs may need to assess, in addition to the matters referred to in paragraphs A29-A31 above, any legal or contractual implications of the change.

A32. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

(a) The original audit engagement; or

(b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

A33. In case of some entities, law or regulation may supplement the financial reporting standards established by an authorised or recognised standards setting organization with additional requirements relating to the preparation of financial statements. In such cases, the applicable financial reporting framework for the purposes of applying the SAs encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards20.

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Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

A34. Law or regulation may prescribe that the wording of the auditor’s opinion use the phrases “present fairly, in all material respects” or “give a true and fair view” in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor’s report are significantly different from the requirements of SAs (see paragraph 21).

Auditor’s Report Prescribed by Law or Regulation (Ref: Para. 21)

A35. SAs require that the auditor shall not represent compliance with SAs unless the auditor has complied with all of the SAs relevant to the audit. When law or regulation prescribes the layout or wording of the auditor’s report in a form or in terms that are significantly different from the requirements of SAs and the auditor concludes that additional explanation in the auditor’s report cannot mitigate possible misunderstanding, the auditor may consider including a statement in the auditor’s report that the audit is not conducted in accordance with SAs. The auditor is, however, encouraged to apply SAs, including the SAs that address the auditor’s report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with SAs.

A36. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a regulator or the legislative body or the stakeholders if the entity attempts to limit the scope of the audit.

Material Modifications to ISA 210, “Agreeing the Terms of Audit Engagements”

Addition

Paragraph A8 of ISA 210 provides the examples of the financial reporting standards, which can be used for the preparation and presentation of general purpose financial statements. Since in India, financial reporting standards, used for the preparation and presentation of financial statements, can be ‘Accounting Standards issued by the Institute of Chartered Accountants of India or Accounting Standards, notified under Companies (Accounting Standards) Rules, 2006’ or ‘Accounting Standards for Local Bodies issued by the Institute of Chartered Accountants of India (ICAI)’, these have been added in the list of examples of financial reporting standards. References have accordingly been changed.

Deletions

1. Paragraph A10 of the ISA 210 deals with situations where the entity operates in a jurisdiction that does not have a standard setting organization or a prescribed financial reporting framework. Since in India, this kind of situation does not exist, paragraph A10 has been deleted. However, the reference to Appendix 2, Determining Acceptability of General

21 SA 200, paragraph 20.

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Purpose Frameworks, has been shifted to paragraph A9.

2. Paragraph A27 of ISA 210 deals with the condition where the law or regulation governs the operations of public sector audits, and also prescribes the public sector auditor’s responsibilities and powers. Paragraph A37 of ISA 210 deals with the specific reporting requirements within the legislation governing the audit which may mandate; for example, the auditor may be required to report directly to a minister or the legislature or to public if the entity attempts to limit the scope of the audit in case of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted. However, since it is also possible that such situations may also exist in case of certain non-public entities pursuant to a requirement under the statute or regulation under which they operate the spirit of erstwhile A27 and A37 has been retained.

Appendix 1
(Ref: Paras. A22-A23)

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements prepared in accordance with Financial Reporting Standards\(^ {22}\) of a company registered under the Companies Act, 1956. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this SA. It will need to be varied according to individual requirements and circumstances. It is drafted to refer to the audit of financial statements for a single reporting period and would require adaptation if intended or expected to apply to recurring audits (see paragraph 13 of this SA). It may be appropriate to seek legal advice that any proposed letter is suitable.

To the Board of Directors of ABC Company Limited:\(^ {23}\)

[The objective and scope of the audit]

You\(^ {24}\) have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting

\(^{22}\) Refer footnote 6.

\(^{23}\) The addressees and references in the letter would be those that are appropriate in the circumstances of the engagement, including the relevant jurisdiction. It is important to refer to the appropriate persons – see paragraph A21.

\(^{24}\) Throughout this letter, references to “you”, “we”, “us”, “management”, “those charged with governance” and “auditor” would be used or amended as appropriate in the circumstances.

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policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.\footnote{Where the financial statements of the entity include financial statements/ information of its component(s) which have been audited by another auditor/ auditors, the engagement letter may be modified as under:}

\textit{[The responsibilities of the auditor]}

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity’s preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

\textit{[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example it is assumed that the auditor has determined that the provisions of the Companies Act, 1956 relating to responsibility of the Board of Directors be supplemented by the descriptions in paragraph 6(b) of this SA).]}

\footnote{You have requested that we audit the financial statements of ABC Company Limited, which comprise the Balance Sheet as at March 31, 20X1, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Further, as informed by you, the financial statements of the components of ABC Company Limited, viz., PQR Company Limited and XYZ Company Pvt Limited, whose financial information/ financial statements have been included in the financial statements of ABC Company would be/ have been audited by another auditor/ auditors. However, we expect to be furnished the reports of such other auditor(s) before the date of our audit report so as to enable us to deal with such reports in accordance with the principles enunciated in the Standard on Auditing (SA) 600, Using the Work of Another Auditor, issued by the Institute of Chartered Accountants of India".}
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Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards. This includes:

- the responsibility for the preparation of financial statements on a going concern basis.
- the responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
- The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

(b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide us with:

(i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that we may request from [management] for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

26 Use terminology as appropriate in the circumstances.
27 Or, if appropriate, “For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards”.

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We look forward to full cooperation from your staff during our audit.

[Other relevant information]

[Insert other information, such as fee arrangements, billings\(^{28}\) and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor’s report.]

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.
Chartered Accountants
Firm’s Registration Number

…………………………
(Signature)

Date: (Name of the Member)
Place: (Designation\(^{29}\))

Acknowledged on behalf of ABC Company by

…………………………
(Signature)
Name and Designation
Date

Appendix 2
(Ref: Para. A9)

Determining the Acceptability of General Purpose Frameworks

1. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:

(a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.

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\(^{28}\) For example, “Our fees will be billed as the work progresses”.

\(^{29}\) Partner or proprietor, as the case may be.

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(b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.

(c) Reliability, in that the information provided in the financial statements:
   (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and
   (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.

(d) Neutrality, in that it contributes to information in the financial statements that is free from bias.

(e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

2. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to IFRSs. For an audit of a small entity, the auditor may decide to compare the accounting conventions to a financial reporting framework specifically developed for such entities by an authorised or recognised standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation and presentation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.

3. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the industry to which the entity belongs by preparers and users.
SA 220*
Quality Control for an Audit of Financial Statements
(Effective for all audits relating to accounting periods beginning on or after April 1, 2010)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This SA is to be read in conjunction with relevant ethical requirements.

System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and

(b) The reports issued by the firm or engagement partners are appropriate in the circumstances¹.

This SA is premised on the basis that the firm is subject to SQC 1. (Ref: Para. A1)

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

4. Engagement teams are entitled to rely on the firm’s system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

Effective Date

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

¹ Published in March, 2010 issue of the Journal.

¹ Standard on Quality Control (SQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”, paragraph 10.
Objective
6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

(a) The audit complies with professional standards and regulatory and legal requirements; and

(b) The auditor’s report issued is appropriate in the circumstances.

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

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

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

(c) Engagement quality control reviewer – a partner, other person2 in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.

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

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

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

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

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

2 Such other person should be a member of the Institute of Chartered Accountants of India.
(i) Network firm – A firm or entity that belongs to a network.
(j) Network – A larger structure:
   (i) That is aimed at cooperation, and
   (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.
(k) Partner – any individual with authority to bind the firm with respect to the performance of a professional services engagement.
(l) Personnel – partners and staff.
(m) Professional Standards – Engagement Standards, as defined in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, issued by the Institute of Chartered Accountants of India and relevant ethical requirements as contained in the Code of Ethics issued by the Institute.
(n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise the Code of Ethics of the Institute of Chartered Accountants of India related to an audit of financial statements.
(o) Staff – professionals, other than partners, including any experts which the firm employs.
(p) Suitably qualified external person – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner or an employee\(^3\) (with appropriate experience) of another firm.

Requirements

Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner’s attention through the firm’s system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

Independence

11. The engagement partner shall form a conclusion on compliance with independence

\(^3\) Such employee should be a member of the Institute of Chartered Accountants of India.
requirements that apply to the audit engagement. In doing so, the engagement partner shall:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) Evaluate information on identified breaches, if any, of the firm’s independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A5-A7)

Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

Assignment of Engagement Teams

14. The engagement partner shall be satisfied that the engagement team, and any auditor’s experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

(a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements; and

(b) Enable an auditor’s report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

Engagement Performance

Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:

(a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and (Ref: Para. A13-A15, A20)

(b) The auditor’s report being appropriate in the circumstances.

Reviews

16. The engagement partner shall take responsibility for reviews being performed in
accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)

17. On or before the date of the auditor's report, the engagement partner shall, through a
review of the audit documentation and discussion with the engagement team, be satisfied
that sufficient appropriate audit evidence has been obtained to support the conclusions
reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

**Consultation**

18. The engagement partner shall:

(a) Take responsibility for the engagement team undertaking appropriate consultation on
difficult or contentious matters;

(b) Be satisfied that members of the engagement team have undertaken appropriate
consultation during the course of the engagement, both within the engagement team
and between the engagement team and others at the appropriate level within or outside
the firm;

(c) Be satisfied that the nature and scope of, and conclusions resulting from, such
consultations are agreed with the party consulted; and

(d) Determine that conclusions resulting from such consultations have been
implemented. (Ref: Para. A21-A22)

**Engagement Quality Control Review**

19. For audits of financial statements of listed entities, and those other audit engagements, if
any, for which the firm has determined that an engagement quality control review is required,
the engagement partner shall:

(a) Determine that an engagement quality control reviewer has been appointed;

(b) Discuss significant matters arising during the audit engagement, including those
identified during the engagement quality control review, with the engagement quality
control reviewer; and

(c) Not date the auditor's report until the completion of the engagement quality control
review. (Ref: Para. A23-A25)

20. The engagement quality control reviewer shall perform an objective evaluation of the
significant judgments made by the engagement team, and the conclusions reached in
formulating the auditor's report. This evaluation shall involve:

(a) Discussion of significant matters with the engagement partner;

(b) Review of the financial statements and the proposed auditor's report;

(c) Review of selected audit documentation relating to the significant judgments the
engagement team made and the conclusions it reached; and

(d) Evaluation of the conclusions reached in formulating the auditor's report and
consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-
A27, A29-A31)

21. For audits of financial statements of listed entities, the engagement quality control reviewer,
on performing an engagement quality control review, shall also consider the following:

(a) The engagement team’s evaluation of the firm’s independence in relation to the audit engagement;

(b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and

(c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments made and supports the conclusions reached. (Ref: Para. A28-A31)

Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm’s policies and procedures for dealing with and resolving differences of opinion.

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm’s monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

Documentation

24. The auditor shall document:

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A35)

25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

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

(b) The engagement quality control review has been completed on or before the date of the auditor’s report; and

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

Application and Other Explanatory Material

System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

A1. SQC 1 deals with the firm’s responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

Reliance on the Firm’s System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm’s system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to regulatory and legal requirements through the monitoring process.

Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:
   (i) Performing work that complies with professional standards and regulatory and legal requirements;
   (ii) Complying with the firm’s quality control policies and procedures as applicable;
   (iii) Issuing auditor’s reports that are appropriate in the circumstances; and
   (iv) The engagement team’s ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

Relevant Ethical Requirements

Compliance with Relevant Ethical Requirements (Ref: Para. 9)

A4. The Code of Ethics issued by the Institute of Chartered Accountants of India establishes
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the fundamental principles of professional ethics, which include:
(a) Integrity;
(b) Objectivity;
(c) Professional competence and due care;
(d) Confidentiality; and
(e) Professional behavior.

Definition of “Firm”, “Network” and “Network Firm” (Ref: Para. 9-11)

A5. The definitions of “firm”, “network” or “network firm” in relevant ethical requirements may differ from those set out in this SA. For example, the Code of Ethics of the Institute of Chartered Accountants of India (ICAI) defines the “Network Firm” as:

“Networking amongst two or more firms under common control, ownership or management with the firm or having affiliation with an accounting entity or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally”.

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply to the extent necessary to interpret those ethical requirements.

Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

A7. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), statutory measures may provide safeguards for the independence of auditors of certain entities. However, such auditors or audit firms carrying out audits on behalf of the statutory auditor may, depending on the terms of the applicable legal or regulatory framework, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the auditor’s applicable law or regulation does not permit withdrawal of the auditor from the engagement, disclosure through a public report, of circumstances that have arisen that would, have otherwise lead the auditor to withdraw.

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

A8. SQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an
existing client\(^4\). Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

A9. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A7 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to the auditors of such entities in performing risk assessments and in carrying out reporting responsibilities.

**Assignment of Engagement Teams** (Ref: Para. 14)

A10. An engagement team also includes a member using expertise in a specialised area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team’s:

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical expertise, including expertise with relevant information technology and specialised areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm’s quality control policies and procedures.

A12. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a

\(^4\) SQC 1, paragraph 28.
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particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of audit of such entities may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with legislative authorities and preventing and detecting fraud and corruption.

Engagement Performance

**Direction, Supervision and Performance** (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by SA 200\(^5\).
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity’s business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A15. Supervision includes matters such as:

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

Reviews

\(^5\) SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, paragraph 15.
Part I: Engagement and Quality Control Standards

**Review Responsibilities (Ref: Para. 16)**

A16. Under SQC 1, the firm’s review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members.6

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor’s report; and
- The objectives of the engagement procedures have been achieved.

**The Engagement Partner’s Review of Work Performed (Ref: Para. 17)**

A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner’s satisfaction on or before the date of the auditor’s report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;
- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by SA 230, the partner documents the extent and timing of the reviews.7

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraphs A17 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

**Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialised Area of Accounting or Auditing Is Used (Ref: Para. 15-17)**

A20. Where a member of the engagement team with expertise in a specialised area of accounting or auditing is used, direction, supervision and review of that engagement team member’s work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member’s work; and the respective roles of, and the nature, timing and extent of communication between

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6 SQC 1, paragraph 50.
7 SA 230, “Audit Documentation”, paragraph 9(c).
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that member and other members of the engagement team.

- Evaluating the adequacy of that member’s work including the relevance and reasonableness of that member’s findings or conclusions and their consistency with other audit evidence.

**Consultation** (Ref: Para. 18)

A21. Effective consultation on significant technical, ethical, and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organisations that provide relevant quality control services.

**Engagement Quality Control Review**

**Completion of the Engagement Quality Control Review before Dating of the Auditor’s Report** (Ref: Para. 19(c))

A23. SA 700 requires the auditor’s report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor’s opinion on the financial statements. In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer’s satisfaction on or before the date of the auditor’s report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor’s report as part of the assembly of the final audit file. SA 230 establishes requirements and provides guidance in this regard.

**Nature, Extent and Timing of Engagement Quality Control Review** (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

A27. The extent of the engagement quality control review may depend, among other things,

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8 SA 700, “Forming an Opinion and Reporting on Financial Statements”, paragraph 41.
9 SA 230, paragraphs 14-16 and A21-A24.
on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor’s report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with SA 315\(^{10}\), and the responses to those risks in accordance with SA 330\(^{11}\), including the engagement team’s assessment of, and response to, the risk of fraud in accordance with SA 240\(^{12}\).
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Considerations Specific to Smaller Entities (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for such audit engagements also that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm’s audit engagements may meet the criteria that would subject them to such a review.

Considerations Specific to Central/State Governments and Related Government Entities (Ref: Para. 20-21)

A30. In case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for certain entities audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

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\(^{10}\) SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment”.

\(^{11}\) SA 330, “The Auditor’s Responses to Assessed Risks”.

\(^{12}\) SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”.

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A31. Certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), may not necessarily be listed entities yet may be significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the certain entities may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, auditors of such entities evaluate which of these entities may be of sufficient significance to warrant performance of an engagement quality control review.

**Monitoring** (Ref: Para. 23)

A32. SQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control is relevant, adequate and operating effectively\(^\text{13}\).

A33. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A34. A deficiency in the firm’s system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory and legal requirements, or that the auditor’s report was not appropriate.

**Documentation**

**Documentation of Consultations** (Ref: Para. 24(d))

A35. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

**Modifications vis-à-vis ISA 220, “Quality Control for an Audit of Financial Statements”**

**Deletion**

Paragraphs A7, A9, A12, A30 and A31 of the Application Section of ISA 220 dealt with the application of the requirements of ISA 220 to the audits of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that these requirements may also exist in case of non public sector entities pursuant to a requirement under the statute. Accordingly, the spirit of paragraphs A7, A9, A12, A30 and A31 has, accordingly, been made more generic in its application.

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\(^{13}\) SQC 1, Paragraph 86.
SA 230*  
Audit Documentation  
(Effective for audits of financial statements for periods beginning on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this SA and the specific documentation requirements of other relevant SAs provides:
   (a) Evidence of the auditor’s basis for a conclusion about the achievement of the overall objectives of the auditor; and
   (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

3. Audit documentation serves a number of additional purposes, including the following:
   ♦ Assisting the engagement team to plan and perform the audit.
   ♦ Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 2201.
   ♦ Enabling the engagement team to be accountable for its work.
   ♦ Retaining a record of matters of continuing significance to future audits.
   ♦ Enabling the conduct of quality control reviews and inspections in accordance with SQC 12.

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* Published in January, 2009 issue of the Journal.
2 SQC 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”, paragraphs 46, 60, 63, 65 and 85.

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Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

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

Objective
5. The objective of the auditor is to prepare documentation that provides:
(a) A sufficient and appropriate record of the basis for the auditor’s report; and
(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Definitions
6. For purposes of the SAs, the following terms have the meanings attributed below:
(a) Audit documentation – The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used).
(b) Audit file – One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
(c) Experienced auditor – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
   (i) Audit processes;
   (ii) SAs and applicable legal and regulatory requirements;
   (iii) The business environment in which the entity operates; and
   (iv) Auditing and financial reporting issues relevant to the entity’s industry.

Requirements
Timely Preparation of Audit Documentation
7. The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)

Documentation of the Audit Procedures Performed and Audit Evidence Obtained
Form, Content and Extent of Audit Documentation
8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16- A17)
(a) The nature, timing, and extent of the audit procedures performed to comply with the SAs and applicable legal and regulatory requirements; (Ref: Para. A6-A7)
(b) The results of the audit procedures performed, and the audit evidence obtained; and
(c) Significant matters arising during the audit, the conclusions reached thereon, and
significant professional judgments made in reaching those conclusions. (Ref: Para. A8-A11)

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
   (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)
   (b) Who performed the audit work and the date such work was completed; and
   (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)

10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para. A14)

11. If the auditor identified information that is inconsistent with the auditor’s final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (Ref: Para. A15)

**Departure from a Relevant Requirement**

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in a SA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Ref: Para. A18-A19)

**Matters Arising after the Date of the Auditor’s Report**

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor’s report, the auditor shall document:
   (Ref: Para. A20)
   (a) The circumstances encountered;
   (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor’s report; and
   (c) When and by whom the resulting changes to audit documentation were made and reviewed.

**Assembly of the Final Audit File**

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report. (Ref: Para. A21-A22)

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. (Ref: Para. A23)

16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature
of the modifications or additions, document: (Ref: Para. A24 -A25)

(a) The specific reasons for making them; and
(b) When and by whom they were made and reviewed.

Application and Other Explanatory Material

Timely Preparation of Audit Documentation (Ref: Para. 7)

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor’s report is finalised. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation (Ref: Para. 8)

A2. The form, content and extent of audit documentation depend on factors such as:

♦ The size and complexity of the entity.
♦ The nature of the audit procedures to be performed.
♦ The identified risks of material misstatement.
♦ The significance of the audit evidence obtained.
♦ The nature and extent of exceptions identified.
♦ The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
♦ The audit methodology and tools used.

A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

♦ Audit programmes.
♦ Analyses.
♦ Issues memoranda.
♦ Summaries of significant matters.
♦ Letters of confirmation and representation.
♦ Checklists.
♦ Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity’s records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity’s accounting records.

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking,
previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

**Documentation of Compliance with SAs (Ref: Para. 8(a))**

A6. In principle, compliance with the requirements of this SA will result in the audit documentation being sufficient and appropriate in the circumstances. Other SAs contain specific documentation requirements that are intended to clarify the application of this SA in the particular circumstances of those SAs. The specific documentation requirements of other SAs do not limit the application of this SA. Furthermore, the absence of a documentation requirement in any particular SA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that SA.

A7. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

♦ The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.

♦ The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.

♦ An auditor’s report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.

♦ In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
  
  • For example, there may be no single way in which the auditor’s professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor’s exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management’s responses to the auditor’s inquiries.
  
  • Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner’s timely involvement in aspects of the
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audit, such as participation in the team discussion required by SA 315. 

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

♦ Matters that give rise to significant risks (as defined in SA 315).

♦ Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor’s previous assessment of the risks of material misstatement and the auditor’s responses to those risks.

♦ Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.

♦ Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor’s report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor’s conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

♦ The rationale for the auditor’s conclusion when a requirement provides that the auditor ‘shall consider’ certain information or factors, and that consideration is significant in the context of the particular engagement.

♦ The basis for the auditor’s conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).

♦ The basis for the auditor’s conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides

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4 SA 315, paragraph 4(e).
such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor’s consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer (Ref: Para. 9)

A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

♦ For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
♦ For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
♦ For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period April 1 to September 30, starting with report number 12345 and selecting every 125th report).
♦ For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
♦ For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A13. SA 220\textsuperscript{5} requires the auditor to review the audit work performed through review of the audit documentation. The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others (Ref: Para. 10)

A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity’s personnel

\textsuperscript{5} SA 220, paragraph 17.
and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

Documentation of How Inconsistencies have been addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref: Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, determined in accordance with SA 320, assessed risks, significant matters noted during the audit, and conclusions reached.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The requirements of the SAs are designed to enable the auditor to achieve the objectives specified in the SAs, and thereby the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the SAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant only in the cases where:

(a) The entire SA is not relevant [for example, if an entity does not have an internal audit function, nothing in SA 610 is relevant]; or

(b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor’s opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

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6 SA 320, “Materiality in Planning and Performing an Audit”.
7 Refer paragraph 22 of SA 200.
8 SA 610, “Using the Work of Internal Auditors.”
Matters Arising after the Date of the Auditor’s Report (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor’s report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor’s report. The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in SA 220, with the engagement partner taking final responsibility for the changes.

Assembly of the Final Audit File (Ref: Para. 14-16)

A21. SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report.

A22. The completion of the assembly of the final audit file after the date of the auditor’s report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

♦ Deleting or discarding superseded documentation.
♦ Sorting, collating and cross referencing working papers.
♦ Signing off on completion checklists relating to the file assembly process.
♦ Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor’s report.

A23. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor’s report, or, if later, the date of the group auditor’s report.

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10 SA 220, paragraph 16.
11 Refer para 74 of SQC 1.
12 Refer para 75 of SQC 1.
13 Refer para 82 of SQC 1.
14 The Council of the Institute had in August 2009, pursuant to the provisions of Rule 12 of the Chartered Accountants (Procedures of Investigations of Professional and Other Misconduct and Cases) Rules, 2007 had amended the audit documentation retention period appearing as ten years in paragraph 83 of SQC 1 to seven years. As a consequence of above decision of the Council, the audit documentation retention period appearing as ten years in paragraph A23 of SA 230, ‘Audit Documentation’, issued in January 2009, shall also stand amended to seven years. The complete text of the Announcement is published in Paragraph ‘C’, “Announcements/Clarifications” of Section 1, “Announcements of the Council regarding Status of Various Documents issued by the Institute of Chartered Accountants of India”, included in Volume I.A of the Handbook.
15 Refer para 83 of SQC 1.
A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

Ownership of Audit Documentation

A25. Standard on Quality Control (SQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements”, issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Material Modifications to ISA 230, “Audit Documentation”

Addition

1. Paragraph A23 of ISA 230 prescribes the minimum period of engagement documentation as five years. The SA 230 prescribes the minimum period of retention of engagement documentation as seven years since, as per the provisions of the Chartered Accountants Act, 1949, and regulations made there under, prescribe the minimum period of retention of working papers as seven years.

2. An additional paragraph A25 has been added from SQC 1, giving provisions regarding Ownership of Audit Documentation.
SA 240*

The Auditor’s Responsibilities Relating to Fraud In An Audit of Financial Statements
(Effective for audits of financial statements for periods beginning on or after April 1, 2009)

Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how SA 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment,” and SA 330, “The Auditor’s Responses to Assessed Risks,” are to be applied in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

3. Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of
controls or other inappropriate influence over the financial reporting process, such as efforts by
management to manage earnings in order to influence the perceptions of analysts as to the
entity’s performance and profitability.

**Responsibilities of the Auditor**

5. An auditor conducting an audit in accordance with SAs is responsible for obtaining
reasonable assurance that the financial statements taken as a whole are free from material
misstatement, whether caused by fraud or error. Owing to the inherent limitations of an
audit, there is an unavoidable risk that some material misstatements of the financial
statements may not be detected, even though the audit is properly planned and performed in
accordance with the SAs.¹

6. As described in SA 200², the potential effects of inherent limitations are particularly
significant in the case of misstatement resulting from fraud. The risk of not detecting a
material misstatement resulting from fraud is higher than the risk of not detecting one
resulting from error. This is because fraud may involve sophisticated and carefully organized
schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or
intentional misrepresentations being made to the auditor. Such attempts at concealment
may be even more difficult to detect when accompanied by collusion. Collusion may cause
the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor’s
ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the
frequency and extent of manipulation, the degree of collusion involved, the relative size of
individual amounts manipulated, and the seniority of those individuals involved. While the
auditor may be able to identify potential opportunities for fraud to be perpetrated, it is
difficult for the auditor to determine whether misstatements in judgment areas such as
accounting estimates are caused by fraud or error.

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from
management fraud is greater than for employee fraud, because management is frequently in
a position to directly or indirectly manipulate accounting records, present fraudulent financial
information or override control procedures designed to prevent similar frauds by other
employees.

8. When obtaining reasonable assurance, the auditor is responsible for maintaining
professional skepticism throughout the audit, considering the potential for management
override of controls and recognizing the fact that audit procedures that are effective for
detecting error may not be effective in detecting fraud. The requirements in this SA are
designed to assist the auditor in identifying and assessing the risks of material misstatement
due to fraud and in designing procedures to detect such misstatement.

**Effective Date**

9. This SA is effective for audits of financial statements for periods beginning on or after 1st
April, 2009.

¹ SA 200, paragraph A51.
² SA 200, paragraph A51.

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Objectives

10. The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement in the financial statements due to fraud;

(b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

(c) To respond appropriately to identified or suspected fraud.

Definitions

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

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

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

Requirements

Professional Skepticism

12. In accordance with SA 200\(^3\), the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance. (Ref: Para. A7–A8)

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion Among the Engagement Team

15. SA 315 requires a discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion\(^4\). This discussion shall place particular emphasis on how and where the entity’s financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members’ beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

\(^3\) SA 200, paragraph 15.

\(^4\) SA 315, paragraph 10.
Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity’s internal control, required by SA 315, the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

(a) Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)

(b) Management’s process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)

(c) Management’s communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

(d) Management’s communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

19. For those entities that have an internal audit function, the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management’s processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

Unusual or Unexpected Relationships Identified

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may
indicate risks of material misstatement due to fraud.

**Other Information**

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

**Evaluation of Fraud Risk Factors**

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

**Identification and Assessment of the Risks of Material Misstatement Due to Fraud**

25. In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)

27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity’s related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

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

**Overall Responses**

28. In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. (Ref: Para. A33)

29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:
   
   (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor’s assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)

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7 SA 315, Paragraph 25.
8 SA 330, paragraph 5.
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(b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management’s effort to manage earnings; and

(c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

30. In accordance with SA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.9 (Ref: Para. A37-A40)

Audit Procedures Responsive to Risks Related to Management Override of Controls

31. Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

32. Irrespective of the auditor’s assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

(a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

(i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

(ii) Select journal entries and other adjustments made at the end of a reporting period; and

(iii) Consider the need to test journal entries and other adjustments throughout the period. (Ref: Para. A41-A44)

(b) Review accounting estimates10 for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the auditor shall:

(i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are

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9 SA 330, paragraph 6.
10 Reference may be made to SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”.

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individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and

(ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year11. (Ref: Para. A45-A46)

(c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (Ref: Para. A47)

33. The auditor shall determine whether, in order to respond to the identified risks of management override of controls, the auditor needs to perform other audit procedures in addition to those specifically referred to above (i.e., when there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 32).

Evaluation of Audit Evidence (Ref: Para. A48)

34. The auditor shall evaluate whether analytical procedures12 that are performed when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud. (Ref: Para. A49)

35. When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. A50)

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A51)

11 Accounting Standard (AS) 5, “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” requires the adjustment of the prior period estimates, which may affect both the period of change in the Accounting Estimates and subsequent periods, in subsequent years.

12 Reference may be made to SA 520, “Analytical Procedures”.

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37. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A52)

**Auditor Unable to Continue the Engagement**

38. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A53-A56)

**Management Representations**

39. The auditor shall obtain written representations from management and, where applicable, those charged with governance that:

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

(b) They have disclosed to the auditor the results of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud;

(c) They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:

(i) Management;

(ii) Employees who have significant roles in internal control; or

(iii) Others where the fraud could have a material effect on the financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity’s financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A57-A58)

**Communications to Management and with Those Charged with Governance**

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the
appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:
(a) Management;
(b) Employees who have significant roles in internal control; or
(c) Others where the fraud results in a material misstatement in the financial statements.

The auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A60-A62)

42. In accordance with SA 260, Communication with Those Charged with Governance\(^{13}\), the auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor’s judgment, relevant to their responsibilities. (Ref: Para. A63)

Communications to Regulatory and Enforcement Authorities

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor’s professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor’s legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A64-A66)

Documentation

44. The auditor’s documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315\(^{14}\) shall include:
(a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity’s financial statements to material misstatement due to fraud; and
(b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

45. The auditor’s documentation of the responses to the assessed risks of material misstatement required by SA 330\(^{15}\) shall include:
(a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and

\(^{13}\) Reference may be made to SA 260, “Communication with Those Charged with Governance”.
\(^{14}\) SA 315, paragraph 32.
\(^{15}\) SA 330, paragraph 28.
(b) The results of the audit procedures, including those designed to address the risk of management override of controls.

46. The auditor shall document communications about fraud made to management, those charged with governance, regulators and others.

47. When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion.

**Application and Other Explanatory Material**

**Characteristics of Fraud** (Ref: Para. 3)

A1. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A2. Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity’s performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:
Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.

Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.

Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity’s purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity’s assets for personal use (for example, using the entity’s assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.
A6. The auditor may, at times, be required to by a legislation or a regulation to make a specific assertion in respect of frauds on/by the entity in his report. For example, Clause (xxi) of Paragraph 4 of the Companies (Auditor’s Report) Order, 2003 requires the auditor to specifically report “whether any fraud on or by the entity has been noticed or reported during the year; if yes, the nature and amount involved is to be indicated”. Similarly, in case of audit of banks, the auditors, in terms of the circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02, is required to report to the Reserve Bank of India anything susceptible to fraud or fraudulent activity or act of excess power or any foul play in any transaction. Consequently, in such cases, the auditor’s responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref: Para. 12-14)

A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor’s professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity’s management and those charged with governance, the auditor’s professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. As explained in SA 200, an audit performed in accordance with SAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

Discussion among the Engagement Team (Ref: Para. 15)

A10. Discussing the susceptibility of the entity’s financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit

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16 SA 200, paragraph A47.
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procedures.

- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor’s attention.

A11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity’s financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.

- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.

- A consideration of management’s involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.

- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.

- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.

- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.

- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.

- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity’s financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.

- A consideration of any allegations of fraud that have come to the auditor’s attention.

- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management’s Assessment of the Risk of Material Misstatement Due to Fraud [Ref: Para. 17(a)]

A12. Management accepts responsibility for the entity’s internal control and for the preparation of the entity’s financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management’s own assessment of the risk of fraud and the
controls in place to prevent and detect it. The nature, extent and frequency of management’s assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management’s assessment may be less structured and less frequent. The nature, extent and frequency of management’s assessment are relevant to the auditor’s understanding of the entity’s control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management’s assessment may be on the risks of employee fraud or misappropriation of assets.

Management’s Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14. In the case of entities with multiple locations management’s processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15. The auditor’s inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management’s responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. SA 315 and SA 610, establishes requirements and provides guidance in audits of those
entities that have an internal audit function. In carrying out the requirement of those SAs in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

**Obtaining an Understanding of Oversight Exercised by Those Charged With Governance**

(Ref: Para. 20)

A19. Those charged with governance of an entity have oversight responsibility for systems for monitoring risk, financial control and compliance with the law. In many entities, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity’s assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

**Considerations Specific to Smaller Entities**

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

**Consideration of Other Information** (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor’s client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

17 SA 315, paragraph 23 and SA 610, “Using the Work of Internal Auditors”.
18 SA 260, “Communication with Those Charged with Governance”, paragraphs A1-A8, discusses with whom the auditor communicates when the entity’s governance structure is not well defined.
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Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in assessing the risks of material misstatement of the financial statements due to fraud requires the exercise of professional judgment.

A25. Examples of fraud risk factors related to fraudulent financial reporting and misappropriation of assets are presented in Appendix 1. These illustrative risk factors are classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information. Although the fraud risk factors described in Appendix 1 cover a broad range of situations that may be faced by auditors, they are only examples and other risk factors may exist.

A26. The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Considerations Specific to Smaller Entities

A27. In the case of a small entity, some or all of these considerations may be inapplicable or
less relevant. For example, a smaller entity may not have a written code of conduct but, instead, may have developed a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example. Domination of management by a single individual in a small entity does not generally, in and of itself, indicate a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. In some entities, the need for management authorization can compensate for otherwise deficient controls and reduce the risk of employee fraud. However, domination of management by a single individual can be a potential deficiency in internal control since there is an opportunity for management override of controls.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

**Risks of Fraud in Revenue Recognition** (Ref: Para. 26)

A28. Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue recognition or recording fictitious revenues. It may result also from an understatement of revenues through, for example, improperly shifting revenues to a later period.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year-over-year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity’s Related Controls (Ref: Para. 27)

A31. As explained in SA 315 management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In

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19 SA 315, paragraph A48.
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doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor’s assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

A35. The extent of supervision reflects the auditor’s assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work.

Unpredictability in the Selection of Audit Procedures (Ref: Para. 29(c))

A36. Incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures to be performed is important as individuals within the entity who are familiar with the audit procedures normally performed on engagements may be more able to conceal fraudulent financial reporting. This can be achieved by, for example:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level (Ref: Para. 30)

A37. The auditor’s responses to address the assessed risks of material misstatement due to
fraud at the assertion level may include changing the nature, timing, and extent of audit procedures in the following ways:

- The nature of audit procedures to be performed may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of audit procedures to be performed and their combination. For example:

  - Physical observation or inspection of certain assets may become more important or the auditor may choose to use computer-assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.

  - The auditor may design procedures to obtain additional corroborative information. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a related risk that management is inflating sales by entering into sales agreements that include terms that preclude revenue recognition or by invoicing sales before delivery. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor might find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

- The timing of substantive procedures may need to be modified. The auditor may conclude that performing substantive testing at or near the period end better addresses an assessed risk of material misstatement due to fraud. The auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement—for example, a misstatement involving improper revenue recognition—may have been initiated in an interim period, the auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.

- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

A38. If the auditor identifies a risk of material misstatement due to fraud that affects inventory quantities, examining the entity’s inventory records may help to identify locations or items that require specific attention during or after the physical inventory count. Such a review may lead to a decision to observe inventory counts at certain locations on an unannounced basis or to conduct inventory counts at all locations on the same date.
A39. The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. These may include asset valuation, estimates relating to specific transactions (such as acquisitions, restructurings, or disposals of a segment of the business), and other significant accrued liabilities (such as pension and other post-employment benefit obligations, or environmental remediation liabilities). The risk may also relate to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

A40. Examples of possible audit procedures to address the assessed risks of material misstatement due to fraud, including those that illustrate the incorporation of an element of unpredictability, are presented in Appendix 2. The appendix includes examples of responses to the auditor’s assessment of the risks of material misstatement resulting from both fraudulent financial reporting, including fraudulent financial reporting resulting from revenue recognition, and misappropriation of assets.

Audit Procedures Responsive to Risks Related to Management Override of Controls

Journal Entries and Other Adjustments (Ref: Para. 32(a))

A41. Material misstatement of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

A42. Further, the auditor’s consideration of the risks of material misstatement associated with inappropriate override of controls over journal entries is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or to the financial reporting system. Furthermore, when IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

A43. When identifying and selecting journal entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance:

- The assessment of the risks of material misstatement due to fraud – the presence of fraud risk factors and other information obtained during the auditor’s assessment of the risks of material misstatement due to fraud may assist the auditor to identify specific classes of journal entries and other adjustments for testing.

- Controls that have been implemented over journal entries and other adjustments – effective controls over the preparation and posting of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that the
The auditor has tested the operating effectiveness of the controls.

- The entity’s financial reporting process and the nature of evidence that can be obtained – for many entities routine processing of transactions involves a combination of manual and automated steps and procedures. Similarly, the processing of journal entries and other adjustments may involve both manual and automated procedures and controls. When information technology is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.

- The characteristics of fraudulent journal entries or other adjustments – inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make journal entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the financial statements that do not have account numbers, or (e) containing round numbers or consistent ending numbers.

- The nature and complexity of the accounts – inappropriate journal entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (c) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain unreconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select journal entries from multiple locations.

- Journal entries or other adjustments processed outside the normal course of business – non standard journal entries may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements.

A44. The auditor uses professional judgment in determining the nature, timing and extent of testing of journal entries and other adjustments. However, because fraudulent journal entries and other adjustments are often made at the end of a reporting period, paragraph 32(a)(ii) requires the auditor to select the journal entries and other adjustments made at that time. Further, because material misstatements in financial statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, paragraph 32(a)(iii) requires the auditor to consider whether there is also a need to test journal entries and other adjustments throughout the period.

**Accounting Estimates (Ref: Para. 32(b))**

A45. In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same
fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity’s performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor’s professional judgments made in the prior year that were based on information available at the time.

Business Rationale for Significant Transactions (Ref: Para. 32(c))

A47. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref: Para. 34-37)

A48. SA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.20 This evaluation is primarily a qualitative matter based on the auditor’s judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

Analytical Procedures Performed in the Overall Review of the Financial Statements (Ref: Para. 34)

A49. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-

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20 SA 330, paragraph 25.
end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

**Consideration of Identified Misstatements** (Ref: Para. 35-37)

A50. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A51. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A52. SA 450, “Evaluation of Misstatements Identified during the Audit”, and SA 700, “Forming an Opinion and Reporting on Financial Statements”, establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor’s opinion in the auditor’s report.

**Auditor Unable to Continue the Engagement** (Ref: Para. 38)

A53. Examples of exceptional circumstances that may arise and that may bring into question the auditor’s ability to continue performing the audit include:

(a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even when the fraud is not material to the financial statements;

(b) The auditor’s consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A54. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor’s conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A55. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary under different legislations and regulations and, accordingly, the

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clients. Under some legislations/ regulations, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.  

A56. In some cases, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the terms of appointment or public interest considerations.

Management Representations (Ref: Para. 39)

A57. SA 580, “Written Representations”, establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A58. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

(a) The results of management’s assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

A59. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity’s organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication with Those Charged with Governance (Ref: Para. 41)

22 The Code of Ethics issued by the Institute of Chartered Accountants of India contains guidance on communication between the outgoing and incoming auditor.

23 SA 580, “Written Representations”.

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A60. The auditor’s communication with those charged with governance may be made orally or in writing. SA 260 identifies factors the auditor considers in determining whether to communicate orally or in writing. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

A61. In some cases, the auditor may consider it appropriate to communicate with those charged with governance when the auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the auditor and those charged with governance agree at an early stage in the audit about the nature and extent of the auditor’s communications in this regard.

A62. In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

**Other Matters Related to Fraud** (Ref: Para. 42)

A63. Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management’s assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- The auditor’s evaluation of the entity’s control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management’s selection and application of accounting policies that may be indicative of management’s effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity’s performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

**Communications to Regulatory and Enforcement Authorities** (Ref: Para. 43)

A64. The auditor’s professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor’s legal responsibilities vary by law & statute and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some entities, for example, in case

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24 SA 260, Paragraph A42.
of audit of banks, the auditor has a statutory duty to report the occurrence of fraud to the supervisory authorities, i.e., the Reserve Bank of India, in terms of the latter’s circular no. DBS.FGV.(F).No. BC/23.08.001/2001-02. Also, in some entities the auditor may have a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.

A65. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

A66. In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation.

Material Modifications to ISA 240, The Auditor’s Responsibility relating to Fraud in an Audit of Financial Statements

Addition

In paragraph A64, the guidance has been made more entity specific, in the context of Indian legal requirement, by way of an example.

Deletions

1. Paragraph A6 of the Application Section of ISA 240 dealt with the application of the requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A6, highlighting the fact that in some cases, the auditors may be required by the legislature or the regulator to specifically report on the instances of actual/suspected fraud in the client entity, has been retained and examples of such situations have also been added.

2. Paragraph A56 of the Application Section of ISA 240 dealt with the considerations specific to public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that option of withdrawal may not be available in case of non public sector entities pursuant to a requirement under the statute or terms of appointment of the auditor. Accordingly, the spirit of erstwhile A56, highlighting that in some cases, the auditors may not be having an option to withdraw from the engagement has been retained.

3. Paragraph A66 of the Application Section of ISA 240 dealt with the application of the
requirements of ISA 240 to the audits of public sector entities. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such a specific reporting requirement may also exist in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of A66 as given in ISA 240, highlighting the fact that in some cases, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation, has been retained.

Appendix 1
(Ref: Para. A25)

Examples of Fraud Risk Factors

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor’s consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.

Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.

Rapid growth or unusual profitability especially compared to that of other companies in the same industry.

New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.

Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.

Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.

Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

Significant financial interests in the entity.

Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.25

Personal guarantees of debts of the entity.

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

A strong financial presence or ability to dominate a certain industry sector that allows
the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.

- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

**Attitudes/Rationalizations**

- Communication, implementation, support, or enforcement of the entity’s values or ethical standards by management, or the communication of inappropriate values or ethical standards, that are not effective.
- Non-financial management’s excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
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- Excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
  - Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor’s report.
  - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor’s work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
Known or anticipated future employee layoffs.
Recent or anticipated changes to employee compensation or benefit plans.
Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities
Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations
- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
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- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

Appendix 2
(Ref: Para. A40)

Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor’s assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect.

The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity’s quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.

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For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.

Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.

Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.

When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.

If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert’s assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.

Performing audit procedures to analyze selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.

Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.

Performing computer-assisted techniques, such as data mining to test for anomalies in a population.

Testing the integrity of computer-produced records and transactions.

Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor’s assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.

Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or

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agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

➢ Inquiring of the entity’s sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.

➢ Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.

➢ For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

➢ Examining the entity’s inventory records to identify locations or items that require specific attention during or after the physical inventory count.

➢ Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.

➢ Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.

➢ Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.

➢ Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.

➢ Using computer-assisted audit techniques to further test the compilation of the physical inventory counts—for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

➢ Using an expert to develop an independent estimate for comparison to management’s estimate.

➢ Extending inquiries to individuals outside of management and the accounting department to corroborate management’s ability and intent to carry out plans that are relevant to developing the estimate.
Specific Responses—Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor’s assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.
Examples of Circumstances that Indicate the Possibility of Fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees’ access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity’s records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity’s record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
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- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor’s critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity’s Code of Conduct.
SA 250*
Consideration of Laws and Regulations in an Audit of Financial Statements
(Effective for all audits commencing on or after April 1, 2009)

Introduction
Scope of this SA
1. This Standard on Auditing (SA) deals with the auditor’s responsibility to consider laws and regulations when performing an audit of financial statements. This SA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Effect of Laws and Regulations
2. The effect on the financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity’s financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity’s financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

Responsibility of Management for Compliance with Laws and Regulations
3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity’s operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity’s financial statements. (Ref: Para. A1-A2)

Responsibility of the Auditor (Ref: Para. A3-A6)
4. The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.

* Published in December, 2008 issue of the Journal.

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However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.\(^2\) In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.\(^3\) In the context of laws and regulations, the potential effects of inherent limitations on the auditor’s ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity’s information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognise the non-compliance.

6. This SA distinguishes the auditor’s responsibilities in relation to compliance with two different categories of laws and regulations as follows:

(a) The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws. (see paragraph 13); and

(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity’s ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 14).

7. In this SA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor’s responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those

\(^2\) SA 200, paragraph 5.

\(^3\) SA 200, paragraph 52.
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laws and regulations. For the category referred to in paragraph 6(b), the auditor’s responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this SA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected non-compliance to the auditor’s attention. Maintaining professional skepticism throughout the audit, as required by SA 200, is important in this context, given the extent of laws and regulations that affect the entity.

Effective Date

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

Objectives

10. The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Definition

11. For the purposes of this SA, the following term has the meaning attributed below:

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

Requirements

The Auditor’s Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with SA 315, the auditor shall obtain a general understanding of:

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4 SA 200, paragraph 15.
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(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
(b) How the entity is complying with that framework. (Ref: Para. A7)

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements. (Ref: Para. A8)

14. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:
(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities. (Ref: Para. A9-A10)

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor’s attention. (Ref: Para. A11)

16. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (Ref: Para. A12)

17. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity’s compliance with laws and regulations, other than those set out in paragraphs 12-16.

**Audit Procedures When Non-Compliance is Identified or Suspected**

18. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para. A13)
(a) An understanding of the nature of the act and the circumstances in which it has occurred; and
(b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A14)

19. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor’s judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. (Ref: Para. A15-A16)

20. If sufficient information about suspected non-compliance cannot be obtained, the
The auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor’s opinion.

21. The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor’s risk assessment and the reliability of written representations, and take appropriate action. (Ref: Para. A17-A18)

**Reporting of Identified or Suspected Non-Compliance**

**Reporting Non-Compliance to Those Charged with Governance**

22. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor’s attention during the course of the audit, other than when the matters are clearly inconsequential.

23. If, in the auditor’s judgment, the non-compliance referred to in paragraph 22 is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

24. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

**Reporting Non-Compliance in the Auditor’s Report on the Financial Statements**

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705, express a qualified or adverse opinion on the financial statements.

26. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

27. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor’s opinion in accordance with SA 705.

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Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. *(Ref: Para. A19-A20)*

Documentation

29. The auditor shall document identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.* *(Ref: Para. A21)*

Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations

Responsibility of Management for Compliance with Laws and Regulations *(Ref: Para. 3)*

A1. Management, with the oversight of those charged with governance, is responsible for ensuring that the entity’s operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity’s financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework.* *(Ref: SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing, paragraph 13 (a)).* They may also establish certain legal rights and obligations of the entity, some of which will be recognised in the entity’s financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

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9 SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing”, paragraph 13 (a).
Responsibility of the Auditor (Ref: Para. 4-8)

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor’s consideration of the integrity of management or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter for legal determination, which is ordinarily beyond the auditor’s professional competence to determine. Nevertheless, the auditor’s training, experience and understanding of the entity and its industry or sector may provide a basis to recognise that some acts, coming to the auditor’s attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, Revised SA 700\(^\text{10}\) or SA 800\(^\text{11}\) deal with how these audit responsibilities are addressed in the auditor’s report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with those provisions of the laws and regulations.

A6. In some audit engagements, specially those relating to audit of government ventures and undertakings, etc., there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity’s operations.

The Auditor’s Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 12)

A7. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor’s existing understanding of the entity’s industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity’s policies and procedures regarding

\(^{10}\) Revised SA 700, “Forming an Opinion and Reporting on Financial Statements”; paragraph 38.

\(^{11}\) SA 800, “Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks”, paragraph 11.
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compliance with laws and regulations; and

- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

**Laws and Regulations Generally Recognised to have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements** (Ref: Para. 13)

A8. Certain laws and regulations are well-established, known to the entity and within the entity’s industry or sector, and relevant to the entity’s financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or retirement benefits.

Some matters may be relevant to specific assertions (for example, the completeness of income tax provisions), while others may be relevant to the financial statements as a whole (for example, the required statements constituting a complete set of financial statements). Non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

**Procedures to Identify Instances of Non-Compliance – Other Laws and Regulations** (Ref: Para. 14)

A9. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity’s continuance as a going concern. For example, non-compliance with the requirements of the entity’s license or other entitlement to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements). To illustrate further, a Non Banking Financial Company might have to cease to carry on the business of a non-banking financial institution if it fails to obtain a certificate of registration issued under Chapter III B of the Reserve Bank of India Act, 1934 and if its Net Owned Funds are less than the amount specified by the RBI in this regard. There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity’s information systems relevant to financial reporting.

A10. As the financial reporting consequences of other laws and regulations can vary depending on the entity’s operations, the audit procedures required by paragraph 14 are directed to bringing to the auditor’s attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.
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Non-Compliance brought to the Auditor’s Attention by Other Audit Procedures (Ref: Para. 15)

A11. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor’s attention. For example, such audit procedures may include:

- Reading minutes;
- Inquiring of the entity’s management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 16)

A12. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management’s knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the auditor.12

Audit Procedures When Non-Compliance is Identified or Suspected

Indications of Non-Compliance with Laws and Regulations (Ref: Para. 18)

A13. When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent’s fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers’ cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.


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- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Matters Relevant to the Auditor’s Evaluation (Ref: Para. 18(b))

A14. Matters relevant to the auditor’s evaluation of the possible effect on the financial statements include:
- The potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures (Ref: Para. 19)

A15. The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the possibility of non-compliance with laws and regulations.

A16. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity’s in-house legal counsel or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. When it is not considered appropriate to consult with the entity’s legal counsel or when the auditor is not satisfied with the legal counsel’s opinion, the auditor may consider it appropriate to consult the auditor’s own legal counsel as to whether a contravention of a law or regulation is involved, the possible legal consequences, including the possibility of fraud, and what further action, if any, the auditor would take.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor’s risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest
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authority within the entity.

A18. In exceptional cases, the auditor may consider whether, unless prohibited by law or regulation, withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is prohibited, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter(s) paragraph in the auditor’s report.13

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor’s professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor’s legal responsibilities vary under different laws and regulations and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. Under the present legal and regulatory framework for financial institutions in India, their auditor has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. For example, the auditor is required to report certain matters of non-compliance to the Reserve Bank of India as per the requirements of Non Banking Financial Companies Auditor’s Report (Reserve Bank) Directions, 1988, issued by the Reserve Bank of India. Also, some laws or regulations require the auditor to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

A20. In case of certain entities, such as national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises), the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor’s report.

Documentation (Ref: Para. 29)

A21. The auditor’s documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

Material Modifications to ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”

Deletions

1. Paragraph A6 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the additional audit responsibilities with respect to the consideration of laws and regulations. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity’s operations. Accordingly, the spirit of erstwhile A6, highlighting the fact that in case of certain entities, there may be additional audit responsibilities with respect to the consideration of laws and regulations, has been retained.

2. Paragraph A20 of the Application Section of ISA 250 deals with the application of the requirements of ISA 250 to the audits of public sector entities regarding the obligation to report on instances of non-compliance to governing authorities or to report them in the auditor’s report. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that even in case of non public sector entities, the auditor may be obliged to report on instances of non-compliance to governing authorities or to report them in the auditor’s report. Accordingly, the spirit of erstwhile A20, highlighting the fact that in case of certain entities, there may be instances of reporting non-compliance to governing authorities or to report them in the auditor’s report, has been retained.
Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibility to communicate with those charged with governance in an audit of financial statements. Although this SA applies irrespective of an entity’s governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity, and for listed entities. This SA does not establish requirements regarding the auditor’s communication with an entity’s management or owners unless they are also charged with a governance role.

2. This SA is written in the context of an audit of financial statements, but may also be applicable, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation of the other historical financial information.

3. Recognizing the importance of effective two-way communication in an audit of financial statements, this SA provides an overarching framework for the auditor’s communication with those charged with governance, and identifies some specific matters to be communicated with them. Additional matters to be communicated, which complement the requirements of this SA, are identified in other SAs (see Appendix 1). In addition, SA 265\(^1\) establishes specific requirements regarding the communication of significant deficiencies in internal control the auditor has identified during the audit to those charged with governance. Further matters, not required by this or other SAs, may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body. Nothing in this SA precludes the auditor from communicating any other matters to those charged with governance. (Ref: Para. A33–A36)

The Role of Communication

4. This SA focuses primarily on communications from the auditor to those charged with governance. Nevertheless, effective two-way communication is important in assisting:

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\(^1\) SA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.
a. The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor’s independence and objectivity;

b. The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

c. Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

5. Although the auditor is responsible for communicating matters required by this SA, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility. Similarly, communication by management with those charged with governance of matters that the auditor is required to communicate does not relieve the auditor of the responsibility to also communicate them. Communication of these matters by management may, however, affect the form or timing of the auditor’s communication with those charged with governance.

6. Clear communication of specific matters required to be communicated by SAs is an integral part of every audit. SAs do not, however, require the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance.

7. Law or regulation may restrict the auditor’s communication of certain matters with those charged with governance. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor’s obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider obtaining legal advice.

Effective Date

8. This SA is effective for audits of financial statements for periods beginning on or after April 1, 2017.

Objectives

9. The objectives of the auditor are:

   (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;

   (b) To obtain from those charged with governance information relevant to the audit;

   (c) To provide those charged with governance with timely observations arising from the
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...audit that are significant and relevant to their responsibility to oversee the financial reporting process; and

d) To promote effective two-way communication between the auditor and those charged with governance.

Definitions

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

(a) **Those charged with governance** – The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1–A8.

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

Requirements

Those Charged with Governance

11. The auditor shall determine the appropriate person(s) within the entity’s governance structure with whom to communicate. (Ref: Para. A1–A4)

Communication with a Subgroup of Those Charged with Governance

12. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5–A7)

When All of Those Charged with Governance Are Involved in Managing the Entity

13. In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A8)

Matters to Be Communicated

The Auditor’s Responsibilities in Relation to the Financial Statement Audit

14. The auditor shall communicate with those charged with governance the responsibilities
of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9–A10)

**Planned Scope and Timing of the Audit**

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: Para. A11–A16)

**Significant Findings from the Audit**

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

(a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)

(b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)

(c) Unless all of those charged with governance are involved in managing the entity:
   i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)
   ii. Written representations the auditor is requesting;

(d) Circumstances that affect the form and content of the auditor’s report, if any; and (Ref: Para. A23–A25)

(e) Any other significant matters arising during the audit that, in the auditor’s professional judgment, are relevant to the oversight of the financial reporting process. (Ref: Para. A26–A28)

**Auditor Independence**

17. In the case of listed entities, the auditor shall communicate with those charged with governance:

(a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and

   i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor’s professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by
the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and

ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level. (Ref: Para. A29–A32)

The Communication Process

Establishing the Communication Process

18. The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A37–A45)

Forms of Communication

19. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor’s professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A46–A48)

20. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

Timing of Communications

21. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A49–A50)

Adequacy of the Communication Process

22. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor’s assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A51–A53)

Documentation

23. Where matters required by this SA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. (Ref: Para. A54)

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2 SA 230, Audit Documentation, paragraphs 8–11, and A6.
Application and Other Explanatory Material

Those Charged with Governance (Ref: Para. 11)

A1. Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some entities, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a "two-tier board" structure). In other entities, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a “one-tier board” structure).
- In some entities, those charged with governance hold positions that are an integral part of the entity’s legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.
- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility).

A2. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A3. Such diversity means that it is not possible for this SA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor’s understanding of an

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3 As described in paragraph A60 of SA 700 (Revised), Forming an Opinion and Reporting on Financial Statements, having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

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entity’s governance structure and processes obtained in accordance with SA 315\(^4\) is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A4. SA 600 includes specific matters to be communicated by group auditors with those charged with governance. When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 12)

A5. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

A6. When deciding whether there is also a need to communicate information, in full or in summary form, with the governing body, the auditor may be influenced by the auditor’s assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor may make explicit in agreeing the terms of engagement that, unless prohibited by law or regulation, the auditor retains the right to communicate directly with the governing body.

A7. Audit committees (or similar subgroups with different names) exist in many entities. Although their specific authority and functions may differ, communication with the audit committee, where one exists, has become a key element in the auditor’s communication with those charged with governance. Good governance principles suggest that:

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without management present at least annually.

When All of Those Charged with Governance Are Involved in Managing the Entity (Ref: Para.13)

\(^4\) SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
A8. In some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position. In such cases, communication with person(s) with management responsibilities may not adequately inform all of those with whom the auditor would otherwise communicate in their governance capacity. For example, in a company where all directors are involved in managing the entity, some of those directors (e.g., one responsible for marketing) may be unaware of significant matters discussed with another director (e.g., one responsible for the preparation of the financial statements).

**Matters to Be Communicated**

*The Auditor's Responsibilities in Relation to the Financial Statement Audit (Ref: Para. 14)*

A9. The auditor’s responsibilities in relation to the financial statement audit are often included in the engagement letter or other suitable form of written agreement that records the agreed terms of the engagement.\(^5\) Law, regulation or the governance structure of the entity may require those charged with governance to agree the terms of the engagement with the auditor. When this is not the case, providing those charged with governance with a copy of that engagement letter or other suitable form of written agreement may be an appropriate way to communicate with them regarding such matters as:

- The auditor’s responsibility for performing the audit in accordance with SAs, which is directed towards the expression of an opinion on the financial statements. The matters that SAs require to be communicated, therefore, include significant matters arising during the audit of the financial statements that are relevant to those charged with governance in overseeing the financial reporting process.

- The fact that SAs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.

- When SA 7016 applies, the auditor’s responsibilities to determine and communicate key audit matters in the auditor’s report.

- When applicable, the auditor’s responsibility for communicating particular matters required by law or regulation, by agreement with the entity or by additional requirements applicable to the engagement, for example, the standards of a national professional accountancy body.

A10. Law or regulation, an agreement with the entity or additional requirements applicable to the engagement may provide for broader communication with those charged with governance. For example, (a) an agreement with the entity may provide for particular matters to be communicated when they arise from services provided by a firm or network firm other than the financial statement audit; or (b) the mandate of a public sector auditor may provide for matters to be communicated that come to the auditor’s attention as a result of other work, such as performance audits.

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\(^5\) See paragraph 10 of SA 210, Agreeing the Terms of Audit Engagements.  
\(^6\) SA 701, Communicating Key Audit Matters in the Independent Auditor’s Report. 

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Planned Scope and Timing of the Audit (Ref: Para. 15)

A11. Communication regarding the planned scope and timing of the audit may:

- Assist those charged with governance to understand better the consequences of the auditor’s work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures; and
- Assist the auditor to understand better the entity and its environment.

A12. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

A13. Matters communicated may include:

(a) How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.
(b) How the auditor plans to address areas of higher assessed risks of material misstatement.
(c) The auditor’s approach to internal control relevant to the audit.
(d) The application of the concept of materiality in the context of an audit.\(^7\)
(e) The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor’s expert.\(^8\)
(f) When SA 701 applies, the auditor’s preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, how the external auditor and internal auditors can work together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.\(^9\)
- The views of those charged with governance of:
  - The appropriate person(s) in the entity’s governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity’s objectives and strategies, and the related business risks that may result

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\(^7\) SA 320, Materiality in Planning and Performing an Audit.
\(^8\) See SA 620, ‘Using the Work of an Auditor’s Expert’.
in material misstatements.

- Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
- Significant communications with regulators.
- Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity’s internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, exchange listing rules, and related matters.
- The responses of those charged with governance to previous communications with the auditor.

A15. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor’s sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

A16. Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

**Significant Findings from the Audit** (Ref: Para. 16)

A17. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

A18. When SA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor’s determination of matters that required significant auditor attention and which therefore may be key audit matters.\(^\text{10}\)

**Significant Qualitative Aspects of Accounting Practices** (Ref: Para. 16(a))

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting

\(^{10}\) SA 701, paragraphs 9–10.
estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to “critical accounting estimates” or “critical accounting policies and practices” to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor’s views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor’s evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks. Open and constructive communication about significant qualitative aspects of the entity’s accounting practices also may include comment on the acceptability of significant accounting practices. Appendix 2 identifies matters that may be included in this communication.

Significant Difficulties Encountered during the Audit (Ref: Para. 16(b))

A21. Significant difficulties encountered during the audit may include such matters as:

(i) Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor’s procedures.

(ii) An unreasonably brief time within which to complete the audit.

(iii) Extensive unexpected effort required to obtain sufficient appropriate audit evidence.

(iv) The unavailability of expected information.

(v) Restrictions imposed on the auditor by management.

(vi) Management’s unwillingness to make or extend its assessment of the entity’s ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor’s opinion.11

Significant Matters Discussed, or Subject to Correspondence with Management (Ref: Para. 16(c)(i))

A22. Significant matters discussed, or subject to correspondence with management may include such matters as:

- Significant events or transactions that occurred during the year.
- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.

11 SA 705 (Revised), Modifications to the Opinion in the Independent Auditor’s Report.

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- Concerns about management’s consultations with other accountants on accounting or auditing matters.
- Discussions or correspondence in connection with the initial or recurring appointment of the auditor regarding accounting practices, the application of auditing standards, or fees for audit or other services.
- Significant matters on which there was disagreement with management, except for initial differences of opinion because of incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information.

Circumstances that Affect the Form and Content of the Auditor’s Report (Ref: Para 16(d))

A23. SA 210 requires the auditor to agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement are required to be recorded in an audit engagement letter or other suitable form of written agreement and include, among other things, reference to the expected form and content of the auditor’s report. As explained in paragraph A9, if the terms of engagement are not agreed with those charged with governance, the auditor may provide those charged with governance with a copy of the engagement letter to communicate about matters relevant to the audit. The communication required by paragraph 16(d) is intended to inform those charged with governance about circumstances in which the auditor’s report may differ from its expected form and content or may include additional information about the audit that was performed.

A24. Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor’s report in accordance with the SAs, and for which communication with those charged with governance is required, include when:

- The auditor expects to modify the opinion in the auditor’s report in accordance with SA 705 (Revised).
- A material uncertainty related to going concern is reported in accordance with SA 570 (Revised).
- Key audit matters are communicated in accordance with SA 701.
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matters paragraph in accordance with SA 706 (Revised) or is required to do so by other SAs.

In such circumstances, the auditor may consider it useful to provide those charged with
governance with a draft of the auditor’s report to facilitate a discussion of how such matters will be addressed in the auditor’s report.

A25. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor’s report in accordance with SA 700 (Revised), the auditor is required to discuss this intention with those charged with governance to inform the auditor’s assessment of the likelihood and severity of a significant personal security threat. The auditor also may communicate with those charged with governance in circumstances when the auditor elects not to include the description of the auditor’s responsibilities in the body of the auditor’s report as permitted by SA 700 (Revised).18

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

A26. SA 30019 notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. The auditor may communicate with those charged with governance about such matters, for example, as an update to initial discussions about the planned scope and timing of the audit.

A27. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, in accordance with SA 220.20

Auditor Independence (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.21

A30. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

(a) Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm’s own systems and procedures.

A31. Relevant ethical requirements or law or regulation may also specify particular

18 SA 700 (Revised), paragraph 40.
20 See paragraphs 19–21 and A23–A31 of SA 220, Quality Control for an Audit of Financial Statements.
21 SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, paragraph 14.
communications to those charged with governance in circumstances where breaches of independence requirements have been identified. For example, the Code of Ethics issued by ICAI requires the auditor to communicate with those charged with governance in writing about any breach and the action the firm has taken or proposes to take.

A32. The communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor’s firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A33. The oversight of management by those charged with governance includes ensuring that the entity designs, implements and maintains appropriate internal control with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

A34. The auditor may become aware of supplementary matters that do not necessarily relate to the oversight of the financial reporting process but which are, nevertheless, likely to be significant to the responsibilities of those charged with governance in overseeing the strategic direction of the entity or the entity’s obligations related to accountability. Such matters may include, for example, significant issues regarding governance structures or processes, and significant decisions or actions by senior management that lack appropriate authorization.

A35. In determining whether to communicate supplementary matters with those charged with governance, the auditor may discuss matters of this kind of which the auditor has become aware with the appropriate level of management, unless it is inappropriate to do so in the circumstances.

A36. If a supplementary matter is communicated, it may be appropriate for the auditor to make those charged with governance aware that:

(a) Identification and communication of such matters is incidental to the purpose of the audit, which is to form an opinion on the financial statements;

(b) No procedures were carried out with respect to the matter other than any that were necessary to form an opinion on the financial statements; and

(c) No procedures were carried out to determine whether other such matters exist.

The Communication Process

Establishing the Communication Process (Ref: Para. 18)
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A37. Clear communication of the auditor’s responsibilities, the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication.

A38. Matters that may also contribute to effective two-way communication include discussion of:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are better placed to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) in the engagement team and among those charged with governance who will communicate regarding particular matters.
- The auditor’s expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit, for example, strategic decisions that may significantly affect the nature, timing and extent of audit procedures, the suspicion or the detection of fraud, and concerns with the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

A39. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor’s view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with governance is not adequate for the purpose of the audit (see paragraph A52).

Considerations Specific to Smaller Entities

A40. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of listed or larger entities.

Communication with Management

A41. Many matters may be discussed with management in the ordinary course of an audit, including matters required by this SA to be communicated with those charged with governance. Such discussions recognize management’s executive responsibility for the conduct of the entity’s operations and, in particular, management’s responsibility for the preparation of the financial statements.

A42. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be
appropriate to discuss questions of management’s competence or integrity with management. In addition to recognizing management’s executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

**Communication with Third Parties**

A43. Those charged with governance may be required by law or regulation, or may wish, to provide third parties, for example, bankers or certain regulatory authorities, with copies of a written communication from the auditor. In some cases, disclosure to third parties may be illegal or otherwise inappropriate. When a written communication prepared for those charged with governance is provided to third parties, it may be important in the circumstances that the third parties be informed that the communication was not prepared with them in mind, for example, by stating in written communications with those charged with governance:

- That the communication has been prepared for the sole use of those charged with governance and, where applicable, the group management and the group auditor, and should not be relied upon by third parties;
- That no responsibility is assumed by the auditor to third parties; and
- Any restrictions on disclosure or distribution to third parties.

A44. In some entities, the auditor may be required by law or regulation to, for example:

- Notify a regulatory or enforcement body of certain matters communicated with those charged with governance. For example, in some countries the auditor has a duty to report misstatements to authorities where management and those charged with governance fail to take corrective action;
- Submit copies of certain reports prepared for those charged with governance to relevant regulatory or funding bodies, or other bodies such as a central authority in the case of some public sector entities; or
- Make reports prepared for those charged with governance publicly available.

A45. Unless required by law or regulation to provide a third party with a copy of the auditor’s written communications with those charged with governance, the auditor may need the prior consent of those charged with governance before doing so.

**Forms of Communication (Ref: Para. 19)**

A46. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The auditor may communicate matters other than those identified in paragraphs 19–20 either orally or in writing. Written communications may include an engagement letter that is provided to those charged with governance.

A47. In addition to the significance of a particular matter, the form of communication (e.g., whether to communicate orally or in writing, the extent of detail or summarization in the
communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

(a) Whether a discussion of the matter will be included in the auditor’s report. For example, when key audit matters are communicated in the auditor’s report, the auditor may consider it necessary to communicate in writing about the matters determined to be key audit matters.

(b) Whether the matter has been satisfactorily resolved.

(c) Whether management has previously communicated the matter.

(d) The size, operating structure, control environment, and legal structure of the entity.

(e) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity’s general purpose financial statements.

(f) Legal requirements. In some entities, a written communication with those charged with governance is required in a prescribed form by local law.

(g) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(h) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(i) Whether there have been significant changes in the membership of a governing body.

A48. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

**Timing of Communications (Ref: Para. 21)**

A49. Timely communication throughout the audit contributes to the achievement of robust two-way dialogue between those charged with governance and the auditor. However, the appropriate timing for communications will vary with the circumstances of the engagement. Relevant circumstances include the significance and nature of the matter, and the action expected to be taken by those charged with governance. For example:

(a) Communications regarding planning matters may often be made early in the audit engagement and, for an initial engagement, may be made as part of agreeing the terms of the engagement.

(b) It may be appropriate to communicate a significant difficulty encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified, prior
to communicating these in writing as required by SA 265.\textsuperscript{22}

- When SA 701 applies, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit (see paragraph A13), and the auditor also may have more frequent communications to further discuss such matters when communicating about significant audit findings.

- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion.

- Communications regarding findings from the audit, including the auditor’s views about the qualitative aspects of the entity’s accounting practices, may also be made as part of the concluding discussion.

- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

A50. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.

- Any legal obligation to communicate certain matters within a specified timeframe.

- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (e.g., noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

**Adequacy of the Communication Process (Ref: Para. 22)**

A51. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.

- The apparent openness of those charged with governance in their communications with the auditor.

\textsuperscript{22} SA 265, paragraphs 9 and A14.
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- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A52. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, SA 315 identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity’s control environment.23 Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor’s assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A53. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor’s opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Documentation (Ref: Para. 23)

A54. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

23 SA 315, paragraph A70.
Specific Requirements in SQC 1 and Other SAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in SQC 1\(^1\) and other SAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in SAs.

- SQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* – paragraph 42(a).
- SA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9.
- SA 560, *Subsequent Events* – paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17.
- SA 570 (Revised), *Going Concern* – paragraph 25.
- SA 610 (Revised), *Using the Work of Internal Auditors* – paragraphs 20 and 31.
- SA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* - paragraph 18.

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\(^1\) SQC 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.
Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

**Accounting Policies**

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity’s financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.

- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.

- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).

- The effect of the timing of transactions in relation to the period in which they are recorded.

**Accounting Estimates**

- For items for which estimates are significant, issues discussed in SA 540, including, for example:
  
  - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
  
  - Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
  
  - Whether management’s decision to recognize, or to not recognize, the accounting estimates in the financial statements is in accordance with the applicable financial reporting framework.
  
  - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the

1 SA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.
outcome of accounting estimates in prior periods.

- Management’s process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.
- Whether the significant assumptions used by management in developing the accounting estimate are reasonable.
- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management’s intent to carry out specific courses of action and its ability to do so.
- Risks of material misstatement.
- Indicators of possible management bias.
- How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- The adequacy of disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (e.g., disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks, exposures and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. This communication may highlight:
  - The non-recurring amounts recognized during the period.
  - The extent to which such transactions are separately disclosed in the financial statements.
  - Whether such transactions appear to have been designed to achieve a particular accounting or tax treatment, or a particular legal or regulatory objective.
  - Whether the form of such transactions appears overly complex or whether extensive advice regarding the structuring of the transaction has been taken.
  - Where management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- The factors affecting asset and liability carrying values, including the entity’s bases for
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determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.

- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.
Introduction

Scope of this SA

1. This Standard on Auditing (SA) deals with the auditor’s responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control¹ that the auditor has identified in an audit of financial statements. This SA does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SA 315 and SA 330². SA 260³ establishes further requirements and provides guidance regarding the auditor’s responsibility to communicate with those charged with governance in relation to the audit.

2. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement⁴. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This SA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

3. Nothing in this SA precludes the auditor from communicating to those charged with governance and management other internal control matters that the auditor has identified during the audit.

¹ Published in September, 2009 issue of the Journal.
² SA 330, “The Auditor’s Responses to Assessed Risks”.
³ SA 260, “Communication with Those Charged with Governance”.
⁴ SA 315, paragraph 12.

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

Objective
5. The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor’s professional judgment, are of sufficient importance to merit their respective attentions.

Definitions
6. For purposes of the SAs, the following terms have the meanings attributed below:
   (a) Deficiency in internal control – This exists when:
       (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
       (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
   (b) Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor’s professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)

Requirements
7. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)
8. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)
9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)
10. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27)
   (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21)
   (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention. (Ref: Para. A22-A26)
11. The auditor shall include in the written communication of significant deficiencies in internal control:

(a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)

   (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

   (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

   (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Application and Other Explanatory Material

Determination of Whether Deficiencies in Internal Control Have Been Identified (Ref: Para. 7)

A1. In determining whether the auditor has identified one or more deficiencies in internal control, the auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion provides an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the auditor to discuss the auditor's findings directly with management, for example, if the findings appear to call management's integrity or competence into question (see paragraph A20).

A2. In discussing the facts and circumstances of the auditor's findings with management, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
- A preliminary indication from management of its response to the findings.

Considerations Specific to Smaller Entities

A3. While the concepts underlying control activities in smaller entities are likely to be similar
to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management. For example, management’s sole authority for granting credit to customers and approving significant purchases can provide effective control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A4. Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

**Significant Deficiencies in Internal Control** (Ref: Para. 6(b), 8)

A5. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit.

A6. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:
  - General monitoring controls (such as oversight of management).
  - Controls over the prevention and detection of fraud.
  - Controls over the selection and application of significant accounting policies.
  - Controls over significant transactions with related parties.
  - Controls over significant transactions outside the entity’s normal course of business.
  - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
A7. Indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
  - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
  - Identification of management fraud, whether or not material, that was not prevented by the entity’s internal control.
  - Management’s failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management’s failure to identify a risk of material misstatement that the auditor would expect the entity’s risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor’s procedures that were not prevented, or detected and corrected, by the entity’s internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year’s Statement of Profit and Loss.
- Evidence of management’s inability to oversee the preparation of the financial statements.

A8. Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements. For example, controls over accounts receivable may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the account balance. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

A9. Law or regulation in some jurisdictions may establish a requirement (particularly for audits of listed entities) for the auditor to communicate to those charged with governance or

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5 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.

6 SA 315, paragraph A66.
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to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the auditor has identified during the audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the auditor to use these terms and definitions for the purpose of the communication, the auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

A10. Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated but has not defined such terms, it may be necessary for the auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the auditor may consider it appropriate to have regard to the requirements and guidance in this SA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this SA to be communicated to those charged with governance.

A11. The requirements of this SA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.7

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, in case of listed entities, those charged with governance may need to receive the auditor’s written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor’s written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement8 for the auditor to complete the assembly of the final audit file on a timely basis. SA 230 states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report9.

7 SA 260, paragraph 9.
9 SA 230, paragraph A21.
A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this SA requires.

A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor’s professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature of the entity. For instance, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For instance, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.
- The entity’s governance composition. For instance, more detail may be needed if those charged with governance include members who do not have significant experience in the entity’s industry or in the affected areas.
- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year’s communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.
A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management’s competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

A21. SA 250 establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance. SA 240 establishes requirements and provides guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.

Communication of Other Deficiencies in Internal Control to Management (Ref: Para. 10(b))

A22. During the audit, the auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management’s attention. The determination as to which other deficiencies in internal control merit management’s attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies.

A23. The communication of other deficiencies in internal control that merit management’s attention need not be in writing but may be oral. Where the auditor has discussed the facts and circumstances of the auditor’s findings with management, the auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has

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been previously communicated to management by other parties, such as internal auditors or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor’s attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor’s judgment in the circumstances.

A25. In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies to management. In either case, the auditor may report orally or in writing to those charged with governance as appropriate.

A26. SA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.

A27. In the case of certain entities, such as, Central/State governments and related government entities (for example, agencies, boards, commissions), the auditors may have additional responsibilities to communicate deficiencies in internal control that the auditor has identified during the audit, in ways, at a level of detail and to parties not envisaged in this SA. For example, significant deficiencies may have to be communicated to the legislature or other governing body. Law, regulation or other authority may also mandate that the auditors report deficiencies in internal control, irrespective of the significance of the potential effects of those deficiencies. Further, legislation may require the auditors to report on broader internal control-related matters than the deficiencies in internal control required to be communicated by this SA, for example, controls related to compliance with legislative authorities, regulations, or provisions of contracts or grant agreements.

Content of Written Communication of Significant Deficiencies in Internal Control (Ref: Para. 11)

A28. In explaining the potential effects of the significant deficiencies, the auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The auditor may also include in the written communication suggestions for remedial action on the deficiencies, management’s actual or proposed responses, and a statement as to whether or not the auditor has undertaken any steps to verify whether management’s responses have been implemented.

A29. The auditor may consider it appropriate to include the following information as additional context for the communication:

- An indication that if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded

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12 SA 260, paragraph 9.
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that some of the reported deficiencies need not, in fact, have been reported.

● An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

A30. Law or regulation may require the auditor or management to furnish a copy of the auditor’s written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the auditor’s written communication may identify such regulatory authorities.

Material Modifications to ISA 265, “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management”

Deletions
1. Paragraph A7 of ISA 265 provides the examples of the indicators of significant deficiencies in internal control which may include restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud. Since in India Accounting Standard (AS) 5, “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived, the restatement of the prior period financial statements does not exist in the Indian scenario. Hence, to align with the requirements of AS 5, the requirement of restatement of prior period items has been replaced with the requirement to disclose the prior period items in the current year’s Statement of Profit & Loss.

2. Paragraph A27 of ISA 265 deals with the additional responsibilities of the public sector auditors to communicate/report deficiencies in internal control to the legislature or governing body. Since as mentioned in the “Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services”, the Standards issued by the Auditing and Assurance Standards Board, apply equally to all entities, irrespective of their form, nature and size, a specific reference to applicability of the Standard to public sector entities has been deleted.

Further, it is also possible that such additional responsibilities may also be imposed on the auditor in case of non public sector entities pursuant to a requirement under the statute or regulation under which they operate. Accordingly, the spirit of erstwhile A22, highlighting the fact, has been retained though a specific reference to public sector entities has been deleted.
SA 299
Responsibility of Joint Auditors
(Effective for all audits relating to accounting periods beginning on or after April 1, 1996)

Introduction
1. The practice of appointing more than one auditor to conduct the audit of large entities is in vogue these days. Such auditors, known as joint auditors, conduct the audit jointly and report on the financial statements of the entity. This Standard deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The Standard does not deal with the relationship between a principal auditor who is appointed to report on the financial statements of an entity and another auditor who is appointed to report on the financial statements of one or more divisions or branches included in the financial statements of the entity, e.g., the relationship between a company auditor appointed under section 224 of the Companies Act, 1956 and a branch auditor appointed under section 228 of the said Act.

Division of Work
2. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.
3. The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Coordination
4. Where, in the course of his work, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgement by, other joint auditors, he should communicate the same to all the other joint auditors in writing. This should be done by the submission of a report or note prior to the finalisation of the audit.

Relationship Among Joint Auditors
5. In respect of audit work divided among the joint auditors, each joint auditor is...
responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

6. If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7. Subject to paragraph 5(b) above, it is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issues such as appropriateness of using test checks or sampling should be decided by each joint auditor in relation to his own area of work. This responsibility is not shared by the other joint auditors. Thus, it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor.

8. In the case of audit of a large entity with several branches, including those required to be audited by branch auditors, the branch audit reports/returns may be required to be scrutinised by different joint auditors in accordance with the allocation of work. In such cases, it is the specific and separate responsibility of each joint auditor to review the audit reports/returns of the divisions/branches allocated to him and to ensure that they are properly incorporated into the accounts of the entity. In respect of the branches which do not fall within any divisions or zones which are separately assigned to the various joint auditors, they may agree among themselves as regards the division of work relating to the review of such branch returns. It is also the separate and specific responsibility of each joint auditor to exercise his judgement with regard to the necessity of visiting such divisions/branches in respect of which the work is allocated to him.

9. A significant part of the audit work involves obtaining and evaluating information and
explanations from the management. This responsibility is shared by all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain appropriate information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by him.

10. Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

11. Where separate financial statements of a division/branch are audited by one of the joint auditors, the other joint auditors are entitled to proceed on the basis that such financial statements comply with all the legal and professional requirements regarding the disclosures to be made and present a true and fair view of the state of affairs and of the working results of the division/branch concerned, subject to such observations as may be communicated by the joint auditor concerned.

**Reporting Responsibilities**

12. Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

**Effective Date**

13. This Standard on Auditing becomes operative in respect of all audits relating to accounting periods beginning on or after April 1, 1996.

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2 Reference may be made in this regard to the Standards on Auditing and other mandatory Statements relating to auditing matters issued by the Council of the Institute from time to time.