Workshop on Auditing Standards

Organized by AASB & YMEC

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SA 250 – Consideration of Laws & Regulations in an Audit of Financial Statements

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Scope

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Auditors' responsibility

- To consider impact of laws & regulations while performing audit
- To identify material misstatement of financial statements due to non compliance

Managements' responsibility and those charged with governance

- Ensure compliance with laws & regulation
- Conduct operations of the entity in accordance with laws & regulations
- Comply with laws & regulations that determine reported amounts & disclosures in financial statements

Section 134(5)(f) of Companies Act 2013

Auditors' responsibility excludes

- Engagements where scope is to test & report on compliance with specific laws or regulations
- For preventing non compliance & not expected to detect non compliance

Objective

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Obtaining sufficient audit evidence having direct effect on the material amounts and disclosures in the financial statements (e.g. contingent liability on account of litigations, provision for taxes)

Perform specific audit procedures to identify instances on non compliance of laws & regulations which have a material effect on financial statements (e.g. confirmation circularization with company's lawyers)

Respond to non compliance or suspected non compliance with laws & regulations during audit (e.g. breach of licensing requirements)

Auditor should :

- Remain alert to possibility that **other audit procedures** applied for forming an opinion on financial statement may bring to light identified/ suspected non compliance (e.g. meeting with legal head, review of account captions like legal & professional fees)
- SA assists auditor in identifying material misstatements in financial statements due to non compliance

Definition

Non compliance

- Acts of omission or commission
- Being intentional or unintentional
- Which are contrary to the prevailing laws & regulations
- Shall not include personal misconduct – which is not related to business

Management is responsible for compliance with those laws & regulations which directly or indirectly impact the financial statements of the entity

Management's responsibility (1/5) SA 250

Responsibility

- Overseeing the operations of entity to be conducted in accordance with laws & regulations

Policies & procedures

- Monitor legal requirements
- Ensure operating effectiveness of internal controls
- Develop, monitor & publicize code of conduct
- Proper training of employees
- Legal advisors
- Register of laws & regulations applicable

Supplemental procedures for large entities

- Compliance with those laws & regulations that determine the form and content of the financial statements (e.g banking)
- Formation of an internal audit function with a scope specific to ensure compliance with the laws & regulations
- A robust audit committee which looks into the legal compliance part specifically
- Compliance function – which monitors and flags off any non compliance across the functions

Auditors’ responsibility (2/5) SA 250

- Obtain a reasonable assurance that the financial statements as a whole are free from material misstatement, whether by fraud or error
- Understand the legal frame work applicable & how it is complied by the entity
- Perform audit procedures to identify instances of non compliance with laws & regulations
- Remain alert w.r.t other audit procedure which brings out non compliances (e.g. inquires with legal department, specific inquires with respect other allied laws)
- Perform such other audit procedures when non compliance is identified or suspected (e.g. external confirmations to lawyers, adverse media comments)
- Representation – that all the possible non compliances have been disclosed
- Absence of identified or suspected non compliance – auditor not required to perform further procedures

Legal determination of non compliance is beyond the professional competence. However, the auditors’ training, skill, experience and understanding of the industry may provide basis to recognize a non compliance or a potential non compliance

Auditors' consideration - Compliance of laws & regulations (3/5) SA 250

Direct impact – Presentation & disclosure of the financial statements	Indirect impact – Operations & going concern assumption of an entity
▪ Laws & regulation specific to sector or industry (e.g. telecom companies) ▪ Form & content of financial statements (e.g. banking companies & insurance companies) ▪ Accounting under government contracts (e.g specific oil & gas companies) ▪ Accrual & recognition of certain specific expenses (e.g tax laws)	▪ Non compliance with the license or other entitlement requirement (e.g NBFC licenses) ▪ Non compliance with provisions of the law under which the entity is established (broking companies) ▪ Industry specific compliances (NPAs & revenue recognition in banking companies)

Auditor needs to undertake specified audit procedures to help identify non compliance that impact the financial statements & exercise professional skepticism

Audit procedures - Non compliance is identified/ suspected (4/5) SA 250

Non compliance with laws & regulations	Suspected non compliance with laws & regulations
▪ Investigation by government, regulatory agency or payment of fines ▪ Payments to legal advisors, employees, consultants or government employee ▪ Unusual sales commission ▪ Purchasing at a significant higher price ▪ Unusual transactions with Companies in tax heaven locations ▪ Lack of documentation w.r.t exchange control transactions ▪ Adverse media comments etc	▪ Understand nature of act & circumstances (form & content, intentional, omission etc) ▪ Understand impact on financial statement ▪ Discuss with management & those charged with governance ▪ Legal advice if necessary ▪ Evaluate the risk & reliability over written representation ▪ Evaluate proper reporting

Reporting of identified/ suspected non compliance (5/5) SA 250

Management Representation

- Considered by auditor
- Managements knowledge w.r.t the non compliance
- Completeness of the non compliance
- Material impact on the financial statements
- MRL not a sufficient audit evidence impacting the nature & extent of audit evidence

Reporting - those charged with governance

- Communicate the matters that arise during audit
- Communicate early if the non compliance is intentional & material
- Involve management & those charged with governance
- Incase no higher level, seek a legal advice
- In consequential matters need not be reported

Auditors' report

Material non compliance

- Inadequately reflected in financial statements – modified opinion
- Limitation by management & those charged with governance – disclaimer or a qualified opinion
- Limitation by circumstances – evaluate the impact on opinion
  - E.g fraud investigation
  - E.g Operation / Missmanagement
  - E.g FEMA non compliance

Regulators

- Determine the responsibility to report non compliance to external parties
- Client confidentiality –
  - Legal responsibility may vary
  - Law overrides the confidentiality requirements
  - Legal advice

The auditor may consider an option of withdrawal from the engagement. However, materiality, legal advice & where withdrawal is not permitted by law - auditor modify the audit opinion

Audit procedures & documentation – what should an Auditor do ??

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- **Planning stage**
  - Verify the entities financial statement & applicable legal frame work
  - Meeting with legal department & those charged with governance – how entity ensures compliance
  - Meeting & list of the legal advisors of the entity & advice seeked
- **Control testing**
  - Maintenance of compliance register
  - Checking of compliance with applicable regulations
  - Updating the employees & other department
- **Substantive procedures**
  - External legal confirmations
  - Legal opinions

Documentation

- Identified / suspected non compliance
- Minutes of the meetings with those charged with governance & management
- Results of the discussions held
- Copies of records & documents
- Minutes of meetings with outside parties
- Such other evidence that auditor believes to be documented

Examples

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Pharma / FMCG company – FDA non compliance

- Risk – Operational / Going concern
- Cancellation of license & litigations

Entity having FDI – non compliance with

- FEMA rules
- Risk – fines, penalties & litigation

Banking companies – RBI prudential norms non compliance

- Risk – non compliance impacting financial statement i.e revenue recognition & NPAs
- Fines, penalties & cancellation licenses

- **Audit procedures**
  - Inquiry with the legal department
  - How company ensures the compliances
  - Audit evidence of such compliance
  - Trend analysis of previous non compliance
  - Legal confirmations & meeting with lawyers

SA 330 – Auditors' Responses to Assessed Risks

- Introduction
- Objectives
- Definition
- Requirements
- Documentation

Scope, objective & definition

SA 330

Scope

- Design & implement responses to risk of material misstatements identified & assessed as per SA 315 – Identifying & Assessing Risk of Material Misstatement through Understanding Entity & Environments

Objective

- Obtain appropriate audit evidence about assessed risks of material misstatement through design & implementation of appropriate responses to risk i.e audit procedures

Definition

- Test of control – evaluation of operating effectiveness of control preventing/ detecting misstatements
- Substantive procedures – test of details on accounts & class of transaction and substantive analytical procedures

Overall response

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Risk – Financial statement level	▪ Professional skepticism ▪ Experienced & skilled staff ▪ Supervision ▪ Unpredictable audit procedures (e.g stock counts, FA physical verification) ▪ Changes in nature, timing & extent of audit procedures
Risk – Weakness in internal controls	▪ Conduct more audit procedures at period end ▪ Extensive evidence in substantive procedure ▪ Increased location of audit ▪ Changes that significantly affect audit approach

Audit procedures to assessed risk of material misstatement at assertion level (1/7)

SA 330

Auditors' assessment & procedures

- Design & perform procedures to address identified risk of material misstatement at assertion level
- Nature, timing & extent to be based on identified risk
  - Only control tests to perform (e.g IT industry – substantive procedure not possible)
  - Only substantive procedures to perform (e.g no control environment – direct substantive procedure)
  - Combined risk assessment is required (e.g Factoring inherent risk & detect risk & performing ToC & ToD)
- Responding to risk at assertion level
  - Nature – type & purpose (e.g ToC – comforts – V & A assertions, ToD – comforts – C & E – Inventories)
  - Timing – periodicity of audit (e.g interim audit or near to period end audit)
  - Extent – quantity & extent of audit evidence (e.g robust audit evidence where no controls & vice versa)
- Consideration to small entities (e.g promoter driven private company)
  - Control environment does not exist (e.g. approver is owner himself)
  - Substantive procedures (100% vouching or coverage based audit)
  - Difficult to obtain audit evidence (e.g unavailability of documents)

- Design further audit procedures determine the combined risk assessment
  - Misstatement due to particular characteristic of class of transactions/ account balance (Inherent risk)
  - Control testing & operating effectiveness of controls on an account balance or class of transactions (Control risk)
- Higher combined risk assessment (CRA)
  - increase in the quantity of evidence and
  - more reliable evidence
  - Performance of substantive audit procedures near/ at end of period
  - Unpredictable audit procedures
  - Interim audit – helps in identifying significant matters early
  - Timing – will be determined based on controls, risk, availability of information & evidence
  - Extent – will be determined based on materiality, CRA, desired level of assurance
- Use of external evidence & CAATs can be determined based on professional judgment

Audit procedures to assessed risk of material misstatement at assertion level (2/7)

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Audit procedures – Test of controls (TOC)

- Design & perform ToC –controls operate effectively & substantive procedures alone cannot respond to assessed risk
- ToC is different from understanding & evaluating design & implementation of controls – perform ToC & ToD at the same time
- ToC performed with ToD (test of details) – Dual approach
- Heavy reliance on IT controls – ToD is not possible (e.g. IT Industry)
- Design & perform ToC – more persuasive audit evidence to be able to place greater reliance on effectiveness of controls – Substantive procedures alone do not suffice

Nature & Extent of ToC

- Perform other procedures when inquiry alone is not sufficient
- Reliance on indirect controls – Dual approach (control over adequacy of information)
- Extent of ToC – Frequency of control, length of time / period / reliance on control, expected deviation, relevance & reliability of audit evidence, extent of availability of audit evidence
- IT controls – increased testing not necessary – but enquire about the changes w.r.t programs, versions & general controls

Timing – ToC

- Audit evidence pertaining to point of time – controls over physical inventory count
- Audit evidence over a period of time – tests capable of providing audit evidence that controls operated effectively over the period
  - Monitoring & review of the estimated cost in case of construction industries
  - Updating of the price masters of products in FMCG, Liquor & Air conditioning industries
  - Controls over foreign exchanges
  - Controls on purchase transactions & updating of vendor masters

Using audit evidence obtained during interim period (4/7) SA 330

- Obtain audit evidence of operating effectiveness of the controls
- Consideration of obtaining additional audit evidence for remaining period
  - Significance of assessed risk of material misstatement at assertion level
  - Specific controls tested during interim period & changes to it in remaining period
  - Degree of evidence obtained
  - Length of remaining period
  - Auditors’ intention to reduce further audit procedures
  - Control environment
- Control over significant risks should be tested in the current period

Using audit evidence obtained in previous audits (5/7) SA 330

Factors to be considered for using the audit evidence of previous audits

- Establish continuous relevance of the evidence
- Risk of controls – manual / automated
- GITC effectiveness
- Lack of changes in control poses a risk
- Risk of material misstatement & extent of reliance on controls

Considerations to use audit evidence from previous period

- Relevance of the evidence
- Understanding of the changes in the controls – inquire + observe + inspect
- In case of changes in the control – test the new controls
- In case of no changes in the controls – test controls once in 3 years & test some relevant controls every year
- Professional judgment

Greater the reliance on controls – higher the risk of material misstatement – shorter the time span between testing

- Weak monitoring & control environment
- Manual intervention
- Personnel & circumstantial changes that significantly impact the control
- Weak GITC

Substantive procedure – Test of details (ToD) & substantive analytical procedure (6/7)

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ToD – for significant accounts / transactions

- Inherent limitation of internal controls
- Professional judgement involved – all risks not identified
- External confirmation process (e.g. debtors, creditors & bank balances)
- Analytical procedures - large data
- Determining extent of ToD
- Nature & risk of assertions
- Audit sampling – sample size

ToD – Financial statement close process

- Agreeing the financial statements to the books of account
- JE Testing
- Nature & extent of examining the JE & other captions depends on complexity of the financial statements

Responsive to significant risk & ToD at interim date

- Timing of ToD – Audit evidence from substantive procedure of previous period no evidence for current period
- Interim dates – covers the balance period i.e Substantive & ToC or only substantive procedures.
- Control environment & controls
- Purpose of substantive procedures
- Nature of transactions
- Ability to perform ToC/ ToD in balance period

ToD – Interim date & period end

- Depends on predictability of amounts, composition & significance
- Procedures for analyzing & adjusting class of transactions / account balances are reasonably predictable
- Information system to provide relevant financial information

In case material misstatement detected – modify the audit procedures & risk assessment (professional judgment)

Adequacy of presentation & disclosure (7/7) SA 330

- Evaluate whether the overall presentation & disclosure of the financial statements is in accordance with the applicable financial reporting framework

E.G.

- Preparation & presentation as per Schedule III of the Companies Act, 2013
- Disclosure requirements as specified in the accounting standard (e.g. disclosure of the fixed assets block as per AS – 6 & AS – 10 & employee benefit disclosure as per AS – 15)
- Disclosure requirement given in specific law (e.g. MSMED disclosure)
- Classification of the financial statements captions into current & non current
- Disclosure required under section 211(3A), 211(3B) & 211(3C) of the Companies Act, 1956 incase of deviation from the accounting standards & its quantification

Documentation

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- Overall responses to risk of material misstatement at financial statement level & nature timing & extent of further audit procedures
- Linking of the procedures to assessed risk at assertion level
- Results of the audit procedures & conclusions
- Conclusion over operating effectiveness of the controls
- Demonstrate that the financial statements agree to the accounts
- Form & extent of documentation is a matter of professional judgment

Thank you

Appropriateness of audit evidence

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Sufficient & appropriate audit evidence

- Significant potential misstatement & it affecting the financial statements materially
- Effectiveness of management's responses and controls to address the risk
- Experience gained in previous audit for the material misstatements
- Results & procedures – instances of fraud / error, if any
- Source & reliability of information available
- Persuasiveness of audit evidence
- Understanding the entity & its environment

Unable to obtain sufficient appropriate audit evidence

- Qualified / disclaimer of opinion