Department of Commerce

University of Calcutta

Study Material

Cum

Lecture Notes

Only for the Students of M.Com. (Semester IV)-2020

University of Calcutta

(Internal Circulation)

Dear Students,

Hope you, your parents and other family members are safe and secured. We are going through a world-wide crisis that seriously affects not only the normal life and economy but also the teaching-learning process of our University and our department is not an exception.

As the lock-down is continuing and it is not possible to reach you face to face class room teaching. Keeping in mind the present situation, our esteemed teachers are trying their level best to reach you through providing study material cum lecture notes of different subjects. This material is not an exhaustive one though it is an indicative so that you can understand different topics of different subjects. We believe that it is not the alternative of direct teaching learning.

It is a gentle request you to circulate this material only to your friends those who are studying in Semester IV (2020).

Stay safe and stay home.

Best wishes.

CC 403:

Auditing and Assurance Service

(AAS)

AUDIT EVIDENCE

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AUDIT EVIDENCE

- Introduction
  - Evidence
  - Audit Evidence
- Sufficiency and Appropriateness
- Sources of Audit Evidence
- Relevance and Reliability
- Methods of Obtaining Audit Evidences.

Introduction

Evidence:

- Evidence is the pre-requisite for accepting anything whether it is true or not.
- Dictionary meaning of evidence is the information that is used in the court of law to prove somewhat.
- The term ‘Evidence’ includes “all influences on the mind of an auditor which affect his judgement about the truthfulness of the propositions, submitted to him for review.”

Audit Evidence

- Auditors are to express his opinion on the truthfulness and fairness of the financial statements prepared by the organization.
- Therefore, ***audit evidence*** is information obtained and recorded by the auditor in arriving at the conclusions on which he bases his opinion on the financial statements.
- This audit evidence, in form of information, may be documentary or perceptual or both in nature.
- The Institute of Chartered Accountants of India (ICAI) has issued **SA 500** on “Audit Evidence”.

Audit Evidence Include:

- Data generated by the accounting system
- Actual physical inspection of assets
- Documents created outside the organisation
- Documents generated internally by the organisation
- Comparison of account balances between and within periods
- Ratios and
- Other computations

Sufficiency and Appropriateness

- The auditor is required to obtain sufficient appropriate audit evidence to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial statements.
- Here, the word ‘sufficient’ indicates quantum or adequacy of evidence and the word ‘appropriate’ refers to relevance and reliability of evidences.
- As per ***the American Institute of Certified Public Accountants (AICPA)*** “sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination”.
- An auditor can reach to a conclusion about an account balance, class of transactions or an internal control system by way of judgmental or statistical sampling procedures.

Sufficiency and Appropriateness

- The sufficiency and appropriateness of audit evidence is influenced by the following factors:

1. The degree of risk of misstatement. This risk may result from nature of the item, adequacy of the internal control, nature of the business carried on, situational influence on management and the financial position of the enterprise.
2. The materiality of the item in relation to the financial information as a whole
3. The experience gathered during previous audit
4. The results of audit procedures, including fraud or error which may have been found, and
5. The type of information available.

Sources of Audit Evidence

- The nature of audit evidence required for conducting audit varies case to case.
- For example, proper scrutiny of audit evidence is strictly required in absence of efficient system of internal check and internal control in an organization.
- The auditor obtains audit evidence by performing two kinds of procedures, viz.

1. Compliance Procedure
2. Substantive Procedure

Sources of Audit Evidence

Compliance Procedure:

- Compliance procedures are audit tests, which are designed to check the degree of compliance with prescribed internal controls.
- In performing compliance procedures, the auditor checks the **existence, effectiveness** and **continuity** of controls i.e.
  - Whether a control exists,
  - Whether it is operating effectively, and
  - Whether it has operated throughout the period under the audit.

Sources of Audit Evidence

Substantive Procedure:

- Substantive procedures are tests designed to obtain evidence as to the completeness, accuracy and validity of the data produced by accounting system.
- Substantive procedures are of two types:
  A. Tests of details of transactions and balances
  B. Analysis of significant ratios and trends (It includes investigation of unusual fluctuations, if any)
- An auditor undertakes substantive procedures in order to obtain reasonable assurance about the following assertions:

i) **Existence:** An asset or a liability must exist at a given date.

ii) **Rights and obligation:** An asset is a right of an entity and a liability is an obligation of the entity at a given date.

Sources of Audit Evidence

<u>Substantive Procedure:</u>

iii) **<u>Occurrence:</u>** A transaction or an event which pertains to the entity must took place during the relevant period.

iv) **<u>Completeness:</u>** There must not be any unrecorded assets, liabilities or any transactions.

v) **<u>Valuation:</u>** Asset or liability must be recorded at an appropriate carrying value.

vi) **<u>Measurement:</u>** A transaction must be recorded at a proper amount and revenue or expense must be allocated to the proper period

vii) **<u>Presentation and Disclosure:</u>** An item must be disclosed, classifies and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

- The auditor has to obtain sufficient appropriate evidence in support of each of the above assertions.

Sources of Audit Evidence

- Main sources of the audit evidence include the following:

i) Accounting system and underlying documentation of the entity

ii) Tangible assets

iii) Management and employees of the organisation

iv) Customers, suppliers and other third parties who have dealing with or knowledge of the entity or its business.

Relevance and Reliability

- The auditor is to evaluate the sufficiency as well as the **relevance** and **reliability** of audit evidence.
- The reliability of audit evidence depends on its source and nature as well as on the circumstances in which it is obtained.
- In evaluating the reliability of audit evidence the following generalisation may be useful:

1. External evidence is usually more reliable than internal evidence
2. Internal evidence is more reliable when related internal control is satisfactory
3. Evidence in the form of documents and written representations is usually more reliable than oral representation
4. Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

Methods of Obtaining Audit Evidence

- **SA 500** on "Audit Evidence" describes the different methods of obtaining audit evidence to perform compliance and substantive procedures.
- One or more of the following methods can be used to obtain audit evidence.
- This is also known as techniques of auditing. the following are the methods of obtaining audit evidence:
  1. Inspection
  2. Observation
  3. Enquiry and confirmation
  4. Computation, and
  5. Analytical procedures or review

Methods of Obtaining Audit Evidence

1. <u>Inspection:</u>

- This consists of examining records, documents or tangible assets.
- Four major categories of documentary evidence are as under:

  i) Documentary evidence originating from and held by third parties,

  ii) Documentary evidence originating from third parties and held by the entity,

  iii) Documentary evidence originating from the entity and held by third parties, and

  iv) Documentary evidence originating from and held by the entity.
- Physical examination of tangible assets is one of the methods to obtain reliable evidence with respect to their existence but not necessarily as to their ownership or value.

Methods of Obtaining Audit Evidence

2. **Observation:**

- Observation consists of witnessing a process or procedure being performed by others.
- For example, auditor may observe the stock-taking conducted by staff of the entity under audit.

3. **Enquiry and Confirmation:**

- Enquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity through oral questions or written questionnaires.
- Confirmation consists of the response to any enquiry to corroborate certain information contained in the entity's records.
- For example, the entity may request its debtors to confirm their respective balances directly to the auditor.

Methods of Obtaining Audit Evidence

4. <u>Computation:</u>

- Computation consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.
- Recalculation or computation is an evidence gathering activity that may be applied in all the audit stages. However, it is particularly applicable to the substantive testing stage.
- For example, the auditor may trace the postings from cash book to ledger.

Methods of Obtaining Audit Evidence

5. **Analytical Procedure or Review:**

- Analytical procedures consist of studying significant ratios and trends and investigating unusual fluctuations and items.
- In an independent financial audit, the auditor can analyse financial statements by correlating various figures with each other.
- The harmony or consistency of financial statement as a whole can be judged by calculating ratios which show the relationship between one financial statement figure and another.
- Similarly an auditor can reconcile an accounting figure with a related account or piece of information.
- For example, total fee received by a club may be verified by reconciling it with fee that should have been received i.e. *number of members* ***x*** *fee per member.*

Multiple Choice Questions

1. Which of the following is not a method of obtaining audit evidence?
   a. Inspection
   b. Observation
   c. Enquiry and confirmation
   d. Audit files

2. Compliance procedures are audit tests which are designed to check the degree of compliance with prescribed
   a. Internal document
   b. Internal finance
   c. Internal control
   d. Internal management

3. An auditor is required to obtain sufficient and appropriate audit evidence to draw reasonable conclusions in order to express his opinion on financial information. Here, ‘appropriate’ refers to:
   a. Adequacy of evidence
   b. Methods of obtaining evidence
   c. Relevance and reliability of evidence
   d. Effectiveness of evidence

Multiple Choice Questions

4. Which of the following factors is most important in determining the appropriateness of audit evidence?

   a. The reliability of audit evidence and its relevance in meeting the audit objective

   b. The objectivity and integrity of the auditor
   c. The quantity of audit evidence
   d. The independence of the source of evidence

5. Which of the following factors is most important in determining the sufficiency of audit evidence?

   a. Adequacy of evidence

   b. Methods of obtaining evidence

   c. Relevance and reliability of evidence

   d. Effectiveness of evidence

Questions & References

Descriptive Questions:

1. What do you mean by 'sufficient and appropriate audit evidence'?

2. State and discuss the different methods of obtaining audit evidence.

3. What do you understand by 'compliance procedure and substantive procedure'?

4. Discuss the factors influencing the sufficiency and appropriateness of audit evidence.

References:

- Basu, Dr. B. K, An Insight into Auditing – a multidimensional approach, Basushree Book Stall, 2004
- Basu, S. K, Auditing and Assurance, Pearson Education, 2nd edition, 2015
- Ghosh, Dr. Jayanta, Contemporary Auditing and Assurance, The Elegant Publications, 2017
- Kumar, Ravinder and Sharma, Virender, Auditing Principles and Pracice, PHI Learning Pvt. Ltd, 2015


THANK YOU

PAPER: CC.403: AUDIGING AND ASSURANCE SERVICES

MODULE-I

UNIT/CHAPTER 3: AUDITOR'S REPORT AND AUDITOR'S INDEPENDENCE

(PREPARED BY: CMA DR. SAMYABRATA DAS)

[Topics already covered/completed in class: Essential of Good Report-----Elements of Auditor's Report-----Types of Auditor's Reports-----The Companies (Auditor's Report) Order, 2016 (CARO)]

[NOTE: Students are requested to consult the references mentioned at the end of each topic.]

TOPIC 1: AUDIT REPORTS AND CERTIFICATES FOR SPECIAL PURPOSES

Members of the Institute of Chartered Accountants of India (ICAI) are often asked to issue reports/certificates for special purposes (e.g. **reports/ certificates required under the tax laws, Government welfare schemes like MGNREGA**). At times, the management of the entities, for their own purposes,require these special purpose reports/certificates from the members. **The Auditing and Assurance Standards Board of the ICAI, in 1984, had issued the Guidance Note on Audit Reports and Certificates for Special Purposes** to provide guidance to the members carrying out engagements to issue reports/certificates for special purposes.

In some cases, Government and other authorities under various statutes or notifications require reports or certificates from practitioners in support of statements or other information provided by an entity. That apart, to fulfil a contractual reporting obligation such reports or certificates may be required to be issued. Further, these reports or certificates may be required by the management or those charged with governance of an entity for its own special purposes.

Sometimes, the applicable law and regulation or a contractual arrangement that an entity might have entered into, prescribe the wording of report or certificates. The wording often requires the use of a word or phrase like “certify” or “true and correct” to indicate an absolute level of assurance expected to be provided by the practitioner on the subject matter. Absolute assurance indicates that a practitioner has performed procedures as considered appropriate to reduce the engagement risk to zero.

A practitioner is expected to provide **either a reasonable assurance** (about whether the subject matter of examination is materially misstated) **or a limited assurance** (stating that nothing has come to the practitioner’s attention that causes the practitioner to believe that the subject matter is materially misstated). A practitioner is not expected to reduce the engagement risk to zero. This is because there are inherent limitations attached to the procedures which a practitioner may perform concerning the issuance of a report or certificate, as the case may be. The **inherent limitations** arise from:

a) the nature of financial reporting;

b) the use of selective testing;

c) the inherent limitations of internal controls;

d) the fact that much of the evidence available to the practitioner is persuasive rather than conclusive;

e) the nature of procedures to be performed in a specific situation;

f) the use of professional judgment in gathering and evaluating evidence and forming conclusions based on that evidence;

g) in some cases, the characteristics of the underlying subject matter when evaluated or measured against the criteria; and

h) the need for the engagement to be conducted within a reasonable period of time and at a reasonable cost.

Because of the above, depending upon the nature, timing and extent of procedures that can be performed based upon the facts and circumstances of the case, **a report or certificate issued by a practitioner can provide either reasonable or limited level of assurance**. Therefore, whenever a practitioner is required to give a “certificate” or a “report” for a special purpose, the practitioner needs to undertake a careful evaluation of the scope of the engagement, i.e., whether the practitioner would be able to provide reasonable assurance or limited assurance on the subject matter.

The word ‘certificate’ can normally be associated with reasonable assurance. However, depending upon the circumstances and based upon the nature, timing and extent of the procedures which a practitioner can perform, the practitioner can conclude that a reasonable assurance cannot be expressed on the subject matter of the “certificate” and only limited assurance conclusion can be given. The practitioner’s procedures in case where reasonable assurance is to be expressed would be substantially different (and more extensive) from circumstances where limited assurance is to be expressed. Accordingly, the term, **“report” / “certificate” indicates an “assurance report” issued in compliance with the Guidance Note of the ICAI.** This Guidance Note does not apply to assurance engagements for which subject-specific Standards on Assurance Engagements have been issued by the ICAI.

Assurance engagements include (i) assertion based engagements, in which a party other than the practitioner measures or evaluates the underlying subject matter against the criteria, **and (ii) direct reporting engagements**, in which the practitioner measures or evaluates the underlying subject matter against the criteria. To be meaningful, the level of assurance obtained by the practitioner is likely to enhance the intended users’ confidence about the subject matter information to a degree that is more than inconsequential.

In conducting an assurance engagement, the **objectives** of the practitioner are:

a) To obtain either reasonable assurance or limited assurance, as appropriate, about whether the subject matter information is free from material misstatement;

b) To express an opinion (in a reasonable assurance engagement)/a conclusion (in a limited assurance engagement) regarding the outcome of the measurement or evaluation of the underlying subject matter through a written report;

c) Where the subject matter information is made up of several aspects, separate opinion/conclusion may be provided on each aspect. All such separate opinions/conclusions do not need to relate to the same level of assurance;

d) To communicate further as required by the concerned/respective Guidance Note.

When (i) **reasonable assurance or limited assurance cannot be obtained**, and (ii) **a qualified opinion/conclusion in the practitioner’s assurance report is insufficient** in the circumstances to report to the intended users, **the practitioner has two options: (i) To**

disclaims an opinion / a conclusion, or (ii) To withdraw (or resign) from the engagement, where withdrawal is possible under applicable law or regulation.

If the engaging party imposes a limitation on the scope of the practitioner's work and the practitioner believes that the limitation will result in the practitioner disclaiming an opinion / a conclusion on the subject matter information, **the practitioner should not accept such an engagement as an assurance engagement, unless required by law or regulation to do so.**

The practitioner should agree the terms of the engagement with the engaging party. The agreed terms of the engagement should be specified in sufficient detail in an engagement letter or other suitable form of written agreement, written confirmation, or in law or regulation. It is in the interests of both, the engaging party and the practitioner, that the practitioner communicates in writing the agreed terms of the engagement before the commencement of the engagement to help avoid misunderstandings. **The terms of engagement, at a minimum, should include the following:**

a) the objective and scope of the engagement;

b) the responsibilities of the practitioner;

c) the responsibilities of the engaging party;

d) the responsibilities of the responsible party (if different from the engaging party);

e) identification of the suitable criteria to be used;

f) identification of the subject matter including reference to the law or regulation or the contracts;

g) unrestricted access to whatever records, documentation and other information requested in connection with the engagement;

h) the fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist;

i) reference to the expected form and content of the report to be issued by the practitioner; and

j) a statement that there may be circumstances in which a report may differ from its expected form and content.

The agreed terms of engagement can also include other general terms of engagement so long as those terms are not inconsistent with the applicable laws and regulations.

On recurring engagements, the practitioner should assess whether the circumstances require the terms of the engagement to be revised and whether there is a need to remind the engaging party of the existing terms of the engagement.

The practitioner may choose a **“short form” or “long form” style of reporting** to facilitate effective communication to the intended users. **“Short-form” reports ordinarily include only the basic elements.** “Long-form” reports include other information and explanations that are not intended to affect the practitioner’s conclusion. In addition to the basic elements, long-form reports may describe in detail the terms of the engagement, the applicable criteria being used, findings relating to particular aspects of the engagement, details of the qualifications and experience of the practitioner and others involved with the engagement, disclosure of materiality levels, and, in some cases, recommendations.

The assurance report should include at a minimum the following basic elements:

a) **Title**: It should have a **title** that indicates that the report is an independent assurance report.

b) **Anaddressee**: An addressee identifies the party or parties to whom the assurance report is directed. The assurance report is ordinarily addressed to the engaging party. But in some cases, there may be other intended users.

c) **Description of the level of assurance:** The report shall include an identification or description of the level of assurance obtained by the practitioner, the subject matter information and, when appropriate, the underlying subject matter.

d) **Identification of the applicable criteria**. The assurance report identifies the applicable criteria against which the underlying subject matter was measured or evaluated so that the intended users can understand the basis for the practitioner’s opinion/conclusion.

e) **Description of significant inherent limitations:** Where appropriate, a description of any significantinherent limitations associated with the measurement or evaluation of the underlying subject matter against the applicable criteria.

f) **Designing of applicable criteria for a specific purpose:** When the applicable criteria are designed for a specific purpose, the report shall include a statement alerting readers to this fact and that, as a result, the subject matter information may not be suitable for another purpose.

g) **Description of responsibilities:**The report shall include a statement to identify the responsible party and to describe their responsibilities.

h) **Compliance with Guidance Note(s):** The report shall include a statement that the engagement was performed in accordance with the respective/concerned Guidance Note(s).

i) **Quality Control:** The report shall include a statement that the firm, of which the practitioner is a partner, has applied Standard on Quality Control (SQC 1).

j) **Code of Ethics:** The report shall include a statement that the practitioner complies with the independence and other ethical requirements of the Code of Ethics issued by the Institute of Chartered Accountants of India.

k) **Informative summary:** The report shall include an informative summary of the work performed as the basis for the practitioner's opinion/conclusion. The summary must be written in an objective way that allows intended users to understand the work done as the basis for the practitioner's opinion/conclusion.

l) **The practitioner's opinion/conclusion:** (i) When appropriate, the opinion/conclusion should inform the intended users of the context in which the practitioner's opinion/conclusion is to be read. (ii) In a reasonable assurance engagement, the opinion is expressed in a positive form. (iii) In a limited assurance engagement, the conclusion is expressed in a form that conveys whether, based on the procedures performed and evidence obtained, a matter has come to the practitioner's attention to cause the practitioner to believe that the subject matter information is materially misstated.

m) **The practitioner's signature**: The assurance report has to be signed by the practitioner in his name. Where a Firm is appointed to carry out the engagement, the report has to be signed in the personal name of the practitioner and in the name of the audit firm. The partner/proprietor signing the assurance report also needs to mention the membership number assigned by the ICAI.

n) **The date of the assurance report**: The assurance report should be dated no earlier than the date on which the practitioner has obtained the evidence on which the practitioner's opinion/conclusion is based.

o) **The place of signature**: The assurance report shall mention the place of auditor's signature.

Acknowledgement/Reference

(1) **Guidance Note on Reports or Certificates for Special Purposes (Revised 2016)**issued by The Institute of Chartered Accountants of India

TOPIC 2: AUDITOR'S REPORT UNDER THE COMPANIES ACT, 2013

As per the provisions of the Companies Act 2013, the following matters are required to be included in the auditor's report:

1) **True and Fair View Exhibited by the Financial Statements [Section 143(2)]:** The auditor shall make a report to the members of the company on the accounts examined by him and on financial statements which are required by or under the Act to be laid before the company in the general meeting. In the audit report, the auditor shall state whether to the best of his information and knowledge and as per his opinion, the accounts and the financial statements represent a true and fair view of the company's state of affairs as at the end of its financial year and profit or loss and cash flow for the year.
2) **Availability of Information and Explanation [Section 143(3)(a)]:** The auditor's report shall statewhether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements.
3) **Maintenanceof Proper Books of Accounts [Section 143(3)(b)]:** The auditor's report shall state whether, in his opinion, proper books of accounts as required by law are maintained and whether proper returns adequate for the purpose of audit have been received from the branches not visited by him.
4) **Report of the Branch Auditor [Section 143(3)(c)]:** The auditor's report shall statewhether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him.
5) **Agreement between Books of Accounts and Financial Statements [Section 143(3)(d)]:** The auditor's report shall statewhether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns.
6) **Compliance with Accounting Standards [Section 143(3)(e)]:** The auditor's report shall statewhether, in his opinion, the financial statements comply with the accounting standards.
7) **Comments or Observations Having Adverse Impact on Functioning [Section 143(3)(f)]:** The auditor's report shall statethe observations or comments of the auditor on financial transactions or matters which have any adverse effect on the functioning of the company.
8) **Disqualification of Director [Section 143(3)(g)]:** The auditor's report shall state whether any director is disqualified from being appointed as a director under sub-section (2) of Section 164.
9) **Adverse Comment on Maintenance of Books of Accounts [Section 143(3)(h)]:** The auditor's report shall stateany qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.

10) **Adequacy of Internal Control System [Section 143(3)(i)]:** The auditor's report shall statewhether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls.

11) **An Explanation for Negative Remark [Section 143(4)]:** Where any of the matters required to be included in the audit report under this section is answered in negative or with a qualification then in that case auditor is required to state the reasons of such reservations and negative remark.

12) **Compliance with Directions from CAG [Section 143(5)]:** In the case of Government Company, the Comptroller & Auditor General (C&AG) will appoint the auditor to conduct the audit of the company. The C&AG will also give the directions and the manner in which the accounts of the Government Company are required to be audited by the auditor.

13) **Report of Fraud [Section 143(12)]:**If an auditor of the company, in the course of performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by an officer or the employee of the company then the auditor will immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

14) **Matters as per CARO:** The auditor's report shall also include a statement on the matters prescribed by Companies (Auditor's Report) Order.

15) **Other Matters [Rule 11 of Companies (Audit and Auditors) Rules, 2014]:** The auditor's report shall also include his views and comments on the following matters:

    (a) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

    (b) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

    (c) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

Acknowledgement /Reference

(1) https://taxguru.in/company-law/sec-143-power-duties-auditor-auditing-standards-companies-act-2013.html

(2) **Sana, A.K., Biswas, B., Sarkar, S., and Das, S. (2019).** Auditing and Assurance. McGraw Hill Education.

TOPIC 3: AUDITOR'S INDEPENDENCE: MEANING AND DIFFERENT ISSUES

The role and responsibilities of auditors are developing as rapidly as the scope of the audit report. However, increasing responsibilities means increasing expectations, posing a greater risk to the perception of independence, indicated by the amount of research evidence suggesting auditor independence is not at the level it should be (Forbes, 2001). In light of major corporate and audit firm scandals in the last two decades (Toshiba, 2015; Arthur Andersen, 2002), there has never been such focus on auditor independence. Research has shown that the most valuable content of the audit report is the independent opinion. Independence, like scepticism, is primarily a state of mind, and thus unobservable.

It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remainsunaltered.

There are two interlinked perspectives of independence of auditors: (i) independence of mind, and (ii) independence inappearance.

The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term `Independence' as follows:

"Independence is:

1) **Independence of mind –** the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism;and

2) **Independence in appearance –** the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been

compromised."

The relationship between the auditor and his client should be such that firstly, he is himself satisfied withhis independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors'independence.

The idea of independence is instilled in the minds of Chartered Accountants from the commencement of their training under articles or audit service. It has to be applied in their day-to-day work and their success is dependent entirely upon their integrity, competence and independence ofapproach.

Independence is a very subjective matter. One person might be independent in a particular set of circumstances, while another person might feel he is not independent in similar circumstances. It is, therefore, the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case.

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair andmustnotallowprejudiceorbiastooverridehis objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

THREATS TOINDEPENDENCE

The AICPA Code states that "Threats to independence are circumstances that could impair independence" (ET Section 100-1, AICPA, 2011).

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. Theseare:

1) **Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the auditengagement.

Illustration: The audit team is preparing to conduct its 2019 audit for XYZ Company. However, the audit team has not received its audit fees from ABC Company for its 2018 audit.

Issue

The audit team might be tempted to issue a favourable report so that the company is able to secure a loan to settle the fees outstanding for their 2018 audit.(corporatefinanceinstitute.com)

2) **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances, where such threats come into play, are (i) when an auditor having recently been a director or senior officer of the company,and (ii) when auditors perform services that are themselves subject matters of an audit.

Illustration: The auditor prepares the financial statements for PQR Company while also serving as the auditor for PQR Company.

Issue

By having the auditor review his or her own work, the auditor cannot be expected to form an unbiased opinion on the financial statements. (corporatefinanceinstitute.com)

3) **Advocacy threats**, which occur when the auditor promotes or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, (e.g. when an auditor deals with shares or securities of the audited company,or becomes the client's advocate in litigation and third partydisputes).

Illustration: The auditor is assisting in selling XYZ Company while also serving as the auditor for the company.

Issue

The auditor may issue a favourable report to increase the sale price of XYZ Company. (corporatefinanceinstitute.com)

4) **Familiarity threats** are self-evident and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company,its directors or employees.

Illustration: PQR Company has been audited by the same auditor for over 12 years and the auditor regularly plays golf with the CEO and CFO of PQR Company.

Issue

The auditor may have become too familiar with the client and, thus, lack objectivity in their work. (corporatefinanceinstitute.com)

5) **Intimidation threats**, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism.These could happen because of the threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced auditfees.

Illustration: XYZ Company is unhappy with the conclusion of the audit report and threatens to switch auditors next year. XYZ Company is the biggest client of the auditor.

Issue

The auditor's independence may be compromised as XYZ Company is their biggest client and they, quite naturally, do not want to lose such a client. Therefore, the auditor may issue a report that appeases XYZ Company.(corporatefinanceinstitute.com)

FACTORS AFFECTING/IMPAIRING AUDITOR'S/AUDIT INDEPENDENCE

1) **Non-Audit Services:** Auditors are attracted by the economic benefits to provide non-audit services to their audit clients such services are perceived to be more profitable (Tepalagul and Lin, 2015). The provision of non-audit services such as tax services by auditors to the client creates a high tendency for them to compromise their independence (Aschauer and Quick 2018; Tepalagul and Lin 2015). Causholli et al. (2015) argued that auditors' provision of non-audit services to their clients will create economic ties between them which could decrease auditor's independence.
2) **Audit Tenure:** The proponent of mandatory rotation argues that short audit firm tenure can strengthen auditor independence due to the avoidance of close personal relationship between the auditors and the client's management (Dada 2018). However, Tepalagul and Lin (2015) argued that long tenure generally does not impair auditor independence. Mandating audit firm rotation at the expense of other determining factors of audit quality would be bad policy and may impair auditor independence, weaken audit expertise, undermine corporate governance and impair audit quality (Odia, 2015).
3) **Auditor-Client Relationship:** Tobi et al. (2016) showed that long-term auditor-client relationships are positively related to the increased likelihood of the auditor issuing an unqualified opinion. As such, the long-term auditor-client relationship poses a great risk to

the objectivity and auditor independence in the sense that it might lead to weakening audit quality because the auditor becomes more familiar and closer to the client.

4) **Client Importance:** Chen et al. (2016) observed that greater client importance is connected with fewer audit adjustments, i.e., compromised audit quality.

AUDITOR'S INDEPENDENCE IN INDIA

The Institute of Chartered Accountants of India (ICAI) issued a Guidance Note on 'Independence of Auditors' in 1968 which was revised in 2005. The Companies Act 1956 had some safeguards to protect the independence of auditors. The Companies Act 2013 has made many important changes in respect of auditor independence. It is true that in India not much emphasis has been laid on this issue, in comparison to advanced countries. Particularly the role of Government of India (GoI) in relation to the appointment of bank statutory auditors is a reactionary step so far as the independence of auditors is concerned. The Guidance Note concludes that in the opinion of the Council both the Companies Act, 1956 and the Chartered Accountants Act, 1949 have sufficient safeguards so far as auditor independence is concerned. The claim of the Guidance Note was found to be hollow when the Satyam scandal came to light in 2009 and the auditor (Price Waterhouse) was also found to be responsible and the partner and the audit firm was punished. Lack of independence of the auditor was evident from the facts of the case. The Companies Act 2013 has made some significant changes in respect of auditor independence:

i. For private sector listed companies, the auditor shall rotate every five years if the auditor is an individual, and every ten years if a firm is appointed as an auditor.

ii. It has prohibited rendering of some services by the company auditor to its audit client. These are (a) bookkeeping & accounting (b) internal audit (c) financial information system- design and implementation (d) actuarial (e) investment advisory (f) investment banking (g) financial (h) management, and (i) any other prescribed services.

iii. Compliance of Auditing Standards has been made mandatory.

iv. The auditor is required to pay a heavy penalty for non-reporting of fraud.

v. National Financial Reporting Authority (NFRA) has been constituted which is empowered to oversee the quality of service of the professions. NFRA is to monitor and enforce compliance with auditing and accounting standards. NFRA has been given the power to make orders imposing a penalty for professional or other misconduct by the auditors.

vi. The Tribunal has been empowered to remove the auditor in case the auditor acted in a fraudulent manner.

vii. Class action suit can be initiated against the auditor for misstatement in the audit report.

viii. More power has been given to the Audit Committee

ix. Provision for punishment for fraud has been incorporated in case of misstatement in the audit report.

x. The auditor has been made responsible to report as to the presence of adequate internal financial control and their effectiveness.

xi. It puts restriction on the number of audits by an individual auditor (all total20 companies)

(Ray and Gandhi, 2019).

ACKNOWLEDGEMENT/REFERENCE

1) https://andrewscouller.wordpress.com/2016/07/22/how-independent-are-auditors-really/

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3) **Wakil, G.K., Alifiah, M.N., and Tijjani, A.A. (2019).** Auditor Independence Threats and Factors Affecting Independence. *International Journal of Recent Technology and Engineering*, 8(3S2), 917-923. Retrieved from https://www.ijrte.org/wpx-content/uploads/papers/v8i3S2/C12531083S219.pdf

4) **Ray, M., and Gandhi, S.K. (2019).** Auditors' Independence: A Study of International Scenario vis-A-vis Indian Situation. *EPRA International Journal of Economic and Business Review,* 7(6), 50-57. Retrieved from https://eprawisdom.com/jpanel/upload/articles/845pm7.Mandakranta%20Ray%20&%20Sunil%20Kumar%20Gandhi.pdf

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Paper CC 403- Auditing & Assurance Services

Module 1

Internal Control Systems & Risk Assessments

(Prof. Satyajit Dhar, Dept. of Commerce, K.U.)

Study Notes

The module is divided into following topics & sub-topics for ease of understanding.

1. Risk Assessment & Internal Control
    a. Audit Risk
    b. Indentify and Assess Risk of Material Misstatement
    c. Understanding the Entity and its Environment
    d. Risk Assessment Procedure
2. Internal Control
    a. Meaning of Internal Control
    b. Objectives of Internal Control
    c. Limitations of Internal Control
    d. Components of Internal Control
3. Evaluation of Internal Control by the Auditor
4. Internal Auditor and Statutory Auditor
5. Relationship between Audit Risk & Materiality

Among the abovementioned topics , a few up to topics 2(c) have already been covered in the classes. In the following sections a brief overview is being provided as study guides. The students are advised to supplement their studies by consulting prescribed text books.

2. (d) Components of Internal Control

A. The Control Environment
B. The Entity's Risk Assessment Process
C. The information System including the related business process
D. Control Activities
E. Monitoring of Controls

(A) The Control Environment

The control environment includes:

1. The governance and management functions
2. The attitude ,awareness and actions of those charged with governance and management

The control environment of an entity influences its overall control structure and imbibes control consciousness among its people.

The auditor shall obtain an understanding of the control environment. as a part of the obtaining this understanding the auditor shall evaluate whether:

(i) Management has created and maintained a culture of honesty and ethical behaviour

(ii) The strengths in the control environment elements collectively provide and appropriate foundation for or the other components of international internal control.

Elements of control environment are:

- Competition and enforcement of integrity and ethical values
- Commitment to competence
- Participation by those charged with governance
- Management philosophy and operating style
- Organisational structure
- Assignment of authority and responsibility
- Human resource policies and practices.

(B) The Entity's Risk Assessment Process

The entities risk assessment process

The auditor shall obtain an understanding of whether the entity has process for :

a. Identifying business risk relevant to financial reporting objectives
b. Estimating the significance of the risk
c. Assessing the likelihood of their occurrence
d. Deciding about actions to address those risks.

Whether the entities risk assessment process is appropriate to the circumstances is a matter of judgement.

(C) The information System including the related business process relevant to financial reporting and communication

The auditor shall obtain and understanding of the information system including the related business processes relevant to financial reporting including the procedures by which transactions are initiated, recorded, processed, corrected as necessary, transferred to general ledger and reported in the financial statements. Controls surrounding the journal entries are also important. It is also necessary to understand how the information system captures events and conditions that are significant to the financial statements.

Auditor is also required to obtain and understanding of how an entity communicates financial roles and responsibilities including:
(a) Communication between management and those charged with governance
(b) External communications, such as those with regulatory authorities.

(D) Control Activities

Control activities are the policies and procedures that help and sure that management directives are carried out. The auditor shall obtain and understanding of control activities relevant to the audit which auditor considers as necessary to assess the risk of material misstatement.

Control activities, whether within IT or manual systems, have various objectives and they replied at various organisational and functional levels.

Examples of specific control activities include:
(i) Authorisation
(ii) Segregation of duties
(iii) Physical controls
(iv) Information Processing
(v) Performance reviews

The control activities that are relevant to the audit include the control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient and appropriate audit evidence.

It may be noted significant risks often relate to significant non-routine transactions or judgemental matter. The following are always significant risks:
- Risk of material misstatement due to fraud.
- Significant transactions with related parties that are outside the normal course of the business for the entity.

(E) Monitoring of Controls

- Monitoring of controls is the process to assess the internal control performance over time.
- It helps in assessing the effectiveness of controls on a timely basis and in taking necessary remedial measures.
- Management accomplishes monitoring of controls through ongoing activities, separate evaluation or a combination thereof.
- Management’s monitoring activities include using information from communication from external parties such as customer complaints and regular comments.

It may be noted that if the entity has an internal audit function the auditor shall obtain an understanding of the following:

a) The internal audit functions responsibilities and how the internal audit function fits in the entity's organisational structure.
b) The activities performed or to be performed by the internal audit function.

3. Evaluation of Internal Control by the Auditor

The examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate operations of these internal controls upon which she wishes to rely in determining the nature timing and extent of other audit procedure.

Benefits of evaluation of internal control to the auditor

The review of internal controls will enable the auditor to know whether and adequate internal control system is in use and operating as planned by the management. There are several other benefits like the possibility of identification of fraud in the ordinary course of operations of the business.
Furthermore, the auditor can formulate her entire audit programme only after she has had a satisfactory understanding of the internal control system and their actual operation.
In deciding upon a plan of test checking the existence and operations of internal control system is of great significance.
In a situation, where the internal controls are considered weak in some areas, she might extend certain tests to cover the large number of transactions. Also, at times she may perform additional tests to bring her the necessary satisfaction.

Methods of Evaluation

a) Narrative Records
b) Check List
c) Internal Control Questionnaire
d) Flow Chart

MCQ

1. Risk Assessment Procedures by themselves do not provide sufficient and appropriate evidence on which to base the audit evidence
a. True
b. False
c. Partially True and Partially False
d. Can't form opinion

3. When Control Risk and Inherent Risk is High, Detection Risk is ______.
a. High
b. Low
c. Neutral
d. No effect

4. As a part of obtaining the understanding of an entity, the auditor shall evaluate whether the management with the oversight of those charged with governance, has created and maintained a culture of ______
a. Honest and ethical behaviour
b. Discipline
c. Controls
d. Risk assessment

5. If the entity has established risk assessment procedure, the auditor shall obtain _____ of it and result thereof.
a. Planning
b. The mechanism of risk assessment
c. An understanding
d. An accounting

6. Mr. Akhtar was appointed as a statutory auditor of Kapadia & Company Ltd. While commencing the statutory audit, the auditor undertook risk assessment procedure and observed that the detection risk relating to certain items cannot be reduced to an acceptable low level. What is the right course of action an auditor can perform?
a. The auditor should withdraw from the audit engagement
b. The auditor should inform the same to the central government
c. The auditor should express a qualified opinion or a disclaimer of opinion
d. None of the above

PAPER: CC.403: AUDIGING AND ASSURANCE SERVICES

Module-II

(CS Atanu Pramanick)

Management Audit

Concept

Management Audit is the total examination of transaction of an organization, or parts of it, and includes checks on the effectiveness of managers, their compliances with company on professional standard, the reliability of management date, the quality of performance of duties and recommendations for improvement. In this context, the distinction between administration and management should be recognized. Administration is concerned with the structure of the organization and the mechanism of its operations, whereas management relates to the leadership and direction of the people, the way in which they are controlled to exercise their functions within the administrative framework. The question of audit arises only because of the ownership of many companies is widely spread between a large number of shareholders, and the running of the organization lies with people holding comparatively a small portion of the equity. This dichotomy of dispersed ownership and entrenched management necessitates and examination to be done of the Management function itself by an independent authority.

In this context management audit undertakes examination of the effectiveness of management in controlling the total activities of the organization in the accomplishment of the organization objectives. Since a number of audits is conducted in various area, audit responsibility lies in avoiding any overlapping and selecting such areas not covered by an audit already, e.g. if internal audit examines adherence to procedures, management audit should examine the effectiveness of such procedures. Management audit deals with-

- The objectives of an organization;
- The policies and procedures in terms of the objective of the organization; and
- Adequate performance of an organization in terms of objectives, policies, and procedures.

Definition of Management Audit

Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management. A working director is included as a manager for purposes of management audit. It is normally presumed to be a non routine investigation into a performance of a manager or group of managers. But in a number of organizations management audit is now a regular feature to examine and improve managerial effectiveness.

It attempts to look into all aspects of the management performance. Management audit does not concentrate on financial matters alone as in the case of financial audit. It looks into the efficiency and effectiveness of performance in an organization.

However, there is no general agreement as to the precise meaning of the term “management audit”. The term has been various defined by different authorities as follows-

William P. Leonard:- “Management audit may be defined as a comprehensive and constructive examination of an organization structure of a company and its plans and objective, its means of operation and its use of human and physical facilities.”

Leslie Howard:- “Management audit may be more specifically defined as being an investigation of a business from the highest level downwards in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with outside world and the most efficient organization and smooth running internally.”

CIMA Terminology:- “Management audit is an objective and independent appraisal of the effectiveness of the managers and effectiveness of the corporate structure in the achievement of company objectives and policies. Its aim is to identify existing and potential management weaknesses within an organization and to recommend ways to rectify these weaknesses.”

The above definitions lead to the following conclusions:

Management audit is the systematic and dispassionate examination, analysis and appraisal of management’s overall performance. It is a form of appraisal of the total performance of the management by means of an objective and comprehensive examination of the organization structure, its components such as department, its plans and policies, methods of process or operation and controls, and its use of physical facilities and human resources.

Thus management audit is concerned with evaluation and appraisal of the control system and information in the entire or in various segments of the organization. Its scope has been widened to appraise in details the systems and subsystems, procedures, job-description and assignment, authorization, accountability, quality of personnel, quality of information generation etc.

Objectives of Management audit

i. Appraise the management performance at all the levels;
ii. Spotlight the decision or activities, that are not in conformity with organizational objectives;
iii. Ascertain that objectives are properly understood at all level;
iv. Ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations’
v. Evaluate plans with are projected to meet objectives’

vi. Review the company's organizational structure, i.e. assignment of duties and responsibilities and delegation of authority.

The main objectives of management audit can be summarized as follows-

a. To ensure optimum utilization on all the resources employed, including money, materials, machines, men and methods;
b. To highlight efficiencies in objectives, policies, procedures and planning;
c. To suggest improvement in methods of operations;
d. To highlight weak links in organizational structure and in internal control systems, and suggest necessary improvements;
e. To help management by providing health indicators and help prevent sickness or help cure in case of sickness; and
f. To anticipate problems and suggest remedies to solve them in time.

Importance of Management Audit

Management audit is considered with assessment of efficiency and soundness of management which lead the business to its goal. Management audit is very important due to its benefits as under:-

1. **Review, plans and policies**: In an organization, the management holds periodical meeting to review their performance. But if the plans and policies are defectives, the assessment will be of no use. Hence, there should be some review of the plans and policies as formulated by the management. The functions are performed by the management auditors.

2. **Identification of management weaknesses**: Management audit properly spots the inefficiencies and weaknesses of management.

3. **Proper advice to the management**: Management audit makes the proper remedy for removal of these identifying diseases in an organization.

4. **Advising the prospective investors**: Management audit can also be useful to a prospective investor who is considering a big investment in an organization.

5. **Taking over of sick industry**: Before deciding to take over a sick organization, the Government can order for management audit in that organization and learn the actual causes of sickness. On the basis of the recommendations from the management auditors, the Government can take proper steps accordingly.

6. **Helping in foreign collaboration**: In case of industrial collaboration, the foreign collaborator can collect useful information about the management through management audit and can take right decision.

7. **Guide the bank in sanctioning loan**: Before granting loan or participating in the equity capital of any company, a bank or financial institution may get management audit conducted to ensure that the investment in the company would be safe and secured in the hands of the management.

8. **Guard against short-sighted project**: The directors may take decisions keeping in view only short run profit ignoring its adverse effect on the company in the long run. Management audit can act s a guard against such a possibility.

Scope of Management Audit

The scope of management audit extends over all the functions of an organization viz. management, personnel, administration, material administrations, marketing, finance, etc. wherever the effectiveness of management needs to be examined.

Accordingly, the scope of management audit may includes-

i) The suitability, practicability and present compliance or otherwise of the organization with its desired objectives and aims.
ii) The current image of the organization among customers, general public within its own particular industrial or commercial field.
iii) Efficient utilization of resources of the organization.
iv) The rate of return of investors' capital- whether poor, adequate or above average.
v) Relationship of the business with its own shareholders and investing public in general.
vi) Employee relation.
vii) The aims and effectiveness of management at its various levels such as top level, middle level, and operational level.
viii) Financial policies and control relating to production, sales and distribution and in other functions of the organization.

Reasons for undertaking Management Audit

Management audit is a tool to improve management performance by recognizing facts and information about management presented after appropriate examination, verification and evaluation, by professionally qualified and competent people. Followings are few important reasons for undertaking a management audit:

i) Detecting and overcoming current managerial deficiencies in ongoing operations

ii) It represents a more positive, forward-looking approach that evaluates how well management accomplishes its stated organizational objectives

iii) Managerial problems and related operational difficulties can be spotted before the fact rather than after the fact as with a financial audit

iv) Analogous to the preventive maintenance concept found in production

v) Examination the performance of certain managers those are ineffective in their present position and appropriate corrective action should be taken

vi) Helpful in the case of ailing industries, to isolate the problems and account for their ailments

Limitations of Management Audit

Management audit has got following limitations

i. It is very expensive as it is generally got done by a team of highly specialized persons whose fees become very high. So a small firm cannot afford it.
ii. Management has to take decisions in uncertainty when sufficient information may not be available. So, if this constraint of management is not kept in mind, and criticism is leveled against them for no fault of theirs, management audit will have dampening effect on the functioning of management.
iii. As management plans and policies are subject to review, they tend to become file minded rather than action mind. So. Instead of increasing the profitability of the business, management audit may cause a fall in profit by making the management inactive.

Features of Different Types of Audits

Ingredients	**Management Audit**	**Internal Audit**	**Financial, Cost and other Audits**
Expectations	Appraising management	Assisting management to identify problems	Specific under statutory and other's directions
Attitudes	Friend, Philosopher and guide	Policeman/judge	Watch dog/judge
Agency	Outside team or management	Internal or External	Specially designated persons
Force	Voluntary	Statutory in some cases	Statutory/ Voluntary
Area	Complete Management or specific problems	Mainly past/procedural	Specific objectives
Evaluation	Effectiveness/quality of management/policies	Quality of procedures operations/data	Specific information
Period covered	Past, present and future	Past and present	Mainly past
Procedures	Flexible	Structured	Highly structured
Reporting level	Higher	Operational	Designated
Time span	Futuristic	Current and immediate	Current and immediate past
Periodicity	Regular	Regular	Annual

Organizing the Management Audit

The establishment of a general programme for management audit requires management's approval to the plan. It is imperative to give consideration to a statement of policy which reflects a definite plan to achieve the objectives while organizing for the management audit.

i) Devising the statement of policy- The management's support must be reflected clearly and categorically in the company's highest policy statement. The statement of policy should lay down in clear terms the scope of activities to be performed by the management auditor.

ii) Location of audit function within the organization – Some organizations depending upon their size and nature have established a separate department of audit specialists where the head of the department reports directly to the top executive. The greater the independence, greater is the freedom to work effectively. The controversies is that whether the management auditor should report to the finance director or managing director or to an audit committee or to both finance director and audit committee. Though the controversies has no specific solution but the independence of the management auditor is not necessarily related to the person/persons he reports. His independence is entirely dependent on the management's attitude towards audit, the credibility the management auditor has with the management and management's positive will to listen to criticism for self betterment.

iii) Allocation of personnel – Whatever be the size of the enterprise, it is important that all persons selected and assigned t audit possess agood understanding of auditing theory, a thorough knowledge of the fundamentals of both organiston and management, the principles and effective methods of control and the requirements for conducting scientific appraisal.The management auditor should also have a basic knowledge of commerce, law, taxation, cost accounting, economics, quantitative methods and EDP systems.

iv) Staff training programme – A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep of new ways to improve auditing standards.

v) Time and other aspects – The time required to carry out a management audit will vary, depending upon the extent and nature of assignment.

vi) Frequency – It also depends on the nature of the organization. If the company is in fast-changing industry or the total resourcesutilized by thecompany are expensive, the frequency of management auditing should be greater (frequency of audit can be every two years) than when it does not undergo rapid changes or the resources employed are not high in value (frequency of audit can be every three years). In essence, management audits should be made often enough to provide protection against growing problems. In no case should the interval be allowed to exceed three years.

Conducting a Management Audit

Once top management has decided on the scope, the staffing, and the frequency of the management audit, the next phase is the undertaking of actual audit. This involves investigating and analyzing the present facts through interviews as well as completing a management questionnaire so as to determine the problems confronting the organization.

i. Getting the facts through interviews

To avoid waste of time and effort, adequate preparation is necessary in management auditing just as in financial auditing. The management auditors should know what information is desired, and they should be prepared to ask a number of direct questions to get the desired information. Reference can be made to the management audit questionnaire for specific questions. Care must be taken in selecting the proper managers to interview so as to obtain pertinent information. The exchange between auditor and manager should be friendly and conducted in an open atmosphere so as to encourage a free exchange of ideas. It is always wise to listen to tentative solutions set forth by the manager for problems that confront him or her. Many times these solutions can be made an integral part of final recommendations, and when the manager sees that his or her solutions are included in the final report, the individual is more apt to support the recommendations. Thus, management auditors will experience less opposition at the end of the engagement by utilizing this approach.

ii. Measuring performance through the Management Audit Questionnaire

During the interview, the management auditors make a careful inquiry into important fats. The next step is to analyze this information, with the aim of measuring current performance. The best way to perform such an analysis is to utilize the sections of the management audit questionnaire that apply to the areas under study. By way of review, a management audit questionnaire aims at a comprehensive and constructive examination of an organization's management and its assigned tasks. Overall, the questionnaire is concerned with the appraisal of management actions in accomplishing organization objectives. Its primary objective is to highlight weaknesses and deficiencies of the organization for possible improvements. More specifically, it includes a review of how well or badly the management functions of planning, organizing, directing and controlling are being performed. In addition, it evaluates how effective the decision-making process is in accomplishing stated organization objectives. Within this framework, the questionnaire provides a means for evaluating an organization's ongoing operations by examining its major functional areas.

The questionnaire is designed to evaluate management practices. There are three possible answers to be management audit questions 'yes' or 'no' and 'N.A' (not applicable). A 'yes' answer indicates that the specific area, function, or aspect under study is functioning in an acceptable manner; no written explanation is needed in that case. On the other hand, a 'no' answer indicates unacceptable performance and should be explained in writing. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. Those questions that are not applicable and should be ignored in the audit are checked in the 'N.A' column.

In any case, these questions are designed to help an individual evaluate real world situations. As such, the questions should be approached from a research-oriented frame of reference. If all questions are answered with a "'yes', operations are proceeding as desired. On the other hand if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyze the current situation; more importantly, it enables the management auditors to synthesis those elements that are causing organizational difficulties and deficiencies. To state it another way, a synthesis (a process of combining separate elements) can be used for determining the problem. The capacity to assess all negative answers goes a long way towards defining the real problem-not just stating its symptoms.

Behavioural aspects encountered in a Management Audit:

It has been experienced that one of the biggest difficulties involved during the course of management audit is that people working in the organization do not wish to accept any change. While at the time of conducting interviews, it seems that people working in the organization are amenable to change but at the time of actual implementation they come up with staff resistance to proposals on account of various behavioural problems arising on this account. Such an unfortunate situation can be avoided by building up a positive approach to management audit and involving the various organization personnel right from the initiation of the management audit. Another fear which haunts executives working in the organization is that the management auditors' recommendations may lead to their removal or reshuffling in the process. This problem may also be overcome by explaining to these executives that the management auditor is there to help them in achieving the results rather acting against their interests. Various problems arising on account of behavioural attitudes and solutions to overcome them during the process of management audit are discussed in the following paragraphs.

Therefore, management auditors must develop and maintain good relations with auditees to gain information and to ensure corrective action on audit findings. Yet, the general image that the auditor seemed to create is that he is a critic, fault finder or private spying authority of the top management. It is an 'occupational risk' of management auditor to come across very often ruffled feelings, hostile relationship and unwelcome atmosphere.

In the following paragraphs, the nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed.

i. **Staff/line conflict:**

The staff/ line relationship is inherently prone to conflict. Management auditors are staff. And the line people in the sense all members of other departments of the organization are likely to regard the management auditor the same way as they regard other staff people. Management auditors being specialists in their field may think that their approach and solutions are the only answers. They tend to discount the difficulty people may face if called on to act on their ideas. And they may feel that they must point out defects to prove themselves to tor management. Line personnel, under such circumstance, will not likely regard staff with antagonism.

ii. **Control:**

As the management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee to have certain amount of fear that his actions when reported are likely to cause adverse effect on those who receive the auditor's report, viz., top management. There is a certain amount of justified fear that top management's opinion of their performance or implementation of control procedures is likely to be affected b the auditor's report. Therefore, the management auditor, being thepart of control system and thorough evaluation of control, leads to breeding of antagonism on the part of the auditees. According to a research study the causes of antagonism are as follows:

- Fear of criticism stemming from adverse audit findings
- Fear of changes in day-to-day working habits because of changes resulting from auditing recommendations
- Punitive action by superiors prompted by reported deficiencies.
- Insensitive audit practices- reports which are overly critical, reports which focus on deficiencies only, the air of mystery cloaking some audits, and the perception that auditors gain personally form reporting deficiencies.
- Hostile audit style- a cold and distant aspect is a lack of understanding of the auditee's problems, an absence of empathy, an air of smugness or superiority, an excessive concentration on insignificant errors, a prosecutional tone when asking questions, and a greater concern with parading defects than helping constructively to improve conditions.

Solution to behavioural problems:

The auditors, if they were to adopt the role of accuser or secret agency of the management to try upon the happenings of the auditee division, they would be unwelcome. Their presence will give rise to problems of personal relationship. Relations between the auditor and the auditee may improve if the auditor acts and is perceived as a professional advisor and consultant.

Constructive criticism:

It is essential that the auditor should concentrate only on constructive criticism. He should also make obvious in his report the value of his comments in tangible terms. Only then would suggestions carry weight with the auditees and they will feel convinced that the auditor has been objective in his remarks in the report. T J Krien in his article on "People assets that talk back" has strongly advocated the view that once the auditor is able to convince the auditees that his approach is one of mutual problem solving rather than one of fault finding, then it would produce positive results and the chances of auditors' recommendations being considered in an objective fashion would be better. If he auditors were to adopt a "fault finding role", the auditees would be constrained to become defensive and would bend backward to justify their position. A few other authors also have strongly advocated the view that the success of the auditors' role would to a great extent depend upon whether the auditee were made to feel convinced that the auditor's role was one of being helpful rather than that of a fault finder.

Reporting methods:

To achieve this objective, the auditor has to make a concerted effort to convey effectively his role by adopting a friendly but firm tone in his report. It is always possible to disagree without being disgraceful, to criticize without being critical. The reports should concentrate on areas which needs improvement rather than listing inefficiencies and deficiencies in performance of the auditee. The mistaken notion that the greater the number of deficiencies reported the higher would be the rating of his performance should be erased or given up. This is an outdated notion can does not in any way contribute to the effectiveness of the auditor.

Participative approach:

It is well established that auditor's reports have better acceptability if the improvements suggested are discussed with those who have to implement them and make to feel that they have participated in the recommendations made for improvements.

The participative approach to the internal audit process has proved to be success. Well known authorities in the field have proved by means of research they have conducted that resistance to change is absent if not minimal when participative method is adopted. Feelings of hostility disappear giving room to feelings of mutual trust. Team spirit is developed and the auditors and the auditeeendeavour to achieve the common goal. Proposed recommendations are discussed with the auditee and such modifications as may be mutually agreed upon are incorporated. With this attitude of the auditors and auditees, it becomes absolutely easy to implement, the proposed suggestions as the auditees themselves take initiative for implementation and auditors do not have to force any changes on the auditees. Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditiees and auditors of the right caliber. May be to expect a combination at all times of all the three is asking for the impossible. But a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

Management Audit Report

The written report is the medium by which the comments, criticisms and recommendations of a management audit department are conveyed to the Board, to functional directors and to management in general. It follows, therefore, that audit reports crystallize the work of the management auditors and merit the closest consideration of all audit staff engaged in their preparation. Reports must be written with very great care after full consideration of the subject matter and with full regard to the fact that it is imperative that the report conveys exactly the right impressions on the reader. Management audit report will inevitably cover a wide variety of subjects, reflecting the many and ever increasing ramifications of management audit departments broadly, however, reports may be divided into four main categories.

1. Reports prepared by the management audit staff aftertheir visits to a unit.
2. Periodical reports prepared by senior members of management audit department which summarize the main audit findings and recommendations for the period under consideration and which afford a concise review of the department's activities for that period.
3. Reports on the results of special investigations and inquiries.
4. An annual audit report.

The right of the management auditor to report to the highest level is now well established in many organizations but in all cases responsible officials of the different units which have been subjected to audit should be afforded the opportunity of discussing matters in the report concerning their departments before this is passed in final form to a higher level.

Difference between Cost Audit and Management Audit

Points of Distinction	**Cost Audit**	**Management Audit**
Definition	Cost audit is the verification of the correctness of cost records and adherence to the cost accounting principles, plans and procedures	Management audit is constructive and comprehensive appraisal and examination of organization structure of a concern, its plants, means of operation and use of resources
Auditor's qualification	As per sub-section (3) of section 148 of the Companies Act, 2013, only a cost accountant in practice is eligible to conduct cost audit.	Management auditor need not necessarily be a qualified accountant. A person with special ability and knowledge can conduct management audit
Objective	Its main objective is to ascertain the reliability and fairness of cost records and cost statements.	The objective of management audit to see whether the company is being run efficiently or inefficiently, prudently or imprudently and to show ways and means of improvement of performance
Periodicity	Cost audit, if ordered by the Central Govt. Is to be conducted for the particular year specified in the order	Management audit is not done for nay such fixed period. It may cover from one to three or four years
Compliance with	As per sub-section 3 of Section 148 of the Cost Audit has to be	There is no such standards for conducting management audit

standards	conducted in compliance with Cost Auditing Standards issued by the Institute of the Cost Accountants of India.	
Statutory Provision	Cost audit, is conducted as per sec. 148 of the Companies Act, 2013 in various sector classified as Regulated sector and Non Regulated Sector	There is no such provision of management audit in the Companies Act. It is done as per requirement of management.
Reporting	The cost audit report is first submitted to the Board of Directors in Form CRA3 which will within a period of 30 days from the date of its receipt forward the same to the Central Government along with full information and explanation on every reservation or qualification made by the cost auditor in Form CRA-4	As management audit is conducted at the behest of management, its report is submitted to the management for their perusal and taking corrective actions.
Coverage	Cost audit is mainly concerned with production or service function	Management audit may cover all important areas of the organization namely Production function, Administrative function, Marketing etc.

Difference between Financial Audit and Management Audit

Points of Distinction	**Financial Audit**	**Management Audit**
Nature	Financial audit is concerned with truthfulness of financial statements. It does not bother about profit or loss of the business. It only tries to ensure that financial effect of all events having taken place in the business are properly reflected in the financial statements	Management audit is concerned with soundness and efficiency of management plans, policies and procedures
Objective	The objective of financial audit is to cater to the information needs of various outside partied related to the business namely shareholders, investors, creditors etc. So that based	Management audit on the other hand, aims at maximizing profit or minimizing loss of the business by pinpointing management deficiencies in various key areas. It

	on the information they can safeguard their interest in the business.	is forward looking and is concerned with future performance improvement
Use of Rules	Financial audit is conducted based on auditing standards as prescribed by the Institute of Chartered Accountants of India	Management audit is not bound by any prescribed rules and procedures
Basis	Financial audit is conducted based on financial data and information collected within the organization.	Management audit is conducted based on financial data and information collected from internal as well as external sources
Scope	Financial audit is only restricted to assessment of financial transactions and their proper recording in books of accounts, plans and policies of the management are taken as grated by the financial auditor	The scope of management audit is vast. It appraises the policies of management in all important matters like organization structure, product diversification, expansion of business, financial policy of management, etc.
Statutory Provision	As per Companies Act, the financial audit of accounts of a company is compulsory.	Management audit is not statutorily compulsory. It depends upon the perception and attitude of management
Periodicity	Financial audit is conducted separately for each accounting year covering the span of twelve months	There is no hard and fast rule regarding period to be covered under management audit. It may range from one to three or four years
Rendering Advice	It is not the duty of the financial auditor to give any advice to management or shareholders. Only when he is specifically requested to give advice on some matter, he can do so	It is the duty of the management auditor to give advice to the management regarding elimination of management deficiency and performance improvement
Qualification of Auditor	A person will be eligible to conduct financial audit of a company if he is a Chartered Accountant and holds a certificate of practice. Unless he is a chartered Accountant and holds certificate of practice, he cannot conduct audit whatever may be his intelligence or knowledge in auditing	A management auditor need not necessarily be a Chartered Accountant. What is required in this case is that he must be tactful, methodical, analytical and well versed in accounting, auditing, economics, law taxation and other related subjects.

	and accountancy	
Submission Report	The financial auditor submits his report to the shareholders as he is appointed to protect their interest along with other outside parties	The management auditor always submits his report to the management only
Auditor's liability	As the financial audit is a statutory necessity, the auditor who has conducted this audit may be criminally prosecuted under the Companies Act for misfeasance of duty	Management auditor cannot be criminally prosecuted under the Companies Act for any misfeasance of duty

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