CHAPTER 3

AUDIT PLANNING, STRATEGY & EXECUTION



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Know factors, benefits and considerations for establishing overall audit strategy.
- Understand the nature and extent of planning.
- Analyse the responsibility of the auditor in audit strategy and audit plan.
- Understand the process of audit execution.

© The Institute of Chartered Accountants of India

CHAPTER OVERVIEW



CA B has qualified final Chartered Accountancy exams. Plunging into the field of auditing practice after setting up his own office, he accepted audit of a company engaged in emerging *"fintech"* sector. The company relies heavily on big data and artificial intelligence. It is also expected to lean upon Blockchain technology in coming years and is working in that direction. Company is also a participant in Regulatory sandbox i.e., of live testing of new products and services under controlled environment.

While planning audit, he felt need for involvement of an expert IT specialist for gaining an insight into various IT controls and IT laws & rules in heavily tech laden company. Is such consideration a factor to be considered in establishing overall audit strategy? In case he chose to involve an expert IT specialist, would his overall responsibility as an auditor be shared in some way? Would it be prudent for him to enter into a formal agreement with the expert detailing out nature, scope and objectives of his work? Besides, he had this nagging doubt in mind over confidentiality requirements pertaining to experts. Involving experts in the exercise of understanding controls may split open the company's systems and sensitive data before him. Wouldn't it tantamount to violation of confidentiality principle of professional ethics? He was keeping his fingers crossed.

As the company and its business-both were new to him, he was keen on gaining knowledge about business of the company. Vividly remembering that knowledge of client's business is foremost requirement for developing an overall audit plan, he proceeded to gain broad regulatory requirements pertaining to *fintech* sector. Learning that not only RBI, but Ministry of Electronics and Information technology (MeitY) has also a role to play in this sector under flagship *Digital India* programme. He was also trying to understand revenue recognition practices of the industry. He also came to know that "Ombudsman scheme for digital

© The Institute of Chartered Accountants of India

transactions" for filing consumer complaints was in existence. Would such knowledge be helpful to him in understanding about the company as far as audit was concerned?

The company also has an internal audit department. He finds that the internal audit department of the company is scantily staffed and is headed by a banker retired from the post of Chief manager of a public sector bank. He didn't appear to be tech-savvy. On enquiry, he came to know that he got the job on recommendation of some government official. In these circumstances, would it be advisable for him to rely upon work performed by an internal auditor? He needed to take a decision in this regard.

1. COMMENCING AN AUDIT

SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" states that in order to achieve the overall objectives of the audit, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit. Without a careful plan, the overall objective of an audit may not be achieved. The audit planning is necessary to conduct an effective audit, in an efficient and timely manner.



© The Institute of Chartered Accountants of India

1.1 Nature and Extent of Planning

So far as the nature of planning is concerned, it would vary according to-

(i) Size and Complexity of the Auditee - If the size and complexity of organization of which audit is to be conducted is large, then much more planning activities would be required as compared to an entity whose size and complexity is small.

(ii) Past Experience & Expertise - The key engagement team members' previous experience & expertise also contributes towards variation in planning activities.

(iii) Change in Circumstances - Another factor contributing towards variation in planning activities is change in circumstances.

1.2 Planning - A Continuous Process

Planning is not a discrete phase of an audit but rather a continual and iterative process. It often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes consideration of the timing of certain activities and audit procedures. It also involves forming audit programme.



1. Planning includes the need to consider such matters as:

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

1.3 Overall Audit Strategy and Audit Plan - Responsibility of the Auditor

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement. **For example - to coordinate some of the planned audit procedures with the work of the entity's personnel.**

Although these discussions often occur but the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters about the overall audit strategy or audit plan, care

© The Institute of Chartered Accountants of India

is required in order not to compromise the effectiveness of the audit to be taken to see there is no compromise in the effectiveness of the audit. **For Example - discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.**

The engagement partner and other key members of the engagement team should be involved in planning the audit. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience, thereby, enhancing the effectiveness and efficiency of the planning process.

1.4 Acceptance and Continuance of Client Relationships and Audit Engagements

Acceptance and Continuance of Client Relationships and Audit Engagements are very important preliminary engagement activities. The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and should determine that conclusions reached in this regard are appropriate.

The auditor shall undertake the following activities at the beginning of the current audit engagement-

(i) Performing procedures required by SA 220, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement. As per the combined reading of SA 220 and SQC 1, information and procedures such as the following, assists the auditor 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, expertise, 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.

© The Institute of Chartered Accountants of India

In the 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.

(ii) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and

(iii) Establishing an understanding of the terms of the engagement, as required by SA 210.

1.5 Contents of an Audit Plan

The auditor should develop an audit plan that shall include a description of-

(i) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

(ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330, "The Auditor's Responses to Assessed Risks".

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.



2. Planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures.

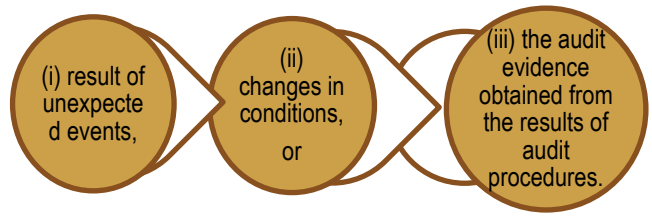
In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

1.6 Changes to Planning Decisions

The auditor should update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

© The Institute of Chartered Accountants of India

The auditor may need to modify the overall audit strategy and audit plan due to below mentioned factors-



Further, the auditor would also have to modify the nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

This may be the case when information coming to the auditor differs significantly from the information when he planned the audit procedures.

3. Audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

In addition to above, there may be a possibility of change in law, notifications, government policies which may warrant updating of overall audit strategy.

TEST YOUR UNDERSTANDING 1

XWL Limited was engaged in dealing in commodity futures trading based in Surat. CA P, based at Delhi, was auditor of the company. The auditor did not even once visit the office of the company and failed to understand the nature of business of the company. All the papers and account books were received on emails and audit was concluded.

There were also included in his working papers checklists which had a requirement of test checking of cost of raw material consumed & cost of stores and spares. There was nothing in his working papers showing understanding of the nature of business of company. What does it reflect upon planning of audit by CA P?

2. OVERALL AUDIT STRATEGY

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

© The Institute of Chartered Accountants of India

2.1 Factors while establishing Overall Audit Strategy

Overall audit strategy would involve-

(i) **Determination of Characteristics of Audit:** Identify the characteristics of the engagement that defines its scope.

(ii) **Reporting Objectives:** Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.

(iii) **Team's Efforts:** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.

(iv) **Considering result of preliminary engagement activities:** Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.

(v) **Nature, timing and Extent of Resources:** Ascertain the nature, timing and extent of resources necessary to perform the engagement.

2.2 Benefits of Overall Audit Strategy

The process of establishing the overall audit strategy assists the auditor to determine such matters as-

(i) **Employment of Qualitative Resources:** The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters like review of valuation, hedging transactions.

(ii) **Allocation of Quantity of Resources:** The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the allocation of audit budgeted hours to high risk areas.

(iii) **Timing of Deployment of Resources:** When these resources are to be deployed, such as whether at an interim audit stage or at or close to key cut-off dates.

(iv) **Management of Resources:** How such resources shall be managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

© The Institute of Chartered Accountants of India

2.3 Documenting the Audit Plan

The auditor shall document-

(i) The overall audit strategy;

(ii) The audit plan; and

(iii) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. Documentation of these matters assists auditor as under: -

(a) **Record of Key Decisions:** The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team

(b) **Record of Nature, Timing and Extent of Risk Assessment Procedures:** The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and additional audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

(c) **Record of reasons for change in audit strategy and plan:** A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

© The Institute of Chartered Accountants of India

2.4 Relationship between the Overall Audit Strategy and the Audit Plan



Fig 1: Audit Strategy and the Audit Plan are interrelated.*

The audit strategy is prepared before the audit plan. The audit plan is more detailed than the overall audit strategy. Audit strategy and audit plan are inter-related because change in one would result into change in the other. The audit strategy provides the guidelines for developing the audit plan. It establishes the scope and conduct of the audit procedures and thereby, works as basis for developing a detailed audit plan. Detailed audit plan would include the nature, timing and extent of the audit procedures so as to obtain sufficient appropriate audit evidence.



4. CA. Sam has already developed an audit strategy for Hitesh Ltd. While a detailed audit plan is being developed, she decided that materiality levels set earlier need to be lowered as weaknesses in the internal controls were highlighted in the internal audit report. Subsequently, a deviation from the audit strategy is felt necessary. Therefore, Sam would first modify the overall strategy and thereafter, prepare the audit plan in line with the strategy. This shows that the audit strategy and audit plan are closely inter-related as change in one is resulting into change in the other.

The overall audit strategy & audit plan should take into consideration the element of materiality and its relationship with Risks & procedures to be adopted.

3. AUDIT PROGRAMME

An audit programme is commonly prepared to allocate work to team members which may include the list of audit procedures and instructions to be followed by the member. It also estimates the duration for completing an audit task.

---

* *Source : msp-c.com*

© The Institute of Chartered Accountants of India

3.1 Formulating an Audit Programme

It is very useful for you to know how to formulate an audit programme. The programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as means to control the proper execution of work. It may be emphasized that a clear spelling out of audit objectives for each area is important to link up the procedures with audit objectives and to ensure a purposeful audit.

The important matters which need to be considered in this regard are:

(a) Nature of business in which the organisation is engaged: On his first appointment, the auditor should examine in detail the financial and accounting organisation of the business by visiting the client's office; by observing different stages through which documents pass before each transaction is authorised and recorded; the record that is kept and the type of books maintained.

In the case of an industrial concern, he must also visit the factory to acquaint himself with the different processes of manufacture, the quantitative records maintained and the manner in which statistics are compiled in respect of losses in process.

The auditor, therefore, should draw up the audit programme after considering the technical, financial and accounting set-up of the company.

(b) Overall plan: Audit programme should be drawn up to ensure a systematic approach to the work. If in drawing the audit programme, any divergence from the overall plan becomes necessary, first the overall plan should be modified after due consideration and thereafter, only that specific matter may be taken in the audit programme. The framework provided under the overall plan should be strictly adhered to.

(c) System of internal control and accounting procedures: The existence of a system of internal control ensures that both financial and statistical records are checked continuously; it also unearths errors, both of omission and of commission. The auditor, in framing his opinion on financial statements, needs reasonable assurance that transactions are properly authorised and recorded in the accounting records and that transactions have not been omitted. The study and evaluation of internal control helps the auditor to establish the reliance he can place on the internal controls in determining the nature, timing and extent of his substantive auditing procedures.

The auditor's examination of the system of internal control should have three features - review and preliminary evaluation, testing of compliance and evaluation.

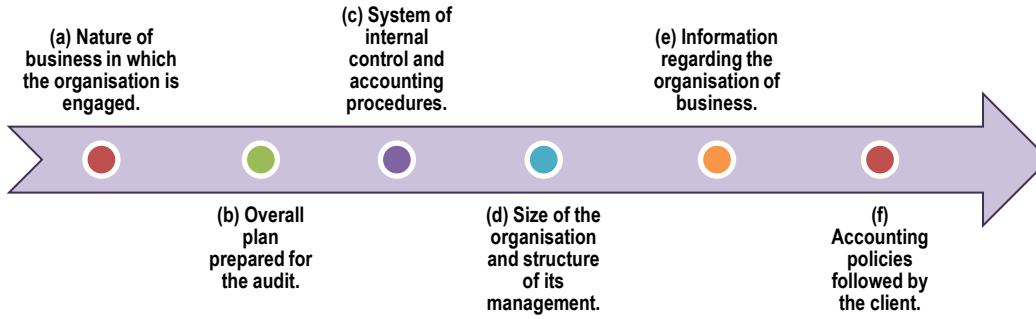
© The Institute of Chartered Accountants of India

(d) Size of the organisation and structure of its management: An increase in the size of the organisation enhances the complexity of the examination of its accounting records specially when it has a number of branches, deals in several products or has a very large turnover.

5. The reports of the Comptroller and Auditor General on audit of accounts of Public Enterprises show that some of them have a very poor system of internal controls. In such cases, the magnitude of the tasks of the auditor increases considerably.

(e) Information as regards organisation of the business: To plan audit programme, it is necessary that the auditor should obtain from his client information as regards the client's history and business, purpose and nature of engagement and time schedule for the completion of audit.

(f) Accounting and management policies: The auditor should review the financial statements of the past several years, audited by his predecessors, especially those of the immediately preceding previous year. This would reveal to him a great deal of information regarding accounting and management policies which have been followed in the past and whether these have been employed consistently.



3.2 Drawing up the Audit Programme

After the auditor has collected the aforementioned information, he will be in a position to draw up the programme of audit. He can now decide the areas to be covered by audit, also those to be covered in detail and those which should be covered by the applications of the test checks. He will also be able to decide the specific audit procedures which should be applied in each case. These procedures vary widely because of the conditions under which each concern operates, its form of organisation, its nature of business and the condition of its accounts. On this account, it is not practicable to draw up a typical audit programme. When an auditor is appointed to audit the accounts of an entity for the first time, the audit programme should be developed in three stages stated below:

(i) To begin with, a broad outline of the audit programme should be drawn up.

© The Institute of Chartered Accountants of India

(ii) After the internal and accounting procedures have been reviewed, the details should be filled up on consideration of the deficiencies in the system of internal control.

(iii) After the detailed checking procedure is over, the extent to which the special procedures (first time/ opening balance audit procedures) that are required to be applied should be determined, e.g., independent verification of balances of debtors and creditors, physical inspection of fixed assets, personal inspection of various items of stock included in closing inventories and testing their values. At times, special procedures may have to be applied on a consideration of the nature of business e.g. verification of provision for tax liability in case of a shipping company regarding freight booked in different countries or for making a provision for unexpired liability in case of an insurance company, etc.

At each subsequent engagement, the programme should be reviewed and, if necessary, modified on account of:

(i) experience gained during the previous audits;

(ii) important changes that have taken place in the business specially in the system of internal control, accounting procedures or in the structure of management or of the scope of business; and

(iii) evaluation of internal control made for the current year.

Given below are a few circumstances where in the audit programme would have to be suitably altered:	
(1)	If the audit procedures were designed for a certain volume of turnover and subsequently the volume have substantially increased. Also, when there have been significant changes in the accounting organisation, procedures and personnel subsequent to the audit procedures.
(2)	Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.
(3)	Where there has been an extraordinary increase in the amount of book debts or that in the value of stocks as compared to that in the previous year.
(4)	When a suspicion has aroused during the course of audit or information has been received that assets of the company have been misappropriated.
It may be noted that the audit plan and related programme should be reconsidered as the audit progresses. Such re-consideration is based on the auditor's review of internal control, his preliminary evaluation thereof and the result of his compliance and substantive procedures	

© The Institute of Chartered Accountants of India

TEST YOUR UNDERSTANDING 2

CA Pradyuman is planning for audit of a listed company headquartered in Noida. While doing this exercise, he has made a list of various procedures intended to be performed by him during the course of audit. He has further made up his mind to decide about sample size at time of performing various planned procedures. Is the above approach of CA Pradyuman proper?

TEST YOUR UNDERSTANDING 3

CA Nikita is conducting audit of a leading society engaged in promoting awareness regarding usefulness of internet among the disadvantaged sections of society through easily understandable means and methods. The society is also registered under FCRA, 2010 for receipt of foreign contributions. During the course of audit, she embarked upon extensive procedures relating to verification of receipt of foreign contributions to rule out "round-tripping" in comparison to procedures originally thought of. She is documenting various procedures performed by her including relevant audit findings.

However, she doesn't feel need for putting into writing about how she planned the whole exercise. Does she require refreshening of her knowledge?

4. AUDIT EXECUTION

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting.

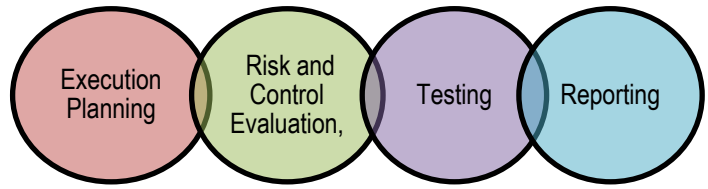


Image showing Stages of Audit Execution

4.1 Execution Planning

Prior to commencement of an audit engagement, it is important to lay down the roadmap for audit execution to ensure timely and quality audit results. The auditors need to plan their work in order to carry out the audit in an effective, efficient and timely manner. A detailed audit program is prepared laying down the audit objectives, scope and audit approach. The manpower requirement, audit team

© The Institute of Chartered Accountants of India

qualifications, and the time element, etc. are some of the important considerations during execution planning. In order to plan effectively, the auditor may need some more information about the audit area. A preliminary survey would help in gathering the required information.

4.2 Risk and Control Evaluation

For each segment of audit, the auditors should conduct a detailed risk and control assessment i.e. list the risks that must be reviewed in that segment, capture for each risk the controls that exist or those that are needed to protect against the risk and show for each control, the work steps required to test the effectiveness of the controls. While making Risk & Control assessment, it is necessary to bear in mind the Materiality levels as the same is linked to Audit Risks.

(Note: Students may refer Chapter 4 for understanding and evaluation of the Risk and Control for more details)

4.3 Testing

Once a comprehensive understanding is gained of the key risks and the controls to be evaluated in a given audit area, the auditors should test the operating effectiveness of the controls to determine whether controls are operating as designed. There are multiple test methods which can be used to arrive at conclusions on the effectiveness of the controls.

4.4 Reporting

SA 700, "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involve considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements such as compliance of Provisions & Enactments of the Company Law, Accounting Standards framed by ICAI, latest Guidelines etc.

The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report.

(Note: For details Students may refer SA 700 discussed in Chapter 7 of this study material)

© The Institute of Chartered Accountants of India

4.5 Other Important Considerations

In addition to above, there are certain other considerations which auditor is required to take care while executing the audit, that are given below:

4.5.1 SA 600 - Using the Work of Another Auditor

When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, the auditor's report should expressly state the fact of such reliance.

Auditor who uses the work performed by other auditors is Principal auditor.

SA 600 does not deal with those instances where two or more auditors are appointed as joint auditors nor does it deal with the auditor's relationship with a predecessor auditor.

Principal Auditor

- the auditor with responsibility for reporting on the financial information of an entity
- when that financial information includes the financial information of one or more components audited by another auditor.

Other Auditor

- an auditor, other than the principal auditor,
- with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.

"Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

© The Institute of Chartered Accountants of India



The purpose of SA 600, "Using the Work of Another Auditor" is to:
✓ establish standards to be applied in situations where Principal auditor,
✓ uses the work of other auditor
✓ with respect to the financial information of one or more components
✓ included in the financial information of the entity.

This Standard also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor. In this Standard, the term 'financial information' encompasses 'financial statements'.

SA 600 does not deal with those instances where two or more auditors are appointed as joint auditors, nor does it deal with the auditor's relationship with a predecessor auditor.

I. ACCEPTANCE AS PRINCIPAL AUDITOR

The auditor would consider the following before accepting his work as Principal auditor:

- the materiality of the portion of the financial information which the principal auditor audits;
- the principal auditor's degree of knowledge regarding the business of the components;
- the risk of material misstatements in the financial information of the components audited by the other auditor(s); and
- the performance of additional procedures as set out in this SA regarding the components audited by other auditor(s) resulting in the principal auditor having significant participation in such audit.

© The Institute of Chartered Accountants of India

II. THE PRINCIPAL AUDITOR'S PROCEDURES

1. Right of Principal auditor to visit and examine books of accounts of a component

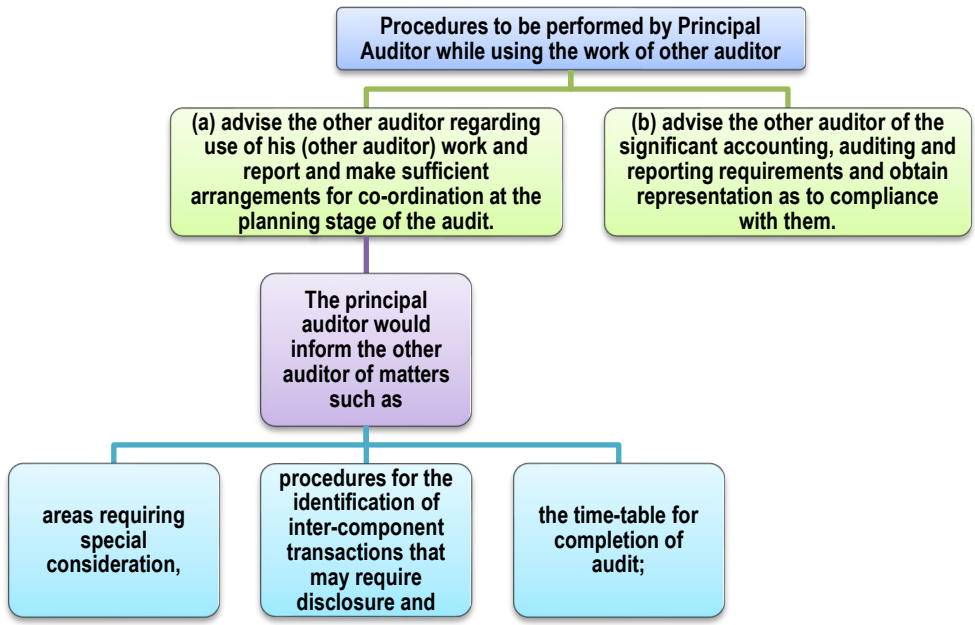
6. In certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would **normally be entitled to rely upon the work of such auditor** unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

2. Principal auditor to consider the professional competence of other auditor

7. When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

3. Procedures to be performed by principal auditor when using the work of other auditor

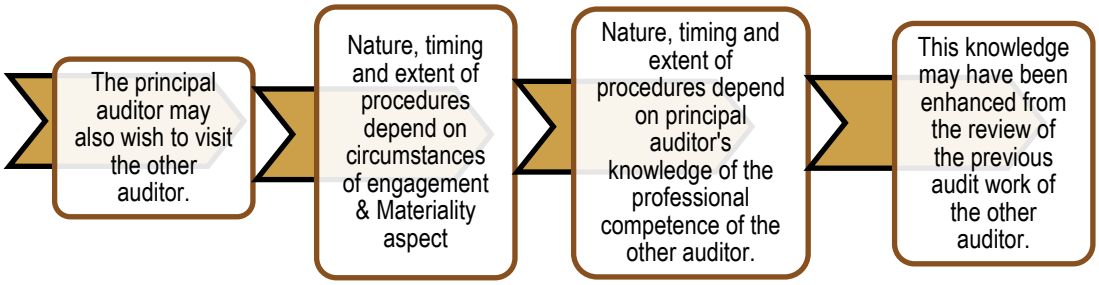
The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the procedures given in diagram below.



© The Institute of Chartered Accountants of India

4. Principal auditor to review – written summary of other auditor's procedures

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.



5. The principal auditor should consider the significant findings of the other auditor.

The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components.

He may also decide as to application of supplementary procedures that supplement tests of the records or the financial statements of the component, if deemed necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

6. When other auditor is not a professionally qualified auditor.

In certain circumstances, the other auditor may happen to be a person other than a professionally qualified auditor.



8. For instance, where a component is situated in a foreign country and the applicable laws permit a person other than a professionally qualified auditor to audit the financial statements of such component.

7. Principal Auditor to document in his working papers – the components whose financial information audited by other auditors. The principal auditor should also document the procedures performed and the conclusions reached.



9. The auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures.

However, the principal auditor need not document the reasons for limiting the procedures in the circumstances where sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of other auditor's practice.

© The Institute of Chartered Accountants of India

Where the other auditor's report is other than unmodified, the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

III. CO-ORDINATION BETWEEN AUDITORS

There should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor-



10. By bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements.

Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

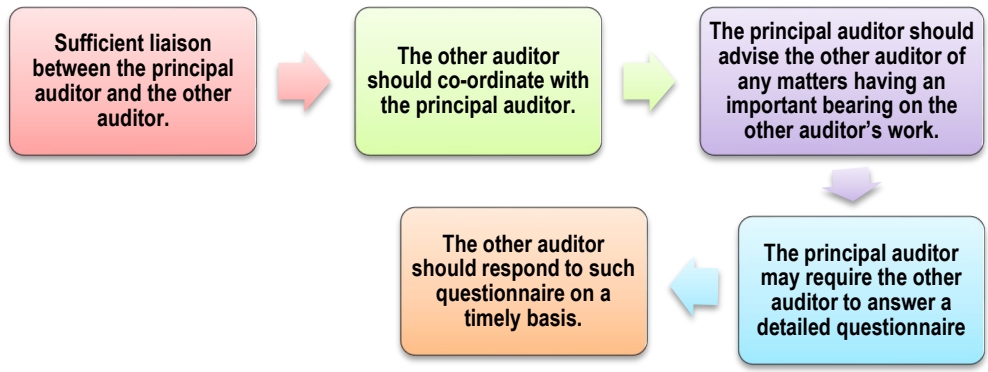


Diagram Showing Coordination Between the Auditors

IV. REPORTING CONSIDERATIONS

1. Principal auditor to express a qualified opinion or disclaimer of opinion in case of a limitation on the scope of audit.



11. When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

© The Institute of Chartered Accountants of India

2. If the other auditor issues a Modified Report



12. In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

V. DIVISION OF RESPONSIBILITY

The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity. However, if the Principal Auditor notices any material discrepancies, the same has to be brought to the knowledge of other Auditor. This should be incorporated in the Audit Report.

TEST YOUR UNDERSTANDING 4

CA Sourabh, an engagement partner, is conducting statutory audit of BBI Bank for SBT & Associates. The bank has 1034 branches spread all over the country which are audited by branch auditors. In respect of one large branch audited by a branch auditor, there were errors in NPA classification of many advances which were not pointed out by branch auditor in his report through memorandum of changes and NIL memorandum of changes was reported electronically.

During overall review of financial statements of bank by statutory auditor, the above said errors did not come into light. The statutory auditor had also called soft copies of internal inspection report and concurrent audit reports of above branch as part of overall review procedures. However, these reports did not point towards any irregularities in such accounts.

Would the statutory auditor of bank be liable for above lapses? What precautions have to be taken by him while expressing opinion considering possibilities of such situations?

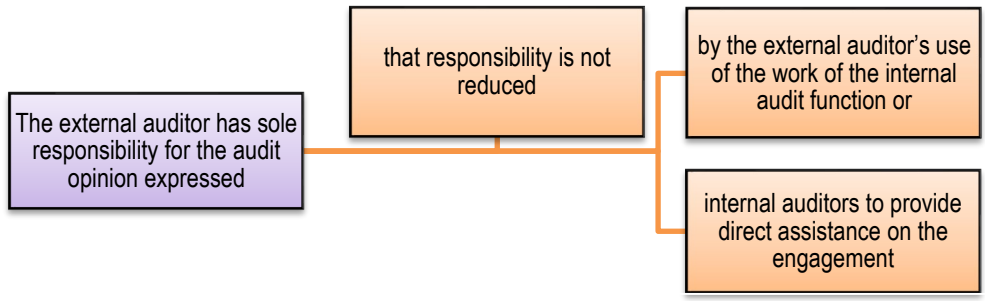
© The Institute of Chartered Accountants of India

4.5.2 SA 610- Using the Work of Internal Auditors

I. THE EXTERNAL AUDITOR'S RESPONSIBILITY FOR THE AUDIT

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200.

SA 610, "Using the Work of Internal Auditors", therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.



Review the Internal Auditor's Report which helps external auditor in procedural tests and audit planning.

II. SCOPE OF THIS SA

This (SA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes	
(a)	using the work of the internal audit function in obtaining audit evidence and
(b)	using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

This SA does not apply if the entity does not have an internal audit function.

© The Institute of Chartered Accountants of India

III. THE OBJECTIVES OF THE EXTERNAL AUDITOR, WHERE THE ENTITY HAS AN INTERNAL AUDIT FUNCTION

The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, or to use internal auditors to provide direct assistance, are:

The objectives of the external auditor, where the entity has an internal audit function		
To determine whether the work of the internal audit function or direct assistance from internal auditors can be used	If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit	If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

Meaning of Internal Audit Function & Direct Assistance–
Internal Audit Function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.
Direct Assistance: The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

The objectives and scope of internal audit functions: The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

Activities Relating to Governance	*Activities Relating to Risk Management*	*Activities Relating to Internal Control*
The internal audit function may assess the governance process in its accomplishment of objectives on : • ethics and values, performance management and accountability, • communicating risk and control information.	• The internal audit function may assist the entity by identifying and evaluating significant exposures to risk. • The internal audit function may perform procedures to assist the entity in the detection of fraud.	• Evaluation of internal control • Examination of financial and operating information • Review of operating activities. • Review of compliance with laws and regulations.

© The Institute of Chartered Accountants of India

IV. EVALUATING WHETHER WORK OF THE INTERNAL AUDIT FUNCTION CAN BE USED FOR PURPOSES OF THE AUDIT

(i) The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:	**(ii) The external auditor shall not use the work of the internal audit function if the external auditor determines that:**
(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (b) The level of competence of the internal audit function; and (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.	(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; (b) The function lacks sufficient competence; or (c) The function does not apply a systematic and disciplined approach, including quality control.

V. DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT FUNCTION THAT CAN BE USED

1. **The external auditor shall consider the nature and scope of the work performed by Internal audit function.**



13. Work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of SA 600).

2. **The external auditor shall make all significant judgments in the audit engagement** and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly:

© The Institute of Chartered Accountants of India

(a)	More judgment is involved in: (i) Planning and performing relevant audit procedures; and (ii) Evaluating the audit evidence gathered;
(b)	The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;
(c)	The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
(d)	The lower the level of competence of the internal audit function.

3. **Extent of involvement of external auditor:** The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

4. **Communicate how the external auditor has planned to use the work of the internal audit function:** The external auditor shall, in communicating with those charged with governance, share an overview of the planned scope and timing of the audit in accordance with SA 260, communicate how the external auditor has planned to use the work of the internal audit function.

VI. USING THE WORK OF THE INTERNAL AUDIT FUNCTION

1. **Discussion and Coordination with the Internal Audit Function:** If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities.

2. The external auditor shall **read the reports of the internal audit function** relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

3. The external auditor **shall perform sufficient audit procedures to determine adequacy of internal audit function** for purposes of the audit, including evaluating whether:

   (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;

   (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and

   (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.

© The Institute of Chartered Accountants of India

4. **The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:**

   (a) The amount of judgment involved;

   (b) The assessed risk of material misstatement;

   (c) The extent to which the internal audit function supports the objectivity of the internal auditors; and

   (d) The level of competence of the function.

5. The external auditor shall also evaluate **whether the external auditor's conclusions** regarding the internal audit function and the determination of the nature and extent of use of the work of the function for purposes of the audit **remain appropriate.**

VII. DETERMINING WHETHER INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE FOR PURPOSES OF THE AUDIT

(a) The external auditor prohibited from obtaining direct assistance from internal auditors.



14. In case where the external auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the principal auditors to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.

(b) Using internal auditors to provide direct assistance is not prohibited

(i) Evaluation of the existence and significance of threats to objectivity and the level of competence of the internal auditors.

(ii) Evaluation of the existence and significance of threats shall include inquiry of the internal auditors.

The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity **shall include inquiry of the internal auditors** regarding interests and relationships that may create a threat to their objectivity.

Objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest or undue influence of others to override professional judgments.

© The Institute of Chartered Accountants of India

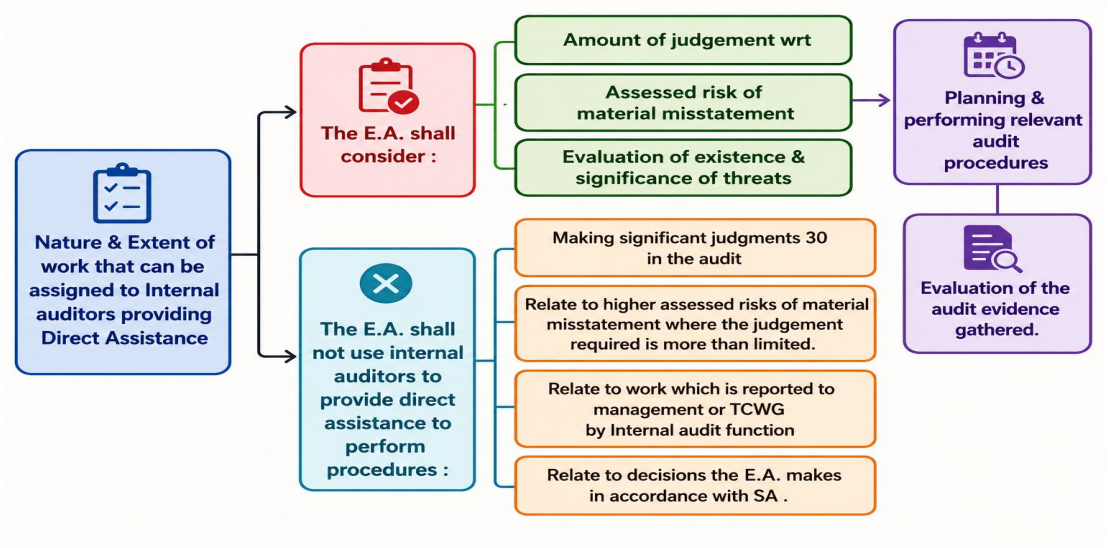
In evaluating the existence and significance of threats to the objectivity of an internal auditor, the following factors may be relevant:

The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
Association with the division or department in the entity to which the work relates.
Significant financial interests in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

The external auditor shall not use an internal auditor to provide direct assistance if:

(a) There are significant threats to the objectivity of the internal auditor; or	(b)The internal auditor lacks sufficient competence to perform the proposed work. As the function of Internal Auditor is again a concept of evaluation of Internal Control mechanism, it would amount to weaknesses in Internal Control System in case internal auditor does not apply required test procedures considering the Materiality aspects. This would in turn result in Higher Audit Risks.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance:



© The Institute of Chartered Accountants of India

Review of the work performed by Internal Auditors

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220. In doing so:

(a) The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity; and

(b) The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

[**Note: Students are advised to refer SA 610 "Using the Work of Internal Auditor" for more details.**]

TEST YOUR UNDERSTANDING 5

CA Keshavraj is conducting statutory audit of a listed company "Live with Nature Limited". The company is engaged in producing environment-friendly niche products for new-born babies. There is also a well-functioning internal audit department in the company. On perusal of internal audit reports, he finds that not only verification of inventories was attended by internal auditor at regular intervals during the year, workings were also made in respect of inventory valuation as at year end.

He has also attended inventory count at end of financial year and no prima facie adverse inferences were drawn by him. However, ongoing through inventory reports, he gathers that inventories are being held for considerably long period before being sold. The internal audit reports have not taken this aspect into consideration. Should he choose to rely upon inventory valuation work performed by internal auditor?

Illustration 1

CA Amboj, a practicing chartered accountant, has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA Kishore, the statutory auditor of the Company, for his view and reporting. Can CA Kishore rely on such report?

Using the Work of Internal Auditor: As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

© The Institute of Chartered Accountants of India

(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;

(b) The level of competence of the internal audit function; and

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

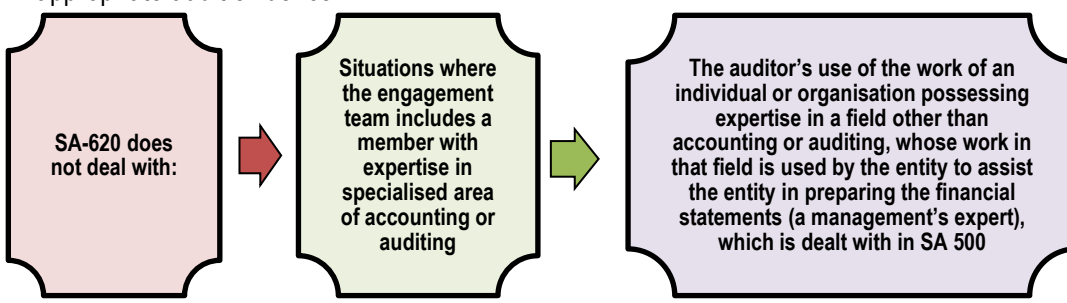
In the instant case, CA. Kishore should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible, he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

4.5.3 SA 620-Using the Work of an Auditor's Expert

I. SCOPE OF SA 620

SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.



© The Institute of Chartered Accountants of India

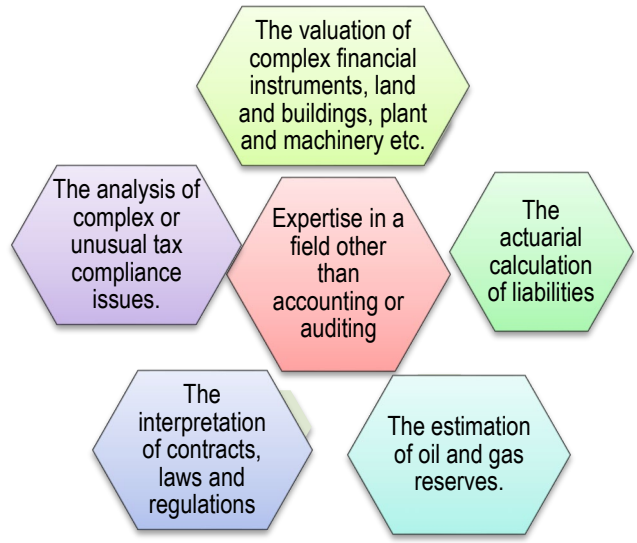
Auditor's Expert – An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

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

II. THE AUDITOR'S RESPONSIBILITY FOR THE AUDIT OPINION

The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert. Nonetheless, if the auditor using the work of an auditor's expert, having followed this SA, concludes that the work of that expert is adequate for the auditor's purposes, the auditor may accept that expert's findings or conclusions in the expert's field as appropriate audit evidence.

The objectives of the auditor are:	
(a)	To determine whether to use the work of an auditor's expert; and
(b)	If using the work of an auditor's expert, to determine whether that work is adequate for the auditor's purposes.



© The Institute of Chartered Accountants of India

III. DETERMINING THE NEED FOR AN AUDITOR'S EXPERT

An auditor's expert may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, including its internal control.
- Identifying and assessing the risks of material misstatement.
- Determining and implementing overall responses to assessed risks at the financial statement level.
- Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures.
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements.

Auditor may obtain understanding of other field: An auditor who is not an expert in a relevant field other than accounting or auditing may nevertheless be able to obtain a sufficient understanding of that field to perform the audit without an auditor's expert. This understanding may be obtained through.



15. Experience in auditing entities that require such expertise in the preparation of their financial statements.

- Education or professional development in the particular field. This may include formal courses, or discussion with individuals possessing expertise in the relevant field for the purpose of enhancing the auditor's own capacity to deal with matters in that field. Such discussion differs from consultation with an auditor's expert regarding a specific set of circumstances encountered on the engagement where that expert is given all the relevant facts that will enable the expert to provide informed advice about the particular matter.
- Discussion with auditors who have performed similar engagements.

IV. CONSIDERATIONS WHEN DECIDING WHETHER TO USE AN AUDITOR'S EXPERT

In other cases, however, the auditor may determine that it is necessary, or may choose, to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence.

Considerations when deciding whether to use an auditor's expert may include:

- Whether management has used a management's expert in preparing the financial statements.
- The nature and significance of the matter, including its complexity.
- The risks of material misstatement in the matter.

© The Institute of Chartered Accountants of India

- The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the availability of alternative sources of audit evidence.

When management has used a management's expert

When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

V. NATURE, TIMING AND EXTENT OF AUDIT PROCEDURES

The nature, timing and extent of the auditor's procedures will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

(a) The nature of the matter to which that expert's work relates;

(b) The risks of material misstatement in the matter to which that expert's work relates;

(c) The significance of that expert's work in the context of the audit;

(d) The auditor's knowledge of and experience with previous work performed by that expert; and

(e) Whether that expert is subject to the auditor's firm's quality control policies and procedures.



16. The following factors may suggest the need for different or more extensive procedures than would otherwise be the case:

- The work of the auditor's expert relates to a significant matter that involves subjective and complex judgments.

© The Institute of Chartered Accountants of India

- The auditor has not previously used the work of the auditor's expert, and has no prior knowledge of that expert's competence, capabilities and objectivity.
- The auditor's expert is performing procedures that are integral to the audit, rather than being consulted to provide advice on an individual matter.
- The expert is an auditor's external expert and is not, therefore, subject to the firm's quality control policies and procedures.

VI. THE COMPETENCE, CAPABILITIES AND OBJECTIVITY OF THE AUDITOR'S EXPERT

The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.



17. In case where that expert's work is subject to technical performance standards or other professional or industry requirements, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

VII. OTHER MATTERS THAT MAY BE RELEVANT INCLUDE

- The relevance of the auditor's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field.



18. A particular actuary may specialise in property and casualty insurance, but has limited expertise regarding pension calculations.

- The auditor's expert's competence with respect to relevant accounting and auditing requirements



19. Knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.

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

© The Institute of Chartered Accountants of India

VIII. EVALUATION OF THE SIGNIFICANCE OF THREATS TO OBJECTIVITY AND NEED FOR SAFEGUARDS

The evaluation of the significance of threats to objectivity and of whether there is a need for safeguards may depend upon the role of the auditor's expert and the significance of the expert's work in the context of the audit.



20. If a proposed auditor's expert is an individual who has played a significant role in preparing the information that is being audited, that is, if the auditor's expert is a management's expert.

Evaluating the objectivity of an auditor's external expert: When evaluating the objectivity of an auditor's external expert, it may be relevant to:

(a) **Inquire of the entity** about any known interests or relationships that the entity has with the auditor's external expert that may affect that expert's objectivity.

(b) **Discuss with that expert** any applicable safeguards, including any professional requirements that apply to that expert; and evaluate whether the safeguards are adequate to reduce threats to an acceptable level. Interests and relationships that may be relevant to discuss with the auditor's expert include:

- Financial interests.
- Business and personal relationships.
- Provision of other services by the expert
- In some cases, it may also be appropriate for the auditor to obtain a written representation from the auditor's external expert about any interests or relationships with the entity of which that expert is aware.

IX. OBTAINING AN UNDERSTANDING OF THE FIELD OF EXPERTISE OF THE AUDITOR'S EXPERT

The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

(a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and

(b) Evaluate the adequacy of that work for the auditor's purposes.

© The Institute of Chartered Accountants of India

X. AGREEMENT WITH THE AUDITOR'S EXPERT

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

(a) The nature, scope and objectives of that expert's work;

(b) The respective roles and responsibilities of the auditor and that expert;

(c) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and

> When the work of the auditor's expert relates to the auditor's conclusions regarding a significant risk, both a formal written report at the conclusion of that expert's work, and oral reports as the work progresses, may be appropriate. Identification of specific partners or staff who will liaise with the auditor's expert, and procedures for communication between that expert and the entity, assists timely and effective communication, particularly on larger engagements.

(d) The need for the auditor's expert to observe confidentiality requirements.

> It is necessary for the confidentiality provisions of relevant ethical requirements that apply to the auditor also to apply to the auditor's expert. Additional requirements may be imposed by law or regulation. The entity may also have requested that specific confidentiality provisions be agreed with auditor's external experts.

XI. EVALUATING THE ADEQUACY OF THE AUDITOR'S EXPERT'S WORK

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence.

> ***The Findings and Conclusions of the Auditor's Expert***
>
> Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:
>
> - Inquiries of the auditor's expert.
> - Reviewing the auditor's expert's working papers and reports.
> - Corroborative procedures, such as:
>   - Observing the auditor's expert's work;

© The Institute of Chartered Accountants of India

- Examining published data, such as statistical reports from reputable, authoritative sources;
- Confirming relevant matters with third parties;
- Performing detailed analytical procedures to see whether Principles of materiality aspects considered; and
- Re-performing calculations.

- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

Assumptions and Methods: When the auditor's expert's work is to evaluate underlying assumptions and methods, including models where applicable, used by management in developing an accounting estimate, the auditor's procedures are likely to be primarily directed to evaluating whether the auditor's expert has adequately reviewed those assumptions and methods.

When the auditor's expert's work is to develop an auditor's point estimate or an auditor's range for comparison with management point's estimate, the auditor's procedures may be primarily directed to evaluating the assumptions and methods, including models where appropriate, used by the auditor's expert.

SA 540 discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- Generally accepted within the auditor's expert's field;
- Consistent with the requirements of the applicable financial reporting framework;
- Dependent on the use of specialised models; and

Consistent with those of management, and if not, the reason for, and effects of, the differences.

© The Institute of Chartered Accountants of India

(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

When an auditor's expert's work involves the use of source data that is significant to that expert's work, procedures such as the following may be used to test that data:

- Verifying the origin of the data, including obtaining an understanding of, and where applicable testing, the internal controls over the data and, where relevant, its transmission to the expert.
- Reviewing the data for completeness and internal consistency

XII. WHEN WORK OF THE AUDITOR'S EXPERT IS NOT ADEQUATE FOR THE AUDITOR'S PURPOSES

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(a) Agree with that expert on the nature and extent of further work to be performed by that expert; or

(b) Perform further audit procedures appropriate to the circumstances.



21. Inadequate Work : If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence.

XIII. REFERENCE TO THE AUDITOR'S EXPERT IN THE AUDITOR'S REPORT

1 The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.



22. In some cases, law or regulation may require a reference to the work of an auditor's expert, for the purposes of transparency in the public sector.

© The Institute of Chartered Accountants of India

2 If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

ILLUSTRATION 2

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

(i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.

(ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

(iii) The estimation of oil and gas reserves.

(iv) The valuation of environmental liabilities, and site clean-up costs.

(v) The interpretation of contracts, laws and regulations.

(vi) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

© The Institute of Chartered Accountants of India

4.5.4 SA 540-Auditing Accounting Estimates, Including Fair Value Accounting Estimates & Related Disclosures

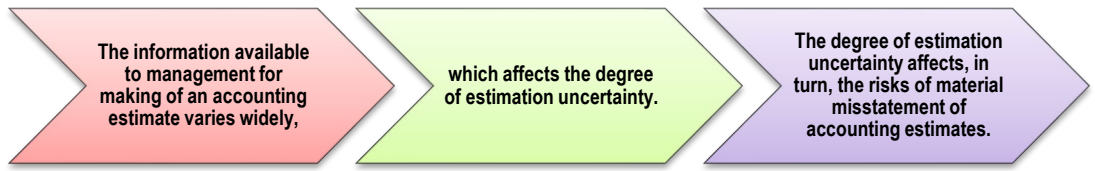
I. SCOPE OF THIS SA

This Standard on Auditing (SA) deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other relevant SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.



II. NATURE OF ACCOUNTING ESTIMATES

Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this SA, such financial statement items are referred to as accounting estimates.



Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item.

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

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

© The Institute of Chartered Accountants of India

- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.



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

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which, there are assumptions or inputs that cannot be observed in the marketplace. Accounting estimates in cases of Wage Revision Agreements wherein negotiations with the Trade Unions is on the way or Government's sanction is awaited leading to uncertainty.

III. THE DEGREE OF ESTIMATION UNCERTAINTY

The degree of estimation uncertainty varies based on :		
the nature of the accounting estimate,	the extent to which there is a generally accepted method used to make the accounting estimate,	the subjectivity of the assumptions used to make the accounting estimate

1. Not all financial statement items requiring measurement at fair value, involve estimation uncertainty.



25. This may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value.

However, estimation uncertainty may exist even when the valuation method and data are well defined. **For example,** valuation of securities quoted on an active and open market at the listed

© The Institute of Chartered Accountants of India

market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.



26. Examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

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



27. Examples of situations where fair value accounting estimates may be required include:

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

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

IV. MANAGEMENT BIAS

Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias **(for example, as a result of motivation to achieve a desired result).**

© The Institute of Chartered Accountants of India

The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it.

Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

Management bias can be difficult to detect at an account level.

- It may only be identified when considered in the aggregate of groups of accounting estimates or
- all accounting estimates, or
- when observed over a number of accounting periods.

Although some form of management bias is inherent in subjective decisions, in making such judgments, there may be no intention by management to mislead the users of financial statements.

Where, however, there is intention to mislead, management bias is fraudulent in nature.

V. THE MEASUREMENT OBJECTIVE OF ACCOUNTING ESTIMATES

The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability.



28. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.

A difference between the outcome of an accounting estimate and the amount originally recognised or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

© The Institute of Chartered Accountants of India

VI. OBJECTIVE OF SA 540

The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate.

Important Definition:
Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this SA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used. **Auditor's point estimate or auditor's range** – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate
Management bias – A lack of neutrality by management in the preparation and presentation of information. **Management's point estimate** – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement. **Outcome of an accounting estimate** –The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

VII. AUDITOR'S RESPONSIBILITY /AUDIT PROCEDURES

1. **Risk assessment procedures and related activities for accounting estimates:** When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by SA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

   (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.

© The Institute of Chartered Accountants of India

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. As the assessment of accounting estimates affects the ultimate decision in forming an opinion, much care has to be taken in this regard. It is highly important as the auditor's conclusion is based on above basis.

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

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

Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

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

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

© The Institute of Chartered Accountants of India

3. **How management makes the accounting estimates:** How management makes the accounting estimates, and an understanding of the data on which they are based, including:

   (i) The method, including where applicable the model, used in making the accounting estimate;

   (ii) Relevant controls;

   (iii) Whether management has used an expert;

   (iv) The assumptions underlying the accounting estimates;

   (v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

   (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty.

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

4. **Estimation uncertainty:** For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, the auditor shall evaluate the following:

   (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

   (b) Whether the significant assumptions used by management are reasonable.

   (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

   If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the

© The Institute of Chartered Accountants of India

auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

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

(a) management's decision to recognise, or to not recognise, the accounting estimates in the financial statements; and

(b) the selected measurement basis for the accounting estimates.

I. Identifying and Assessing the Risks of Material Misstatements:

(a) In identifying and assessing the risks of material misstatement as required by SA 315, the auditor shall evaluate the degree of estimation uncertainty associated with accounting estimates.

(b) The auditor shall determine whether, in the auditor's judgment, any of those accounting estimate that have been identified as having high estimation uncertainty give rise to significant risk.

II. Responses to the Assessed Risks of Material Misstatement:

(a) Based on assessed risk of material misstatement the auditor, shall determine:

- Whether management has appropriately applied the applicable financial reporting framework relevant to the accounting estimate; and
- Whether the methods for making the accounting estimates are appropriate and have been applied consistently.
- If there are changes in accounting estimates or in the method used for making those from prior period, are those appropriate in the present circumstances.

(b) In response to the assessed risk of material misstatement, the auditor shall undertake one or more of the following, taking in account the nature of the accounting estimates.

- Determine whether events occurring up to the date of the auditor's report provide sufficient audit evidence regarding the accounting estimate.
- Test checks the data used by the management for making accounting estimate.

© The Institute of Chartered Accountants of India

- The auditor shall also evaluate whether the method used for measurement is appropriate in the circumstances and assumptions made by the management are reasonable in the light of the measurement objective of the applicable financial reporting. This can be achieved by
  - ➢ Testing the extent to which data on which accounting estimate is based is accurate, complete and relevant and whether the accounting estimate has been properly determined using such data and management assumptions.
  - ➢ Considering the source, relevance and reliability of external data.
  - ➢ Recalculating the accounting estimate and reviewing information about an accounting estimate for internal consistency.
  - ➢ Test checks the effectiveness of the controls over the estimates used by the management together with appropriate substantive procedure.

(c) While determining the matters identified or in responding to the assessed risks of material misstatement, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

5. Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements: The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

VIII. AUDIT REPORTING & DISCLOSURE

Disclosures Related to Accounting Estimates

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

© The Institute of Chartered Accountants of India

For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework

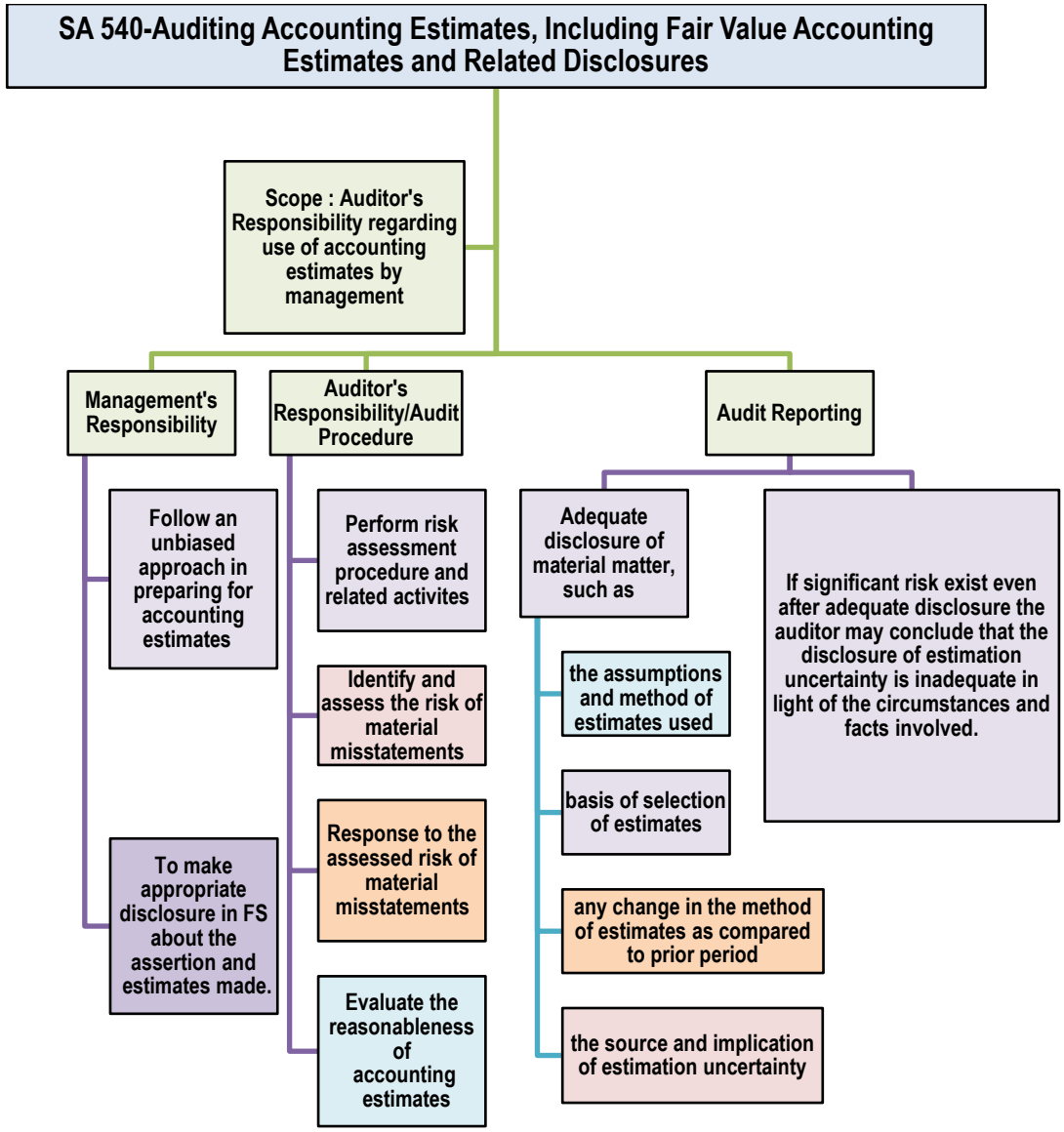
(a) The presentation of financial statement in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. These disclosures may include, • The assumptions used. • The method of estimation used, including any applicable model. • The basis for the selection of the estimation. • Any changes in the method of estimation from prior period and its subsequent effect. • The sources and implication of estimation uncertainty.	**(b)** In relation to accounting estimate having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved.

Written Representations: The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Documentation of Accounting Estimates

The audit documentation shall include:	
(a)	The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
(b)	Indicators of possible management bias, if any.

© The Institute of Chartered Accountants of India



4.5.5 Control of Quality of Audit Work

Under SQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

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

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

© The Institute of Chartered Accountants of India

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.

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. SA 220 deals with audit quality at individual engagement level.

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.

(Students may refer Chapter 1 Quality Control for more details)

4.5.6 Analytical Procedures Prior to Audit as well as Towards Finalization

I. WHEN DESIGNING AND PERFORMING SUBSTANTIVE ANALYTICAL PROCEDURES

As per SA 520, "Analytical Procedures" the auditor shall:

(a) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
(b) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
(c) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
(d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation as required.

© The Institute of Chartered Accountants of India

II. ANALYTICAL PROCEDURES THAT ASSIST WHEN FORMING AN OVERALL CONCLUSION

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

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

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

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

III. INVESTIGATING RESULTS OF ANALYTICAL PROCEDURES

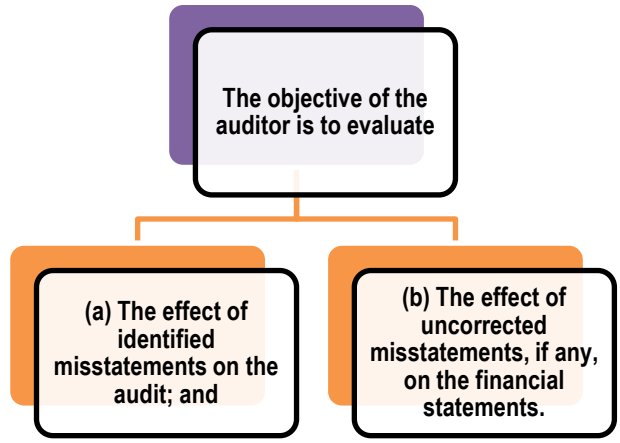
If analytical procedures performed in accordance with this SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
(b) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

4.5.7 SA 450 - Evaluation of Misstatements Identified During the Audit

SA 450 deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

© The Institute of Chartered Accountants of India



Important Definition:

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

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

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

4.5.7.1 Accumulation of Identified Misstatements

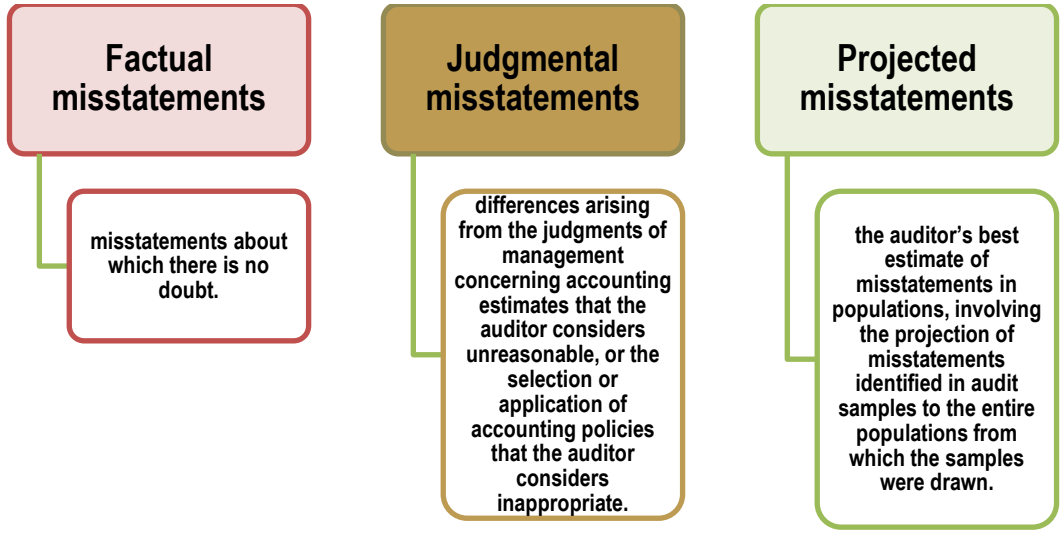
The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. The auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.

"Clearly trivial" is not another expression for "not material". Matters that are "clearly trivial" will be of a wholly different (smaller) order of magnitude than materiality determined in accordance with SA 320, and will be matters that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances.

When there is any uncertainty about whether one or more items are clearly trivial, the matter is considered not to be clearly trivial.

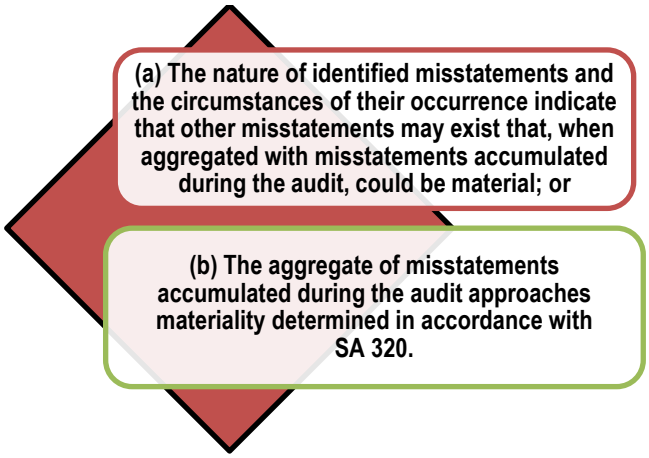
© The Institute of Chartered Accountants of India

To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.



4.5.7.2 Consideration of Identified Misstatements as the Audit Progresses

The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:



If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.

© The Institute of Chartered Accountants of India

4.5.7.3 Communication and Correction of Misstatements

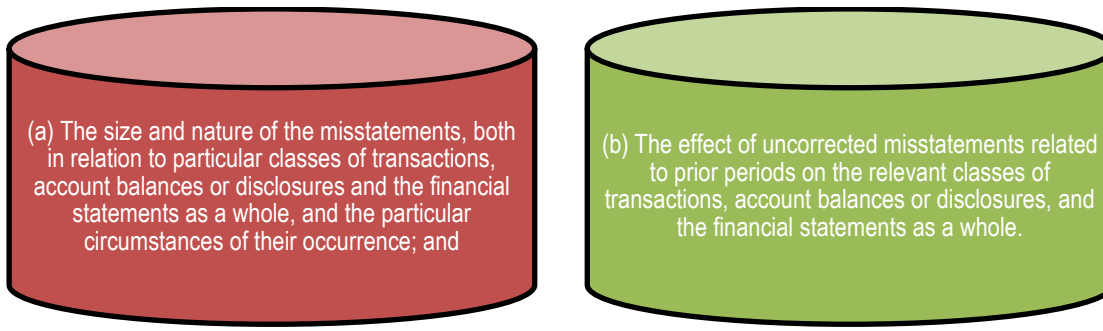
The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

4.5.7.4 Evaluating the Effect of Uncorrected Misstatements

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results.

The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:



4.5.7.5 Communication with Those Charged with Governance

The auditor shall communicate with those charged with governance, in accordance with SA 260, uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

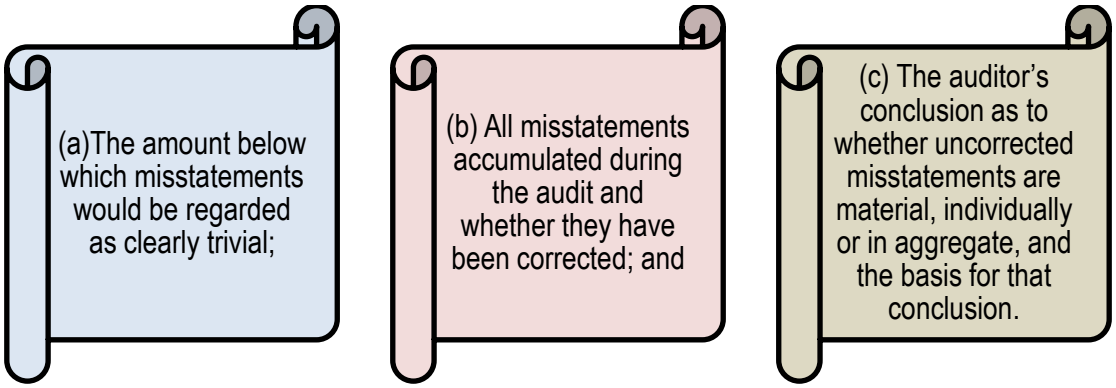
© The Institute of Chartered Accountants of India

4.5.7.6 Written Representation

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

4.5.7.7 Documentation

The audit documentation shall include:



Key Takeaways

- Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan.
- The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
- The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members.
- The audit programme may contain audit objectives for each area and should have sufficient detail to serve as a set of instructions to the assistants involved in the audit and as means to control the proper execution of work.
- During audit execution, there are certain other considerations which auditor is required to take care of while executing the audit including responsibilities to use work of other auditor, work of internal auditors, work of auditor's expert. Besides, the auditor has responsibilities regarding estimates. He has to apply analytical procedures towards finalization of audit in

© The Institute of Chartered Accountants of India

accordance with SA 520. Engagement has to be performed in qualitative manner in accordance with SA 220.

- SA 600 discusses the principal auditor's responsibility in relation to his use of the work of the other auditor.
- SA 610 defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit.
- SA 620 deals with the auditor's responsibilities regarding the use of work in a field of expertise other than accounting or auditing when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence
- SA 540 deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Note:

Content of SA 300 "Planning an Audit of Financial Statements" is covered in depth at Intermediate level, therefore, application part of SA 300 may be discussed in the form of Case Study at Final level.

Student may note that SA 300 is covered in chapter 2: Audit Strategy, Audit Planning and Audit Programme at Intermediate level, available at: **https://resource.cdn.icai.org/93333bos-aps5884-ch2.pdf**.

For a concise revision of the key concepts covered in this chapter, students may refer to the Saransh Booklet for Paper 3: Advanced Auditing, Assurance and Professional Ethics, which serves as a useful last-mile revision resource for examination preparation. Saransh Booklet can be accessed at https://boslive.icai.org/AAAPE_SARANSH.pdf

© The Institute of Chartered Accountants of India

TEST YOUR KNOWLEDGE

Theoretical Questions

1. *While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?*

2. *A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?*

3. *As an auditor of a garment manufacturing company for the last five years, you have observed that new venture of online shopping has been added by the company during current year. What factors would be considered by you in formulating the audit strategy of the company?*

4. *AKJ Ltd is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.*

   The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since the statutory audit is mandated by law, engagement letter may not be required. Auditors did not agree to this and have shared a format of engagement letter with the management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in terms of agreed audit engagement letter?

5. *Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. Its other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises.*

   Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are, therefore, required to draw an audit programme initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points relating to such complex.

© The Institute of Chartered Accountants of India

6. *MK Electronics Limited is a listed company with eight subsidiaries spread across various states. The financial statements of MK Electronics Ltd. are audited by CA Amar, the principal auditor. CA Amar relies on the work of other auditors for auditing the financial statements of subsidiaries. You are required to:*

   (i) Explain the procedures that CA Amar will perform to obtain sufficient appropriate audit evidence to ensure that the work of other auditors is adequate for his purpose.

   (ii) Explain how he will document the working papers with respect to the subsidiaries audited by other auditors. What matters need to be documented if the other auditor's report is modified?

7. *CA A has been appointed as an auditor of Datacom Ltd. to conduct statutory audit. The company has various derivative contracts - options, forward contracts, interest rate swaps etc. which were required to be fairly valued for which company got the fair valuation done through an external third party. CA A involved a registered valuer Mr. S as an auditor's expert to do the valuation of derivatives in order to obtain sufficient appropriate audit evidence. CA A and Mr. S are new to each other and they were working for the first time. Mr. S performed his work and submitted the report. CA A, while evaluating the adequacy of the work of Mr. S, observed that expert's work involved use of significant assumptions and methods. Consequently he wants to test the relevance and reasonableness of those assumptions and methods in the applicable circumstances. Guide CA A in this regard as per relevant Standard on Auditing.*

8. *M/s FG & Co., Chartered Accountants, have been appointed as statutory auditors of Z Ltd. for the F.Y.2025-26. During the course of audit, while carrying out risk assessment procedures and related activities for accounting estimates, CA G the engagement partner, identified provision for warranty as an accounting estimate and considered it to be at significant risk. In accordance with SA 540, explain the matters that need to be evaluated by CA G specifically with respect to estimation uncertainty.*

9. *AXO Automobiles Limited, a leading manufacturer of electric vehicles, appoints WYZ & Co. Chartered Accountants as the statutory auditors for the financial year ended March 31, 2026. CA W, the engagement partner, during the course of audit identifies the following misstatements:*

   - *An amount of ₹4 lakhs of rent income has not been recorded due to oversight.*

© The Institute of Chartered Accountants of India

- *An expense of ₹ 6 lakhs pertaining to F.Y. 2024-25 has been charged to Profit and Loss Account in F.Y. 2025-26.*
- *In a sample testing of warranty provisions, projected misstatement in the population is ₹ 10 lakhs.*

CA W is of the opinion that the above misstatements need to be rectified to portray the correct financial results of the company. The management of AXO Automobiles Ltd. refused to make the necessary corrections on the contention that these amounts were not material in relation to the company's turnover of ₹ 250 crores.

With reference to the relevant Standards on Auditing analyze the circumstances faced by CA W and guide him how he should evaluate the effect of these misstatements which are not corrected by the management. What communication requirements are applicable for the auditor in this situation?

10. *HAM Ltd. is engaged in the business of manufacturing electronic components, including sensors, microchips, and lithium-ion battery cells. The production process requires raw materials such as rare earth metals, semiconductor wafers, and chemical electrolytes. The company maintains a large stock of raw materials, the nature of which is technically complex and requires expert knowledge for physical verification. Therefore, management hired their experts to assist in the stock verification process. Simultaneously, auditors also hired their own expert to evaluate the inventory.*

    During the audit, auditor observed that the work of the auditor's expert was not adequate for the auditor's purposes, and he could not resolve the matter through additional audit procedures which included further work performed by both the auditor's expert and the auditor.

    Though the auditor was aware that he has not obtained sufficient appropriate audit evidence and it would be right to express a modified opinion in the auditor's report. However, he was reluctant in doing so, thus, expressed an unmodified opinion and included the name of the expert in his report to reduce his responsibility for the audit opinion expressed. Comment with respect to the relevant Standard on Auditing relating to the action of the auditor of issuing unmodified audit report.

11. *Mohan Ltd. having a net worth of ₹ 1,750 crore, is mandatorily required to comply with Ind AS. The company had various complex derivative contracts – options such as forward contracts, interest rate swaps etc. which were required to be fair valued as per IND AS 109 and for which company got the fair valuation done through an external third party. Considering the complex nature of these valuations, the statutory auditor*

© The Institute of Chartered Accountants of India

CA Paras decided to involve an auditor's expert to assess the appropriateness and accuracy of the valuation methodology and results.

CA Paras engaged expert Mr. Sohan as an auditor's expert for valuation of derivatives. CA Paras and Mr. Sohan were new to each other i.e., they were working for the first time together but developed a good bonding during the audit. The auditor did not enter into any formal agreement with the auditor's expert. Please advise.

12. *Gamma Ltd is engaged in the Construction business since year 2014. The auditor understands that a thorough construction estimate is vital to the viability of any construction business and requested the information related to financing and operating estimated costs from the management to review the outcome of accounting estimates included in the prior period financial statements and their subsequent re-estimation for the purpose of current period. The management refused to provide the information to the auditor as it believed that the judgments and estimates made in the prior periods were based on the information available at that time, and the review of the prior period information should not be done by the auditor in the current financial year. With reference to the relevant SA, comment on whether the contention of management is correct or not.*

13. *CA Ajeet is appointed as a statutory auditor of Shravasti Ltd. Shravasti Ltd. is required to appoint an internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. Sambhav as its internal auditor. The external auditor CA Ajeet asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements. Discuss whether CA Ajeet, statutory auditor, can ask direct assistance from Mr. Sambhav, internal auditor as stated above in view of auditing standards.*

14. *MNO Ltd., at its annual general meeting, appointed Mr. M, Mr. N, and Mr. O as joint auditors to conduct the audit for the financial year 2025-26. For the valuation of the newly constructed infrastructure project of the company, Mr. M, Mr. N, and Mr. O decided to consult their own known engineers. Due to differences of opinion, each joint auditor sought advice from their respective engineers. As a result, significant discrepancies were found in the valuation reports provided by the engineers. However, Mr. M agreed with the report provided by Mr. N's engineer, while Mr. O did not. Mr. M argues that report of Mr. N's engineer should be included in the audit report due to the majority of votes. Now, Mr. O is in a dilemma.*

© The Institute of Chartered Accountants of India

What would be the responsibility of the auditors if the report provided by Mr. N's engineer is later found to be faulty?

Answers to Test your Understanding

1. SA 300 requires the auditor to plan the audit in such a manner that it is performed effectively. It also requires auditor to establish overall audit strategy including identifying the characteristics of the engagement, facilitating him to define its scope and planning of nature, timing and extent of audit procedures required to be performed to achieve the objective of audit.

SA 300 further requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

In the given situation, auditor didn't even once visit the company and failed to understand about business of the company. Therefore, he has flouted requirement of SA 300 to plan the audit in such a manner that it is performed effectively. The auditor has to plan the audit commensurate to the nature and complexity of the business of the entity and identify and assess the risk of material misstatement.

Further, working papers of auditor also do not show his understanding of nature of business which is again a blatant violation of requirement of SA 300 which requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

Inclusion of a checklist in working papers having requirement of test checking of cost of raw material consumed & cost of stores and spares shows that it was a general checklist and specifics of business were never understood and audit was not planned to be conducted in an effective manner in accordance with requirements of SA 300.

2. SA 300 states that audit plan shall include description about nature, timing and extent of audit procedures. The extent of audit procedures also includes deciding about sample sizes to be tested for performing audit procedures. Therefore, the said approach is not proper. Various procedures planned to be undertaken should also include considerations relating to sample sizes to be tested.

3. SA 300 requires auditor to document audit plan and significant changes made during the audit engagement to the audit plan. It also requires auditor to document reasons for such changes.

© The Institute of Chartered Accountants of India

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

Further, changes to audit plan along with reasons thereof due to embarking upon extensive procedures related to verification of foreign contributions in comparison to what was originally envisaged need to be documented.

Failure to document audit plan could entail risk of not conducting audit according to professional standards in a qualitative manner.

4. SA 600 states that the principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors. When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

In the given situation, nothing has come to light of statutory auditor which would arouse his suspicion about reliability of work performed by branch auditor. Therefore, he would not be responsible for work performed by branch auditor.

Further, it should be clearly stated in the report that 1034 branches of bank have been audited by branch auditors.

5. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

© The Institute of Chartered Accountants of India

In the given situation, inventories are being held for considerably long period before being sold. As company is dealing in niche products for new-born babies, there is a risk of inventory obsolescence due to changes in customer preferences. It carries a significant risk of material misstatement and requires more judgment on part of statutory auditor in planning and performing procedures.

In such circumstances, statutory auditor needs to perform procedures directly like comparing net realizable value of products with costs to verify completeness of provisions, recomputing of provisions for obsolete stocks etc.

Therefore, in the given situation, he should perform procedures directly in accordance with SA 610.

Answers to Theoretical Questions

1. As per **SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates.

(2) Relevant controls.

(3) Whether management has used an expert?

(4) The assumption underlying the accounting estimates.

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

© The Institute of Chartered Accountants of India

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

2. **Development of an overall plan** - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

(i) Terms of his engagement and any statutory responsibilities.

(ii) Nature and timing of reports or other communications.

(iii) Applicable Legal or Statutory requirements.

(iv) Accounting policies adopted by the clients and changes, if any, in those policies.

(v) The effects of new accounting and auditing pronouncement on the audit.

(vi) Identification of significant audit areas.

(vii) Setting of materiality levels for the audit purpose.

(viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.

(ix) Degree of reliance to be placed on the accounting system and internal control.

(x) Possible rotation of emphasis on specific audit areas.

(xi) Nature and extent of audit evidence to be obtained.

(xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.

(xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.

(xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

(xv) Establishing and coordinating staffing requirements.

3. **Formulation of Audit Strategy:** While formulating the audit strategy for a company, following factors may be considered -

General Factors: Refer Para 2.1.

© The Institute of Chartered Accountants of India

Specific Factors for Online Shopping:

The auditor shall also obtain an understanding of the information system including the related business processes due to new venture of online shopping in the following areas:

(i) The classes of transactions in the entity's operations that are significant to the financial statements;

(ii) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

(iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

(v) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

4. As per SA 210 'Agreeing the Terms of Audit Engagements', the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

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:

(i) The objective and scope of the audit of the financial statements;

(ii) The responsibilities of the auditor;

(iii) The responsibilities of management;

(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(v) 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.

5. Audit Programme of Movie Theatre Complex:

(i) Peruse the Memorandum of Association and Articles of Association of the entity.

© The Institute of Chartered Accountants of India

(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:

(1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly and accurately accounted.

(2) Verify the system relating to online booking of various shows and the system of realization of money.

(3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows in a day.

(iv) Verify the internal control system and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.

(v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

(vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

(vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement, any payment of advance made to the distributor is also adjusted against the amount due.

(viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

(ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

(x) Verify the insurance premium paid and ensure it covers the entire assets.

6. ***(i) The principal auditor CA Amar should perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for the principal auditor's purposes. When using the work of another auditor, CA Amar the principal auditor should ordinarily perform the procedures given below:***

(1) advise the other auditor regarding use of his (other auditor) work and report and make sufficient arrangements for co-ordination at the planning stage of the audit. The principal auditor would inform the other auditor of

© The Institute of Chartered Accountants of India

matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit;

(2) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

(ii) CA Amar should document in his working papers, the components whose financial information audited by other auditors. CA Amar should also document the procedures performed and the conclusions reached. For example, the auditor would document the results of discussions with the other auditor and review of the written summary of the other auditor's procedures.

Where the other auditor's report is other than unmodified, the principal auditor should also document how he has dealt with the qualifications or adverse remarks contained in the other auditor's report in framing his own report.

7. Testing the relevance and reasonableness of assumptions and methods used by the auditor's expert: As per SA 620, "Using the Work of an Auditor's Expert", when an auditor uses the work of an expert, they must evaluate whether the expert's work is adequate for the auditor's purposes. In the given case, CA A, statutory auditor of Datacom Ltd., is using the valuation report of Mr. S, a registered valuer, for auditing derivative instruments. CA A also observed that an expert's work involves the use of significant assumptions and methods. Accordingly, he must assess the relevance and reasonableness of the expert's assumptions, methods, and findings in the circumstances as per SA 620.

SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures", discusses the assumptions and methods used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management's assumptions and methods, it may also assist the auditor when evaluating an auditor's expert's assumptions and methods.

When an auditor's expert's work involves the use of significant assumptions and methods, factors relevant to the auditor's evaluation of those assumptions and methods include whether they are:

- *Generally accepted within the auditor's expert's field;*

© The Institute of Chartered Accountants of India

- *Consistent with the requirements of the applicable financial reporting framework;*
- *Dependent on the use of specialised models; and*
- *Consistent with those of management, and if not, the reason for, and effects of, the differences.*

8. *Matters that need to be evaluated with respect to estimation uncertainty as per SA 540: As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates & Related Disclosures", matters that need to be evaluated by the auditor CA G specifically with respect to estimation uncertainty, for accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, are as under:*

   1. *How management has:*

      (i) *Considered alternative assumptions or outcomes,*

      (ii) *Why it has rejected them,*

      (iii) *How management has otherwise addressed estimation uncertainty in making the accounting estimate.*

   2. *Whether the significant assumptions used by management are reasonable.*

   3. *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.*

9. *SA 450 "Evaluation of Misstatements Identified During the Audit", deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.*

   In the given situation, the auditor CA W should categorize the identified misstatements to evaluate their nature and impact in case of rent income of 4 lakhs not recorded due to oversight, expenses of 6 lakhs pertaining to F.Y. 2024-25 charged to Profit & Loss Account in F.Y. 2025-26, and for projected misstatement in the population sample test of warranty provisions of 10 lakhs. However, after insisting for rectification to reflect the correct financial results of the company, Management of AXO Automobiles Ltd. refused to make necessary corrections. Therefore, CA W shall evaluate the effect of these misstatements which are not corrected by management in following manner:

   Refer Para 4.5.7.4 and Para 4.5.7.5

© The Institute of Chartered Accountants of India

10. *As per SA 620, "Using the work of an Auditor's Expert", if the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence.*

In addition, the auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.

If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

In the given case, the auditor cannot reduce his responsibility by referring the name of auditor's expert and thereby issuing a unmodified report. The auditor should have issued a modified report and could have given reference to the work of an auditor's expert in that report if such reference was relevant to understanding of a modification to the auditor's opinion but even in that case the auditor should have indicated in his report that such reference of an auditor's expert does not reduce his responsibility for that opinion.

11. *As per SA 620, "Using the work of an Auditor's Expert", the nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert.*

In certain situations, the need for a detailed agreement in writing is required like -

© The Institute of Chartered Accountants of India

- *The auditor's expert will have access to sensitive or confidential entity information.*
- *The matter to which the auditor's expert's work relates is highly complex.*
- *The auditor has not previously used work performed by that expert.*
- *The greater the extent of the auditor's expert's work, and its significance in the context of the audit.*

In the given case, Mohan Ltd. is mandatorily required to comply with Ind AS as it had complex derivative contracts requiring fair valuation under Ind AS 109. The company obtained valuations from a third party, and statutory auditor CA Paras engaged Mr. Sohan as an auditor's expert to assess their appropriateness and accuracy of the valuation methodology and results. Though it was their first time that they were working together and developed good bonding, no formal written agreement was made with the expert.

Thus, as per SA 620 considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

12. *As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.*

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- *Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.*

© The Institute of Chartered Accountants of India

- *Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.*
- *Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.*

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the contention of management is not correct in refusing the relevant information to the auditor.

13. *As per SA 610, "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.*

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- *Assessing the risks of material misstatement;*
- *Evaluating the sufficiency of tests performed;*
- *Evaluating the appropriateness of management's use of the going concern assumption;*
- *Evaluating significant accounting estimates; and*
- *Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.*

In view of above, CA Ajeet cannot ask for direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

14. *As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the valuation of complex financial instruments, land and buildings, plant*

© The Institute of Chartered Accountants of India

and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired etc., however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. M, Mr. N and Mr. O, jointly appointed as auditors of MNO Ltd., referred their own known engineer for valuation of the newly constructed infrastructure project. Engineers are an auditor's expert as per SA 620. Mr. N's referred Engineer has provided the valuation report, which was later found faulty. Further, Mr. O is not in agreement with this report, therefore, he submitted a separate audit report specifically for such a valuation.

In such a situation, it was the duty of Mr. M, Mr. N and Mr. O, before using the valuation report provided by engineer, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such a report before expressing their opinion.

Mr. M and Mr. N will be held responsible for gross negligence and using such faulty report without examining the adequacy of expert engineer's work whereas Mr. O will not be held liable for the same due to separate opinion expressed by him.

© The Institute of Chartered Accountants of India