


plan due to the factors such as:

- (i) **result of unexpected events,**
- (ii) **changes in conditions,** or
- (iii) **the audit evidence obtained** from the results of audit procedures.

Further, the auditor would also have to **modify the nature, timing & extent** of further audit procedures, based on the revised considerations of assessed risks. This may be the case **when information coming to the auditor differs significantly** from the information when he planned the audit process. In addition to the above, **there may be possibilities of change in** - law, notifications, government policies, which warrants updation of **overall audit strategy and audit plan.**


65.	<b>Additional Considerations in Initial Audit Engagements</b> AB & Associates, a chartered accountant firm, was appointed auditors of KEY Company Ltd. for the financial year ended 31st March 2021. Being the first year of audit, the audit firm AB & Associates, as per its system of quality control, involved senior partner of the firm to review the overall audit strategy prepared by the team members. What additional matters would be considered in initial audit engagement by the senior partner in establishing the overall audit strategy and audit plan of KEY Company Ltd.? <span style="float: right;">(Dec-2021-Old)</span>
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Ans. 	<ol style="list-style-type: none"> <li>(i) <b>As per SA 300 "Planning an Audit of Financial Statements"</b> the purpose and objective of <b>planning the audit are the same</b> whether the audit is an <b>initial or recurring engagement</b>. However, for an initial audit, the auditor may need to <b>expand the planning activities</b> because the auditor does not ordinarily have the <b>previous experience</b> with the entity that is considered when planning recurring engagements.</li> <li>(ii) <b>For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:</b> <ol style="list-style-type: none"> <li>(1) <b>Unless prohibited by law or regulation,</b> arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.</li> <li>(2) <b>Any major issues</b> (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.</li> <li>(3) The audit procedures necessary to obtain <b>sufficient appropriate audit evidence</b> regarding opening balances in accordance with <b>SA 510 "Initial Audit Engagements- Opening Balances"</b>.</li> <li>(4) <b>Other procedures</b> required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).</li> </ol> </li> </ol>
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### SA -315

## Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

66.	<b>Considerations of Auditor for Assessing the ROMM</b> In the course of audit of PB Ltd., you observe that there is a likelihood of misstatement in the account balances and disclosures in the financial statements. What should be your considerations as an auditor for "Assessing the Risk of Material Misstatements"? <span style="float: right;">(Nov-2018-Old)</span>
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Ans. 	<b>As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment",</b> the auditor shall <b>identify and assess the risks of material misstatement</b> at: <ul style="list-style-type: none"> <li>• The <b>financial statement level</b>; and</li> <li>• The <b>assertion level for classes of transactions,</b> account balances, and disclosures to provide a basis for <b>designing and performing further audit procedures.</b></li> </ul>
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For this purpose, the auditor shall-

- (i) **Identify risks throughout the process** of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- (ii) **Assess the identified risks, and evaluate** whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (iii) **Relate the identified risks** to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
- (iv) **Consider the likelihood of misstatement**, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

**67. RoMM at the Assertion Level**  
 SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur. Briefly explain with example. **(Study Material)**

OR

"Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered." Explain stating the different categories of assertions used by the auditor.

Ans.



(i) **According to SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment"**

- **Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures** need to be considered because such consideration **directly assists in determining the nature, timing, and extent of further audit procedures** at the assertion level necessary to obtain sufficient appropriate audit evidence.
- In **identifying and assessing** risks of material misstatement at the assertion level, the auditor may conclude that the **identified risks relate more pervasively** to the financial statements as a whole and **potentially affect many assertions**.

(ii) **Assertions used by the auditor to consider the different types of potential misstatements** that may occur fall into **the following three categories and may take the following forms-**

**(a) Assertions about classes of transactions and events for the period under audit:**

- 1) **Occurrence:-** Transactions and events that have been **recorded have occurred** and pertain to the entity.
- 2) **Completeness:-** All transactions and events that should have been recorded **have been recorded**.
- 3) **Accuracy:-** Amounts and other data relating to recorded transactions and events have been **recorded appropriately**.
- 4) **Cut-off:-** Transactions and events have been recorded in the **correct accounting period**.
- 5) **Classification:-** Transactions and events have been recorded in the **proper accounts**.

**(b) Assertions about account balances at the period end:**

- 1) **Existence**—assets, liabilities, and equity interests exist.
- 2) **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- 3) **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded.
- 4) **Valuation and allocation**—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) **Assertions about presentation and disclosure:**

- 1) **Occurrence and rights and obligations**—disclosed events, transactions, and other matters have occurred and pertain to the entity.
- 2) **Completeness**—**all disclosures** that should have been **included in the financial statements have been included**.
- 3) **Classification and understandability**—financial information is **appropriately presented and described**, and **disclosures** are **clearly expressed**.
- 4) **Accuracy and valuation**—financial and other information are disclosed fairly and at appropriate amounts.

68.

**Inherent Limitations of ICS**

What are the inherent limitations of Internal Control system?

Ans.



**Internal control can provide only reasonable but not absolute assurance** that its objective relating to **prevention and detection of errors/frauds**, safeguarding of assets etc., are achieved.

**This is because it suffers from some inherent limitations, such as:-**

- (i) Management's consideration that **cost of an internal control** does not exceeds the **expected benefits**.
- (ii) Most controls **do not tend to be directed at unusual transactions**.
- (iii) The **potential of human error** due to carelessness, misjudgment and misunderstanding of instructions.
- (iv) The possibility that control may be **circumvented through collusion** with employees or outsiders.
- (v) The possibility that a **person responsible** for exercising control **may abuse that authority**.
- (vi) **Compliance with procedures** may deteriorate because the procedures becoming inadequate **due to change in condition**.
- (vii) **Manipulation by management** with respect to transactions or estimates and judgments required in the preparation of financial statements.

69.

**Control Environment**

"A satisfactory internal control environment may help reduce the risk of fraud but is not an absolute deterrent for fraud." Explain. (May-2017)

Ans.



- **Not an absolute deterrent to fraud:** The existence of a **satisfactory control environment** can be a **positive factor** when the auditor assesses **the risks of material misstatement**.
- However, although **it may help reduce the risk of fraud**, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, **deficiencies in the control environment** may undermine the **effectiveness of controls**, in particular in **relation to fraud**.
- **For example:** - Management's failure to **commit sufficient resources to address IT security** risks may adversely **affect internal control** by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed.
- **As explained in SA 330 "The Auditor's Responses to Assessed Risks":** - The control environment **also influences the nature, timing, and extent** of the auditor's further procedures.
- The control environment in itself **does not prevent, or detect and correct**, a material misstatement. It may, however, **influence the auditor's evaluation** of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the **auditor's assessment of the risks of material misstatement**.

70.

**Specific Risk to an Entity's Internal Control : IT Systems**

Enumerate the specific risks that Information Technology (IT) systems can pose to an entity's internal control.

(Nov-2017)

OR

IT systems also pose specific risks to an entity's internal control? What are those risks?

Ans.



As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses **specific risks** to an entity's Internal Control.

They are–

- (i) **Reliance on systems or programs** that are inaccurately processing data, processing inaccurate data or both.
- (ii) **Unauthorised access to data** that may result in destruction of data or improper changes to data, including the **recording of unauthorized** or **non-existent transactions**, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.
- (iii) **The possibility of IT personnel gaining access** beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iv) **Unauthorised changes** to data in **Master files**.
- (v) **Unauthorised changes** to **systems or programs**.
- (vi) **Failure to make necessary changes** to systems or programs.
- (vii) Inappropriate **manual intervention**.
- (viii) **Potential loss of data** or inability to access data as required.

71.

### Letter of Weakness

Write short note on Letter of Weakness.

Ans.



- (i) The auditor does **compliance procedure** to ascertain that the **internal control system** exist in the entity; it works **effectively**; it work **continuously** in the entity during review period.
- (ii) When he comes across **any weakness in the control points**, he issues **letter of weakness**.
- (iii) **Letter of weakness** is a **report issued by auditor stating the weakness in internal control mechanism**. It also suggests **measures by which the weakness in the system be corrected** and the control system **be made better protected**.
- (iv) **Lapses in operation of internal control** too are reported in the communication of weakness.
- (v) The communication of weakness is **reporting to management** of such weakness in design and operation of internal control as have **come to notice of auditor** during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

72.

### Assessment of Risk & Acceptable Level

As a Statutory Auditor, how would you deal with the following - While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the audit risk relating to certain class of transactions cannot be reduced to acceptance level. Explain (May-2017)

Ans.



- (i) **Audit Risk to be Reduced to Low Levels**
  - SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and SA 330 "The Auditor's Responses to Assessed Risks" establishes standards on the **procedures to be followed** to obtain an **understanding of the accounting and internal control systems** and on **audit risk and its component**: inherent risk, control risk and detection risk.
  - SA 315 and SA 330 require that the auditor should use **professional judgment to assess audit risk** and to **design audit procedures** to ensure that it is reduced to an **acceptably low level**.
- (ii) **Detection Risk as per Assessment of RoMM**
  - "**Detection risk**" is the risk that an **auditor's substantive procedures** will not detect a misstatement that **exists in an account balance or class of transactions** that could be material.
  - The higher the **assessment of inherent and control risks**, the more audit evidence the auditor should **obtain** from **the performance of substantive procedures**.

- When both inherent and control risks are assessed as **high**, the auditor needs to consider whether substantive **procedures** can provide **sufficient appropriate audit evidence** to reduce **detection risk**, and therefore audit risk, to an **acceptably low level**.
- The auditor should **use his professional judgment to assess audit risk** and to design audit procedures to ensure that it is reduced to an acceptably low level.

(iii) **Conclusion:** -If it cannot be reduced to an **acceptable level**, the auditor should **express a qualified opinion** or a **disclaimer of opinion** as may be appropriate.

**73. Points of Indication - Risks Identified may be Significant**

You are engaged by M/s. Real Ltd. as an internal auditor for the financial year 2020-2021. While applying risk assessment procedures of inquiring from management and various analytical procedures, you have identified some risks which in your opinion may lead to material misstatement at the financial level and assertion level. Which factors as an auditor will you consider while exercising judgement as to whether such risks are significant risks or not? (Jan-2021-New)

**OR**

The identified risks are assessed by Auditor as to its significance on account of its likely impact, by way of material misstatement appearing in financial statements or by affecting internal control system. What may be the points of indication that may direct the Auditor to judge that the risks identified may be significant? (Nov-2018-New)

**Ans.**



- (i) The **internal auditor of Real Ltd.** has identified some risks while he was applying **risk assessment procedures** and **various analytical procedures**.
- (ii) As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment", in exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
- Whether the **risk is a risk of fraud**;
  - Whether the **risk is related to recent significant economic, accounting, or other developments** like changes in regulatory environment, etc., and, therefore, requires specific attention;
  - The **complexity of transactions**;
  - Whether the **risk involves significant transactions with related parties**;
  - The **degree of subjectivity** in the measurement of financial information related to the risk, especially those measurements **involving a wide range of measurement uncertainty**; and
  - Whether the **risk involves significant transactions** that are outside the **normal course of business** for the entity, or that otherwise **appear to be unusual**.

**74. Sources of Information**

What are the major sources of obtaining information about the client's business?

**Ans.**



**Major sources of obtaining information about client's business:**

- Annual Reports** circulated among the shareholders;
- Minutes of meetings** of shareholders, directors and their committees;
- Internal reports** over financial aspects for current and previous periods, including budgets;
- Working Papers** of previous year audits;
- Policy and Procedures Manual** of the Client;
- Discussions** with the client;
- Publications** of the ICAI and other professional bodies, industry publication, trade Journals, newspapers etc.;
- Consideration** of general state of the economy and its effects on the client's business; and
- Visits** to the premises of the client.



## SA-320

## Materiality in Planning and Performing an Audit

75. **Concept of Materiality**  
Explain concept of 'Materiality'?

Ans.



Financial reporting frameworks often discuss the **concept of materiality** in the context of the **preparation and presentation of financial statements**. Although financial reporting frameworks may discuss materiality in **different terms**, they generally explain that:

**(i) Influence the decision of users:**

Misstatements, including omissions, are considered to be material **if they, individually or in the aggregate**, could reasonably be **expected to influence the economic decisions of users** taken on the basis of the financial statements;

**(ii) Based on nature and size:**

Judgments about materiality are made in the light of **surrounding circumstances**, and are affected by the **size or nature of a misstatement**, or a **combination of both**; and

**(iii) Based on need of generic users and not specific users**

Judgments about matters that are **material to users of the financial statements** are based on a consideration of the **common financial information needs** of users as a group. The possible effect of misstatements on **specific individual users**, whose needs may vary widely, is not considered.

**(iv) Materiality in FRFW**

Certain cases the FRFW **defines materiality** or basis for making a **choice of materiality level**, however if not provided the characteristics referred above provides the **auditor with such a frame of reference**.

**(v) Matter of professional judgement**

The auditor's determination of materiality is a **matter of professional judgment**, and is affected by the **auditor's perception** of the financial information needs of users of the financial statements.

**(vi) Materiality applied both in planning and performing the audit**

The concept of materiality is applied by the auditor **both in planning and performing** the audit, and in evaluating the **effect of identified misstatements** on the audit and of **uncorrected misstatements**, if any, on the financial statements and in **forming the opinion** in the auditor's report.

76. **Materiality and Audit Risk – Relationship**  
Explain the Relationship between materiality and audit risk.


Ans.




SA 320 on 'Materiality in Planning and Performing an Audit' requires that:

- The auditor should consider **materiality and its relationship** with audit risk when conducting an audit. Materiality depends on the **size and the nature of the items** judged in the particular circumstances of its misstatement.
- The audit should be **planned so that audit risk is kept at an acceptably low level**.
- There is an **inverse relationship** between Materiality and the **degree of audit risk**. Higher the **materiality level** the **lower the audit risk** and vice-versa.
- After the auditor has assessed the **inherent and control risks**, he should consider the **level of detection risk** that he is prepared to accept and, based upon **his judgment**, select appropriate **substantive audit procedures**.
- If the auditor **does not perform any substantive procedures**, detection risk, that is, the risk that the auditor **will fail to detect a misstatement**, will be high.
- The auditor's assessment of **audit risk may change during the course of an audit** according to the **need and development of the circumstances**.

77.	<p><b>Use of Benchmark in determining Materiality</b></p> <p>You are being appointed as the auditor of X Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of materiality while auditing? <span style="float: right;">(Nov-2020-Old)</span></p> <p style="text-align: center;"><b>OR</b></p> <p>Mr. X was appointed as the auditor of M/s Easygo Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose. <span style="float: right;">(MTP-May-2018)</span></p>
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Ans.  	<p>(i) <b>Provision: -SA 320 “Materiality in Planning and Performing an Audit”</b> prescribes :</p> <ul style="list-style-type: none"> <li>• The use of Benchmarks in <b>Determining Materiality</b> for the <b>Financial Statements as a Whole</b>.</li> <li>• Determining <b>materiality</b> involves the exercise of <b>professional judgment</b>.</li> <li>• A percentage is often applied to a <b>chosen benchmark</b> as a starting point in <b>determining materiality for the financial statements as a whole</b>.</li> </ul> <p>(ii) <b>As auditor of X Ltd., for determining the materiality level, Factors that may affect the identification of an appropriate benchmark include the following:</b></p> <ul style="list-style-type: none"> <li>• The <b>elements of the financial statements</b> (for example, assets, liabilities, equity, revenue, expenses);</li> <li>• Whether there are items on which the <b>attention of the users</b> of the particular entity’s financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);</li> <li>• The <b>nature of the entity</b>, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;</li> <li>• The <b>entity’s ownership structure and the way it is financed</b> (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity’s earnings); and</li> <li>• The <b>relative volatility</b> of the benchmark.</li> </ul>
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78.	<p><b>Re-evaluation of the Materiality Concept</b></p> <p>As an auditor of RST Ltd. Mr. P applied the concept of materiality for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company's business, he wants to re-evaluate the materiality concept. Please, guide him. <span style="float: right;">(Study Material)</span></p> <p style="text-align: center;"><b>OR</b></p> <p>Y &amp; Co., Chartered Accountants have come across in the course of audit of a company that certain machinery, had been imported for production of new product. Although the Auditors have applied the concept of materiality for the Financial Statements as a whole, they now want to re-evaluate the materiality Concept for this transaction involving foreign exchange. Give your views in this regard. <span style="float: right;">(MTP-May-2019)(May-2018-New)</span></p>
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Ans.  	<p>(i) <b>In the instant case: -</b> Mr. P, as an <b>auditor of RST Ltd.</b> has applied the <b>concept of materiality</b> for the financial statements as a whole. But he <b>wants to re-evaluate the materiality concept</b> on the basis of <b>additional information</b> of significant contractual arrangements which draws attention to a particular aspect of the company’s business.</p> <p>(ii) <b>SA 320 on Materiality For FS as a whole, Separate for Individual Assertions if Needed</b></p> <ul style="list-style-type: none"> <li>• <b>As per SA 320 “Materiality in Planning and Performing an Audit”,</b> while establishing the <b>overall audit strategy</b>, the auditor shall determine <b>materiality for the financial statement</b> as a whole.</li> <li>• <b>He should set the benchmark</b> on the basis of which he <b>performs his audit procedure</b>. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account</li> </ul>
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balances or disclosures for which misstatements of lesser amounts than the materiality for the **financial statements as a whole could reasonably be expected** to influence the **economic decisions of users** taken on the basis of the financial statements,

- The **auditor** shall also determine **the materiality level or levels to be applied** to those particular classes of transactions, account balances or disclosures.

**(iii) Revision of Materiality Level**

- The auditor shall **revise materiality for the financial statements** in the event of becoming **aware of information** during the audit that would have caused the auditor to have determined **a different amount** (or amounts) initially.
- If the auditor concludes a **lower materiality** for the same, then he should consider the fact that **whether** it is **necessary to revise performance materiality** and whether the **nature, timing and extent** of the further audit procedures remain appropriate.

**(iv) Conclusion:** -Thus, Mr. P can re-evaluate the materiality concepts after considering the necessity of such revision.

### SA-330

#### The Auditor's Responses to Assessed Risks

**79. Tests of Control**

Why Tests of Control are performed? Also explain what does they include.

**Ans.**



- (a) **Tests of control** are performed to obtain **audit evidence** about the **effectiveness** of the -
- design of the **accounting and internal control systems**, that is, whether they are **suited** designed to **prevent or detect and correct** material misstatements; and
  - **operation of the internal controls** throughout the period.
- (b) **Tests of control include tests of elements** of the control environment where **strengths in the control environment** are used by auditors to **reduce control risk**. **Tests of control may include:**
- **Inspection of documents supporting transactions** and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
  - **Inquiries about, and observation of, internal controls** which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
  - **Re-performance of internal controls**, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
  - **Testing of internal control operating** on specific computerised applications or over the overall information technology function, for example, access or program change controls.

**80. Factors Warranting Re-Test of Controls**

In the course of audit of Ambika Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an advisor to the auditor kindly caution him about the factors that may warrant a re-test of controls.

**(RTP-May-2022)(MTP-Nov-2019)(RTP-Nov-2018)**

**Ans.**



- As per SA 330 on "**The Auditor's Responses to Assessed Risks**", changes may affect the **relevance of the audit evidence** obtained in previous audits such that there **may no longer be a basis for continued reliance**.
- The auditor's decision on **whether to rely on audit evidence** obtained in previous audits for control is a matter of **professional judgment**. In addition, **the length of time between retesting such controls** is also a matter of **professional judgment**.
- Factors that may warrant a re-test of controls are-



- A **deficient control environment**.
- **Deficient monitoring of controls**.
- A **significant manual element** to the relevant controls.
- **Personnel changes** that significantly affect the application of the control.
- **Changing circumstances** that indicate the need for changes in the control.
- **Deficient general IT-controls**.

## SA-402

### Audit Considerations Relating to an Entity Using a Service Organization

**81. Understanding of the User Entity**

In the course of audit of Tech limited you observed that processing of accounting data was given to a third party on account of certain considerations like cost reduction, own computer working to full capacity. Tech Limited used a service organisation to record transactions and process related data. As an auditor, what would be your considerations regarding the nature and extent of activities undertaken by service organisation so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk. Discuss with reference to relevant Standard on Auditing. (Dec-2021-New)

OR

G Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of G Ltd. as to how he can obtain an understanding of how G Ltd. uses the services of the outsourced agency in its operations. (MTP-Nov-2019)(RTP-Nov-2018)

OR

In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit. (May-2018)

**Ans. Provision: - As per SA 402 on Audit Considerations Relating to an Entity Using a Service Organisation: -** When obtaining an **understanding of the user entity** in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of **how a user entity uses the services of a service organisation** in the user entity's operations, **including:**

- (i) The **nature of the services provided** by the service organisation and the **significance of those services** to the user entity, including the **effect thereof** on the user entity's internal control;
- (ii) The **nature and materiality of the transactions** processed or accounts or financial reporting processes affected by the service organisation;
- (iii) The **degree of interaction** between the **activities** of the service organisation and those of the user entity; and
- (iv) The **nature of the relationship** between the **user entity and the service organisation**, including the **relevant contractual terms** for the activities undertaken by the service organisation.

"Based on above, the auditor will assess the **effect on the audit risk** and take necessary steps while conducting the audit".

**82. Factors to consideration related to FR in case of User Entities using services of Service Organisation**

Durafone Mobile Co. Ltd. have pan India presence and market leader in mobile operation. It has outsourced all its revenue operation including accounting functions to Set Solutions (P) Ltd. As an Auditor of the mobile company, enumerate the factors to be taken into consideration related to its financial reporting. (May-2018-Old)



Ans.

**Provision: - SA 402 “Audit Considerations relating to an Entity Using a Service Organisation”**

- Deals with the **user auditor’s responsibility** to obtain **sufficient appropriate audit evidence** when a user entity **uses the services of one or more service organisations**.
- Services provided by a **service organisation are relevant** to the audit of a **user entity’s financial statements** when those services, and the controls over them, are part of the user entity’s information system, **including related business processes**, relevant to financial reporting.
- Although **most controls at the service organisation** are likely to relate to **financial reporting**, there may be other controls that may **also be relevant to the audit**, such as controls over the safeguarding of assets.
- **A service organisation’s services are part of a user entity’s information system, including related business processes, relevant to financial reporting if these services affect any of the following:**
  - The **classes of transactions** in the user entity’s operations that are significant to the user entity’s financial statements;
  - The **procedures, within both information technology (IT) and manual systems**, by which the user entity’s transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
  - The **related accounting records**, either in **electronic or manual form**, supporting information and specific accounts in the user entity’s financial statements that are used to **initiate, record, process and report the user entity’s transactions**; this includes the **correction of incorrect information** and how information is **transferred to the general ledger**;
  - How the user **entity’s information system captures events and conditions**, other than transactions, that are **significant** to the financial statements;
  - The financial reporting process **used to prepare the user entity’s financial statements**, including **significant accounting estimates and disclosures**; and
  - **Controls surrounding journal entries**, including **nonstandard journal entries** used to record non-recurring, unusual transactions or adjustments.

83.

**Controls at a Sub-Service Organisation**

When a sub-service organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used. As a user auditor what information would you obtain about controls at a sub-service organization?

**(Study Material)(May-2015)**

Ans.

**(i) Provision: -As per SA 402 - Audit Considerations relating to an Entity Using a Service Organisation**

- A user entity **may use a service organisation** that in turn uses a **sub -service organisation** to provide **some of the services** provided to a user entity that are **part of the user entity’s information system** relevant to **financial reporting**.
- The **sub -service organisation** may be a **separate entity** from the **service organisation** or may be related to the service organisation.

**(ii) User auditor shall obtain an understanding of how a user entity uses the services of a sub-service organisation in the user entity’s operations, including:**

- The **nature of the services** provided by the sub-service organisation and the **significance of those services** to the user entity, including the **effect thereof** on the user entity’s **internal control**;
- **The nature and materiality of the transactions** processed or accounts or financial reporting processes affected by the sub-service organisation;
- The **degree of interaction** between the **activities** of the sub-service organization, service organisation and **those** of the user entity; and

- The **nature of the relationship** between the **user entity and the service organization** and service **organisation**, including the **relevant contractual terms** for the activities undertaken by the sub-service organisation.

**(iii) Reporting: -Type 1 / 2 Reports**

- If the user auditor is **unable to obtain a sufficient understanding** from the user entity, the user auditor shall **obtain that understanding by application of the following two methods** of presenting description of internal controls i.e.
  - **Type 1 report; or**
  - **Type 2 report.**
- **If a service organisation uses a subservice organisation**, the service auditor's report may **either include or exclude** the subservice organisation's **relevant control objectives** and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the **inclusive method and the carve - out method respectively**.
- **In either method**, the service organisation **includes in its description of controls** a description of the **functions and nature** of the processing performed by the sub - service organisation.
- **If the Type 1 or Type 2 report excludes** the control at a **subservice organization** and the services provided by the subservice organization are **relevant to the audit** of the user entity's financial statements, the **user auditor** is required to **apply the requirements of the SA 402** in respect of the **subservice organization**.

- 84. Reporting by the User Auditor**
- ENN Limited is availing the services of APP Private Limited for its payroll operations. Payroll cost accounts for 65% of total cost for ENN Limited. APP Limited has provided the type 2 report as specified under SA 402 for its description, design and operating effectiveness of control. APP Private Limited has also outsourced a material part of payroll operation M/s SMP & Associates in such a way that M/s SMP & Associates is sub-service organization to ENN Limited. The Type 2 report which was provided by APP Private Limited was based on carve-out method as specified under SA 402. CA Raman while reviewing the unmodified audit report drafted by his assistant found that, a reference has been made to the work done by the service auditor. CA Raman hence asked his assistant to remove such reference and modify report accordingly. Comment whether CA Raman is correct in removing the reference of the work done by service auditor?

**(MTP-May-2021)(RTP-Nov-2020)(MTP-Dec-2021)**

**Ans.**



**(i) Provision: - As per SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation":**

- The user auditor shall **modify the opinion** in the user auditor's report in accordance with **SA 705, "Modifications to the Opinion in the Independent Auditor's Report"**, if the user auditor is **unable to obtain sufficient appropriate audit evidence** regarding the services provided by the **service organisation** relevant to the audit of the **user entity's** financial statements.
- The user auditor **shall not refer to the work of a service auditor** in the user auditor's report containing an **unmodified opinion** unless required by **law or regulation** to do so.
- **If such reference is required by law or regulation**, the user auditor's report shall indicate that the reference **does not diminish the user auditor's responsibility** for the audit opinion.

**(ii) Conclusion:-** Thus, in view of above, contention of **CA. Raman in removing reference of the work done by service auditor is in order** as in case of unmodified audit report, **user auditor** cannot refer to the work done by **service auditor**.

**SJ Note – Further explanation on matters to be reported in the report, in case where user auditor issues modified opinion, should also be given**

## SA-450

## Evaluation of Misstatements Identified during the Audits

85.	<p><b>Sources of Misstatement</b></p> <p>In audit plan for T Ltd, as the audit partner you want to highlight the sources of misstatements, arising from other than fraud, to your audit team and caution them. Identify the sources of misstatements. <b>(RTP-May-2022)</b></p> <p style="text-align: center;"><b>OR</b></p> <p>In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in the financial statements. As the audit manager identify the sources of misstatements. <b>(RTP-May-2018)</b></p>
Ans. 	<p><b>SA 450 “Evaluation of Misstatements identified during the Audit”</b> defines the term misstatement as a:</p> <ul style="list-style-type: none"> <li>• <b>Difference between the amounts, classification, presentation, or disclosure</b> of a reported financial statement item <b>and</b></li> <li>• <b>The amount, classification, presentation, or disclosure</b> that is required for <b>the item to be</b> in accordance with <b>the applicable financial reporting framework</b>.</li> </ul> <p><b>Accordingly, misstatement may cause due to following:</b></p> <ul style="list-style-type: none"> <li>➤ An inaccuracy in <b>gathering or processing data</b> from which the financial statements are prepared;</li> <li>➤ An <b>omission of an amount or disclosure</b>;</li> <li>➤ An <b>incorrect accounting estimate</b> arising from overlooking, or clear misinterpretation of facts; and</li> <li>➤ <b>Judgments of management</b> concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.</li> </ul>
86.	<p><b>Consideration of Uncorrected &amp; Unidentified Misstatements</b></p> <p>The auditor should take into account the aggregate of all uncorrected misstatements including those involving estimates in his assessment of materiality in audit.</p>
Ans. 	<p><b>(i) Determination of Materiality for FS as a Whole</b></p> <ul style="list-style-type: none"> <li>• <b>SA 450 “Evaluation of Misstatements identified during the Audit”</b> requires that in forming his opinion on the financial information, the auditor should consider <b>all material aspects</b>, either <b>individual or in aggregate</b> which are relatively important for <b>true and fair view</b> of financial statements.</li> <li>• In this context, the auditor should consider whether the <b>effect of aggregate uncorrected misstatements</b> on the financial information is <b>material</b>.</li> <li>• <b>Qualitative considerations</b> also influence an auditor in <b>reaching a conclusion</b> as to whether the misstatements are material.</li> </ul> <p><b>(ii) Composition of Aggregate Uncorrected Misstatement: -As per SA 320, the aggregate of uncorrected misstatements comprises:</b></p> <ul style="list-style-type: none"> <li>• <b>Specific misstatements</b> identified by the auditor including the <b>net effect of uncorrected misstatements</b> identified during the audit of previous periods; and</li> <li>• The auditor’s <b>best estimate of other misstatements</b> which cannot be specifically identified (that is, projected errors).             <ul style="list-style-type: none"> <li>➤ The <b>analytical procedures</b> employed by the auditor <b>may give him some indication</b> about the <b>existence of misstatements</b>, which can be further substantiated by him through estimates process.</li> <li>➤ <b>When an auditor uses audit sampling</b> to test an account balance or class of transactions, he projects the <b>amount of known misstatements</b> identified by him in his sample to the items in the balance or class from which his sample was selected.</li> <li>➤ <b>That projected misstatement, along with the results of other substantive tests, contributes to the auditor’s assessment of aggregate misstatement in the balance or class.</b></li> </ul> </li> </ul> <p><b>(iii) Impact of Misstatements &amp; Assessment of Materiality:</b></p>

- If the aggregate of the **uncorrected misstatements** that the auditor has identified approaches the materiality level, or **if auditor determines** that the aggregate of **uncorrected misstatements** causes the financial information to be materially misstated, he should **consider requesting the management to adjust the financial information** or **extending his audit procedures**.

**(iv) Reporting**

- **If the management refuses** to adjust the financial information and the results of **extended audit procedures** do not enable the auditor to conclude that the aggregate of **uncorrected misstatements is not material**, the auditor should express a **qualified or adverse opinion**, as appropriate.

## SA-500 Audit Evidence

**87. Assessing the Reliability of Audit Evidence**

Discuss the principles, which are useful in assessing the reliability of audit evidence.

**Ans.**



- (i) As per SA 500 "Audit Evidence"** the **reliability of information** to be used as **audit evidence**, and therefore of the audit evidence itself, is **influenced by its source** and its **nature**, and the **circumstances** under which it is obtained.
- (ii) While recognising that exceptions** may exist, the **following generalisations about the reliability of audit evidence** may be useful:
- The reliability of audit evidence is increased when it is obtained from **independent sources outside the entity**.
  - The reliability of audit evidence that is **generated internally is increased when the related controls**, including those over its preparation and maintenance, imposed by the entity are effective.
  - Audit evidence **obtained directly by the auditor** (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
  - Audit evidence in **documentary form**, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
  - Audit evidence provided by **original documents** is more reliable than audit evidence provided by photocopies or facsimiles.

**88. Meaning of SAAE**

What do you mean by the term 'Sufficient Appropriate Audit Evidence'? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence.

**Ans.**



Accordingly to **SA 500 on 'Audit Evidence'** sufficiency and appropriateness of audit evidence are **interrelated**.

**Sufficiency**

- It is the **measure of the quantity** of audit evidence. The quantity of audit evidence needed is affected by the **auditor's assessment of the risks of misstatement** (the **higher the assessed risks**, the **more audit evidence** is likely to be required), and
- **Also by the quality of such audit evidence** (the **higher the quality**, the **less** may be required). Obtaining more audit evidence, however, may not compensate **for its poor quality**.

**Appropriateness**

- It is the **measure of the quality of audit evidence**; that is, its **relevance and its reliability** in providing **support for the conclusions** on which the **auditor's opinion is based**.
- The reliability of evidence is **influenced by its source** and by its nature, and is dependent on the individual circumstances under which it is obtained including controls over its preparation.



SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.

- Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment.
- In general the various factors which may influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under:
  - Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.
  - The materiality of the item.
  - The experience gained during previous audits.
  - The results of auditing procedures, including fraud and errors which may have been found.
  - The type of information available.
  - The trend indicated by accounting ratios and analysis.

**89. Substantive Procedures**  
Write short notes on Substantive Procedures. What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure?

**Ans.**



- These procedures are **audit tests designed to obtain evidence** to verify balance of an account or a specific **financial statement assertion** i.e. they test the **validity and propriety** of the accounting treatment of the transaction.
- They can be classified as either test of details of transactions and balances or as analytical review procedures.
- They provide assurance to the auditor in respect of the following assertions-
  - **Existence** - The **asset or a liability should exist** at a given date.
  - **Rights and obligations**- The asset should be **owned by the entity** and the **liability is an obligation of the entity** at a given date.
  - **Occurrence** - that a transaction or event took place which pertains to the entity.
  - **Completeness** - There should not be any **unrecorded assets, liabilities or transactions**.
  - **Valuation** -Assets or liabilities should be **recorded at appropriate carrying values**.
  - **Transaction or event** that took place should pertain to the entity during the **relevant period**.
  - **Measurement**-Transaction should be recorded in the **proper amount and revenue or expense** should be allocated to the proper period.
  - **Presentation & disclosure** - Various items should be **disclosed, classified, and described** in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

**90. Assessing the Reliability of Audit Evidence:**  
The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, vouchers and other records which were taken away by the Income Tax Department in search under section 132 of the I.T. Act, 1961. Comment.

**Ans.**



- (i) As per SA 500 "Audit Evidence" the **reliability of information** to be used as **audit evidence**, and therefore of the audit evidence itself, is **influenced by its source** and its **nature**, and the **circumstances** under which it is obtained.
- (ii) **While recognising that exceptions** may exist, the **following generalisations about the reliability of audit evidence** may be useful:

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

**(iii) Applying the above facts:**

- The **degree of reliance** which can be placed by the auditor on the **documentary audit evidence** available in the present case will be considerably increased **if the Xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department**.
- **If the tax authorities refuse to certify the same**, the auditor should get the **certificate to this effect** from the **management of the company**.

**(iv) Audit Procedure:**

- The auditor should use procedure **like confirmation of balances from third parties, inspection of tangible assets, etc.** and obtain evidence which corroborates the documentary evidence available.
- **In any case, the auditor has to satisfy himself** that he has obtained **sufficient and appropriate audit evidence** to support the figures contained in the financial statements and **formulate his opinion** accordingly.

**(v) Reporting**

- Under such circumstances, the auditor should have **appropriately modified his report** and bring this fact to the **attention of shareholders**.
- **In case he was satisfied**, a simple paragraph of information was enough
- But in case the auditor failed to establish the **reliability of evidence available**, he would be required to a **disclaimer of opinion**.

**91. Using the Work of Management's Expert**  
 While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer.

**Ans.**



- The Auditor while considering **advances granted by bank** for purchase of machinery has to consider **valuation report** given by civil engineer to the bank.
- **SA 500 "Audit Evidence"** clearly states that **when information to be used** as audit evidence has been prepared using the **work of a management's expert**, the auditor shall, to the extent necessary, having regard to the **significance of that expert's work** for the auditor's purposes,
  - Evaluate the **competence, capabilities and objectivity** of that expert;
  - Obtain an **understanding of the work** of that expert; and
  - Evaluate the **appropriateness of that expert's work** as audit evidence for the relevant assertion.
- **In the given case:** It is clear from the **facts of the question** that the **civil engineer is not an expert competent** for valuation of machinery.

- **Conclusion:** -if auditor concludes that **civil engineer cannot be considered expert** for valuation of machinery, he should **revert to other audit procedures** like **analytical procedures** to confirm value of machinery. **Even after this**, if he is not satisfied, **he should give qualified opinion**.

**92. Using the Work of Management Expert**

Gap Ltd. possesses some investment for which there is no ready market and to assess its fair market value it hires an expert, the result of which it can use in preparing its financial statement. Being an Auditor of the Company, state the matters which may affect the nature, timing and extent of audit procedure to be adopted by you in the instant case. **(May-2018-Old)**

**Ans.**


- (i) **As per SA 500 "Audit Evidence"** if any information is prepared by the entity **using the work of management expert** and auditor has to consider that **information as audit evidence**, he is required to **evaluate the competence, capability and objectivity of that expert**.
- (ii) **Matters which may affect nature, timing and extent of audit procedures in such a case are:**
- The **nature and complexity of the matter** to which the management's expert relates.
  - The **risks of material misstatement** in the matter.
  - The **availability of alternative sources** of audit evidence.
  - The **nature, scope and objectives** of the management's expert's work.
  - Whether the management's expert is **employed by the entity**, or **is a party engaged by it** to provide relevant services.
  - The **extent to which management can exercise control or influence** over the work of the management's expert.
  - Whether the management's expert is subject to **technical performance standards** or **other professional or industry requirements**.
  - The **nature and extent of any controls** within the entity over the management's expert's work.
  - The **auditor's knowledge and experience** of the management's expert's field of expertise.
  - The **auditor's previous experience** of the work of that expert.

**93. Evaluating the Work of Management's Expert**

PDJ Ltd. has engaged an actuary to ascertain actuarial valuation of defined benefit obligations viz. Gratuity and Leave Encashment liabilities. As an auditor of PDJ Ltd. you would like to use the report of the actuary as audit evidence. How would you evaluate the work of the actuary? **(Jan-2021-New)**

**OR**

CA. Pointer had been appointed as an Auditor of Textile Ltd. During the course of audit, it was observed that inventory including work-in-process has been valued by the Management by using experts hired by them. Analyse relevant factors to decide as to whether CA. Pointer should accept or not accept the findings from the work of Management expert in valuation of inventories. **(MTP-Nov-2020)**

**OR**

CA. Needle had been appointed as an auditor of M/s Fabric Ltd. in the course of audit, it had been observed that inventory including work-in-process had been valued by management by using experts hired by them. Analyse relevant factors to decide as to whether or not to accept the findings from the work of management expert in valuation of inventories. **(May-2018-New)**

**OR**

Y Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as an audit evidence. How do you evaluate the work of the actuary? **(May-2016)**

- Ans.**
- As per **SA 500 "Audit Evidence"**, when information to be used as **audit evidence** has been prepared using the **work of a management's expert**, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes-



- (1) Evaluate the **competence, capabilities and objectivity** of that expert;
  - (2) Obtain an understanding of the **work of that expert**; and
  - (3) Evaluate the **appropriateness of that expert's work** as audit evidence for the relevant assertion.
- The auditor may obtain information regarding the **competence, capabilities and objectivity** of a management's expert from a **variety of sources**, such as personal experience with **previous work of that expert**; **discussions with that expert**; discussions with others who are familiar with that expert's work; **knowledge of that expert's qualifications**; **published papers or books written by that expert**.
  - **Aspects of the management's expert's field** relevant to the auditor's understanding may include what **assumptions and methods** are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
  - The auditor may also consider the following while **evaluating the appropriateness of the management's expert's work** as audit evidence for the relevant assertion:
    - (i) The **relevance and reasonableness** of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
    - (ii) If that expert's work involves **use of significant assumptions and methods**, the **relevance and reasonableness** of those assumptions and methods; and
    - (iii) If that expert's work involves **significant use of source data**, the **relevance, completeness, and accuracy** of that source data.

#### 94. Using the Work of Management's Expert

As a Statutory Auditor, how would you deal with the following cases:

M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures. As a Statutory Auditor, how would you deal in this situation?

Ans.



- (i) **SA 500 (Revised), "Audit Evidence"** states that the auditor has to **evaluate the work of management expert**, say, actuary, before adopting the same.
- (ii) **The work of management expert** is required to be evaluated in **terms of following**:
  - (a) **Relevance and reasonableness** of that expert **findings and conclusion**.
  - (b) **Relevance and reasonableness** of **assumptions and methods** used; and
  - (c) **Relevance, completeness and accuracy of source data**.
- (iii) This becomes more crucial since **M/s LNK's group gratuity scheme's** valuation by actuary shows **wide variation** compared to previous year's figures. There is no doubt that **appropriateness, reasonableness of assumptions** and methods used are the **responsibility of the expert**, but the auditor has to determine whether they are **reasonable based on the auditor's knowledge** of the client's business and result of his audit procedures.
- (iv) **In the present case**: -The auditor must verify the **reasonableness of assumptions** made and **methods adopted** by the actuary in the evaluation particularly with reference to **factors such as** rate of return on investments, retirement age, number and salary of employees, etc.
- (v) **Conclusion**: In view of provisions of SA 500 as discussed above, **the auditor has to satisfy himself** whether valuation done by the **actuary can be adopted**, otherwise **he may report on** his findings for wide variation.

#### 95. Using the Work of Management Expert

The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. Comment.

(MTP-May-2018)

Ans.



- (i) **SA 500 (Revised), "Audit Evidence"** states that the
- Auditor has to **evaluate the work of management expert**, say, actuary, before adopting the same.
  - The work of **management expert is required to be evaluated** in terms of following:
    - (a) **Relevance and reasonableness** of that **expert findings and conclusion**.
    - (b) **Relevance and reasonableness** of **assumptions and methods** used; and
    - (c) **Relevance, completeness and accuracy** of source data.
  - There is no doubt that **appropriateness, reasonableness of assumptions and methods** used are the **responsibility of the expert**, but the auditor has to determine whether **they are reasonable based on the auditor's knowledge** of the client's business and result of his audit procedures.
- (ii) **In the instant case -a qualified actuary** has issued a certificate for **gratuity liability valuation**, for which retirement age adopted is **65 years** against the **existing retirement age of 60 years**; however, the company is considering a **proposal to increase** the retirement age.
- (iii) **Conclusion:**
- **In view of provisions of SA 500** as discussed above, the assumption made by **actuary has no relevance and reasonableness** as presently retiring age is of 60 years.
  - Hence the auditor is required to **bring out the facts to the notice of management** and **advise the modification** accordingly. In case of **failure of compliance** of the same the auditor may **qualify the report**.

96.

**Internal Evidence & External Evidence**

Distinguish between internal evidence and external evidence.

Ans.



- (i) **Internal evidence**
- Evidence which **originates within the organization** being audited is internal evidence.
  - **Example** - sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.
- (ii) **External evidence:** -
- On the other hand is the evidence that **originates outside the client's organization**;
  - **For example** - **purchase invoice, supplier's challan** and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.
- (iii) **In an audit situation-relevance & reliability**
- The bulk of evidence that an auditor gets is **internal in nature**. However, **substantial external evidence** is also available to the auditor.
  - **Since in the origination of internal evidence**, the client and his staff have the control, the auditor should be **careful in putting reliance** on such evidence.
  - **It is not suggested that they are to be suspected**; but an auditor has to be alive to the **possibilities of manipulation** and creation of false and misleading evidence to suit the client or his staff.
  - The external evidence is generally considered to be **more reliable** as they come from **third parties** who are not normally interested in manipulation of the accounting information of others.
  - However, if the auditor has **any reason to doubt the independence** of any third party who has provided any material evidence **e.g., an invoice of an associated concern**, he should exercise greater vigilance in that matter.
  - As an ordinary rule the auditor should **try to match internal and external evidence** as far as practicable. Where external evidence is **not readily available** to match, the auditor should see to **what extent the various internal evidence corroborate each other**.

97.

**Inquiry**

During the course of audit of a Limited company, the statutory auditors collected written representations from the Management. The audit was finalized to addition to other audit procedures but, without making any



inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence. **(July-2021-Old)**

**Ans.**



**Inquiry: As per SA 500 Audit Evidence:**

1. Inquiry consists of **seeking information of knowledgeable persons, financial and nonfinancial, within the entity or outside the entity**. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
2. **Responses to inquiries** may provide the auditor with **information not previously possessed or with corroborative audit evidence**. Alternatively, responses might provide information that **differs significantly** from other information that the auditor has obtained, **for example**, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.
3. Although **corroboration of evidence** obtained through inquiry is often of particular importance, in the case of **inquiries about management intent**, the information available to **support management's intent** may be limited. In these cases, understanding management's **past history** of carrying out its stated intentions, management's **stated reasons** for choosing a particular course of action, and **management's ability to pursue** a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.
4. **In respect of some matters**, the auditor may consider it necessary to **obtain written representations from management** and, where appropriate, **those charged with governance** to confirm responses to oral inquiries.

**SA-501**

### Audit Evidence - Specific Considerations for Selected Items

**98.**

**Impracticable to Attend Physical Inventory Count**

Coccyx Ltd. supplies navy uniforms across the country. The Company has 3 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. Coccyx Ltd. appointed M/s OPAQE & Co. to conduct its audit for the financial year 2021-22. Mr. P, partner of M/s OPAQE & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

**You are required to advise M/s OPAQE & Co.,**

- (I) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?
- (II) How is an auditor supposed to deal when attendance at physical inventory counting is impracticable?

**(RTP-May-2021),(May-2018-Old),(RTP-May-2018)**

**Ans.**



**(i) Special Consideration with Regard to Inventory:** As per SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain **sufficient appropriate audit evidence** regarding the **existence and condition** of inventory by:

- (a) **Attendance at physical inventory counting**, unless impracticable, to:
  - Evaluate **management's instructions and procedures** for recording and controlling the results of the entity's physical inventory counting;
  - **Observe the performance** of management's count procedures;
  - **Inspect the inventory**; and
  - **Perform test counts**; and
- (b) **Performing audit procedures** over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

**(ii) Attendance at Physical Inventory Counting Not Practicable:**

- **In some cases:** - Attendance at physical inventory **counting may be impracticable**. This may be due to **factors such as the nature and location** of the inventory,
- **For example:** - Where inventory is held in a location that **may pose threats to the safety** of the auditor. The matter of **general inconvenience** to the auditor, however, is **not sufficient to support a decision** by the auditor that attendance is impracticable.
- **As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing":** The matter of **difficulty, time, or cost involved** is not in itself a valid basis for the auditor to **omit an audit procedure** for which there is **no alternative** or to be satisfied with audit evidence that is **less than persuasive**.
- **Where attendance is impracticable:** - **Alternative audit procedures, for example**, inspection of documentation of the **subsequent sale of specific inventory** items acquired or purchased prior to the physical inventory counting, may provide **sufficient appropriate audit evidence** about the **existence and condition** of inventory.
- **Reporting:** -In some cases, though, **it may not be possible to obtain sufficient appropriate audit evidence** regarding the **existence and condition** of inventory by performing **alternative audit procedures**. In such cases, **SA 705 on Modifications to the Opinion in the Independent Auditor's Report**, requires the auditor to **modify the opinion** in the auditor's report as a result of the **scope limitation**.

99.

**Unable to Attend Physical Inventory Count**

RIM Private Ltd is engaged in the business of manufacturing of water bottles and is experiencing significant increase in turnover year on year. During the financial year ended 31st March 2022, the company carried out a detailed physical verification of its inventory and property, plant and equipment. You are the auditor of RIM Private Ltd. The inventory as at the end of the year was ₹ 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?

**(Study Material)(RTP-May-2020)****OR**

You are the auditor of Easy Communications Ltd. for the year 2021-22. The inventory as at the end of the year i.e. 31.3.22 was ₹ 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?

**Ans.**

- **SA 501 "Audit Evidence – Specific Considerations for Specific Items"**, requires from the auditor that when **inventory is material** to the financial statements, he shall obtain **sufficient appropriate audit evidence** regarding the **existence and condition** of inventory by attendance at **physical inventory counting, unless impracticable, to:**
  - **Evaluate management's instructions and procedures** for recording and controlling the results of the entity's physical inventory counting;
  - **Observe the performance** of management's count procedures;
  - **Inspect the inventory;** and
  - **Perform test counts.**
- **When unable to present at the physical inventory count:** -**SA 501 provides** that if the auditor is **unable to be present** at the **physical inventory count** on the date planned **due to unforeseen circumstances**, the auditor should take or **observe some physical counts** on an **alternative date** and perform audit procedures on **intervening transactions** to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded.
- The auditor would also verify the **procedure adopted and treatment given** for the discrepancies noticed during the physical count. The auditor would also ensure that **appropriate cut off procedures were followed** by the management.

- The auditor may also seek management's written representation on
  - the **completeness of information** provided regarding the inventory, and
  - **assurance with regard to adherence** to laid down procedures for physical inventory count.
- **Conclusion:** - By following the above procedure it will be ensured that the **physical verification conducted by the management was in order.**

100.

**Inventory under the Custody and Control of a Third Party**

Your firm has been appointed as the statutory auditors of GBM Private Limited for the financial year 2021-22. While verification of company's inventories as on 31st March 2022, you found that the significant amount of inventories belonging to the company are held by other parties. However, the company has kept all the records of the inventories maintained by other parties. What is your duty as an auditor in order to ensure that third parties are not such with whom the stock should not be held and the stock as disclosed in company's records actually belongs to them?

(RTP-Nov-2019)

Ans.



As per SA 501, "Audit Evidence—Specific Considerations for Selected Items" when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the **existence and condition** of that inventory by performing one or both of the following:

- (i) **Request confirmation from the third party** as to the **quantities and condition** of inventory held on behalf of the entity.
- (ii) **Perform inspection or other audit procedures** appropriate in the circumstances, **for example** where information is obtained that raises doubt about the **integrity and objectivity of the third party**, the auditor may consider it appropriate to **perform other audit procedures** instead of, or in addition to, confirmation with the third party.

**Examples of other audit procedures include:**

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

101.

**Inventory Counting at a Date other than the Date of the FSs**

Moon Ltd. is a dealer in electronic appliances. The Company has a centralised warehouse at the outskirts of Mumbai. The Auditors of the company M/s JK Associates normally attend the physical verification of stocks carried out by the Management at the end of the financial year. However, on account of certain disturbances in the region, the physical inventory counting could not be carried out at the year end. The stock taking is decided to be done by management at some other date subsequently, after a month. In the light of the above facts:

Enumerate the audit procedures to be considered by M/s JK Associates, if physical inventory counting is conducted at a date other than the date of the financial statements with reference to the relevant Standard on Auditing.

(Nov-2020-New)

Ans.



- (i) As per SA 501 "Audit Evidence- Specific Considerations for Selected Items"
  - When **inventory is material** to the financial statements, the auditor shall **obtain sufficient appropriate audit evidence** regarding the **existence and condition** of inventory.
  - **For practical reasons**, the physical inventory counting **may be conducted at a date, or dates, other than the date** of the financial statements.
  - (This may be done irrespective of **whether management determines** inventory quantities by an **annual physical inventory counting** or **maintains a perpetual inventory system**.)

- **(In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes.)**
- (ii) If physical inventory counting is conducted at a **date other than the date of the financial statements**, the auditor, JK Associates, **shall perform the following procedures:**
  - (A) Attendance at physical inventory counting, unless impracticable, to:**
    - Evaluate management's **instructions and procedures** for recording and controlling the results of the entity's physical inventory counting;
    - **Observe the performance** of management's count procedures;
    - **Inspect** the inventory; and
    - **Perform** test counts; and
  - (B) Performing audit procedures** over the entity's final inventory records to determine whether they accurately reflect **actual inventory count results**.
- (iii) **Additional Audit Procedure:**
  - In addition to above, auditor shall **also perform audit procedures to obtain audit evidence** about whether **changes in inventory** between the count date and the date of the financial statements are properly recorded.
  - **Relevant matters for consideration** when designing audit procedures to obtain audit evidence about whether changes in inventory amounts **between the count date, or dates, and the final inventory** records are properly recorded include:
    - Whether the perpetual inventory records are **properly adjusted**.
    - **Reliability** of the entity's perpetual inventory records.
    - **Reasons for significant differences** between the information obtained during the physical count and the perpetual inventory records.

102.

**Methods adopted by Management in determination of Segment Information**

GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing. **(Jan-2021-New)**

Ans.



- (i) The auditors, **GHK Associates wanted** to ensure and **obtain sufficient appropriate audit evidence** regarding the **presentation and disclosure of segment information** in accordance with the **applicable financial reporting framework** by obtaining an understanding of the **methods used by management** in determining segment information.
- (ii) **SA 501 guides in this regard: - As per SA 501- "Audit Evidence—Specific Considerations for Selected Items"**
  - **Example of matters** that may be relevant when **obtaining an understanding of the methods used by management** in determining segment information and
  - Whether **such methods** are likely to **result in disclosure** in accordance with the **applicable financial reporting framework** include:
    - (a) **Sales, transfers and charges** between segments, and elimination of inter-segment amounts.
    - (b) **Comparisons with budgets** and other expected results, for example, operating profits as a percentage of sales.
    - (c) The **allocation of assets and costs** among segments.
    - (d) **Consistency with prior periods**, and the adequacy of the disclosures with respect to inconsistencies



102A.

**Special Consideration with Regard to Inventory**

The Engagement Partner of the audit team of High Inventory Limited assessed that the inventory is material with respect to the audit of the financial statement for the current period. Upon inquiring with the management, the Engagement Partner identified that the management will be performing an annual physical inventory count at all the warehouses where the entity stores and maintains its inventory. Moreover, management confirmed in its written representation that they will be performing a 100% physical count of inventory for the current period. As a result, the engagement Partner decided not to perform any physical count of inventory as it will be a duplication of the work. Moreover, he decided that the written representation from management stating “the inventory exists and is in appropriate physical condition” will be sufficient and appropriate with respect to audit evidence to conclude that the inventory balance in the financial statement is free from any material misstatement. In the light of SA 501, evaluate whether the decision taken by the Engagement Partner is appropriate or not.

(MTP-Nov-2022)

Ans.



- (i) As per SA 501 “**Audit Evidence- Specific Considerations for Selected Items**”, when inventory is material to the financial statements, the auditor shall obtain **sufficient appropriate audit evidence** regarding the **existence and condition** of inventory by:
- (a) **Attendance at physical inventory counting**, unless impracticable, to:
- Evaluate **management’s instructions and procedures** for recording and controlling the results of the entity’s physical inventory counting;
  - **Observe the performance** of management’s count procedures;
  - **Inspect the inventory**; and
  - **Perform test counts**; and
- (b) **Performing audit procedures** over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.
- (ii) **Attendance at Physical Inventory Counting involves:**
- **Inspecting the inventory** to ascertain its existence and evaluate its condition and perform test counts.
  - **Observing compliance** with management’s instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
  - **Obtaining audit evidence** as to the reliability of management’s count procedures.
- (iii) **Reporting: - Hence in the given case**, the approach of Engagement Partner is **not appropriate as when inventory is material** to the financial statements, the auditor shall **obtain sufficient appropriate audit evidence** regarding the **existence and condition** of inventory. This should be done by **performing various audit procedures** which also includes attending physical count, observing the count, inspecting the inventory and reperforming physical counts.

**SA -505**
**External Confirmations**

103.

**Reliability of External Confirmations(EC)**




Write short notes on Reliability of external confirmations.

Ans.



- (i) **As per SA 505 “External Confirmation”**
- The reliability of external confirmations **depends among other factors**, upon the application of appropriate procedures by the auditor in **designing the external confirmation request**, **performing the external confirmation procedures**, and **evaluating the results of the external confirmation procedures**.
- (ii) **The factors that affect the reliability of confirmations include:**
- The control which the auditor **exercises over confirmation request and responses**;
  - The **character of respondents** and
  - **Any restrictions** included in the response or **imposed by the management**



104.	<b>External Confirmations – Situations</b> Write short notes on situations where external confirmations can be used.
Ans. 	(i) <b>Bank balance</b> from bankers (ii) <b>Account receivable</b> balances (iii) <b>Inventories held by third parties</b> (iv) <b>Property title deeds</b> held by third parties (v) <b>Investments purchased</b> but delivery not taken (vi) <b>Loan</b> from lenders (vii) <b>Account payable</b> balances (viii) Long outstanding <b>share application money</b> .
105.	<b>External Confirmation as AP</b> External confirmation as audit procedure.
Ans. 	1. An <b>external confirmation represents</b> audit evidence obtained by the auditor as a <b>direct written response</b> to the auditor from a <b>third party</b> (the confirming party), in paper form, or by electronic or other medium. 2. External confirmation procedures <b>frequently are relevant</b> when addressing assertions associated with <b>certain account balances</b> and their elements. However, external confirmations <b>need not be restricted</b> to account balances only. 3. <b>For example:</b> - The auditor <b>may request confirmation</b> of the <b>terms of agreements</b> or <b>transactions an entity</b> has with third parties; the confirmation request may be designed to ask if <b>any modifications</b> have been made to the agreement and, if so, what the relevant details are. 4. <b>External confirmation procedures</b> also are used to obtain audit evidence about the <b>absence of certain conditions</b> , for example, the absence of a <b>“side agreement”</b> that may influence revenue recognition.
106.	<b>Management Refusal to allow Auditor to Send Confirmation Request</b> Never permit Limited refuses to allow you to get direct confirmation of the outstanding balances of trade receivables. You want to ensure on grounds of materiality that atleast outstanding above a threshold limit needs to be confirmed and reconciliation is to be carried out before finalizing the audit. If the Company does not relent, how will you respond? <span style="float: right;">(May-2018-New)</span> <p style="text-align: center;"><b>OR</b></p> The auditor of H Ltd. wanted to obtain confirmation from its trade payables. But the management made a request to the auditor not to seek confirmation from certain trade payables citing disputes. Can the auditor of H Ltd. accede to this request?
Ans. 	(i) <b>SA 505 “External Confirmations”</b> , establishes standards on the auditor’s <b>use of external confirmation</b> as a means of <b>obtaining audit evidence</b> . If the management <b>refuses to allow the auditor</b> to send a confirmation request, <b>the auditor shall:</b> <ul style="list-style-type: none"> <li>• <b>Inquire as to Management’s reasons</b> for the refusal, and seek audit evidence as to their <b>validity and reasonableness</b>,</li> <li>• Evaluate <b>the implications of management’s refusal</b> on the auditor’s assessment of the relevant risks of material misstatement, <b>including the risk of fraud</b>, and on the nature, timing and extent of other audit procedures, and</li> <li>• Perform <b>alternative audit procedures</b> designed to obtain <b>relevant and reliable</b> audit evidence.</li> </ul> (ii) <b>As per SA-260-Communication with TCWG</b> <ul style="list-style-type: none"> <li>• If the auditor concludes that <b>management’s refusal to allow</b> the auditor to <b>send a confirmation request</b> is unreasonable or</li> <li>• The auditor <b>is unable to obtain relevant and reliable audit evidence</b> from alternative audit procedures, the auditor <b>shall communicate with TCWG</b> in accordance with <b>SA 260 “Communication with Those Charged with Governance”</b></li> </ul>

**(iii) Dispute:**

- The auditor may come across **certain situations in which the management may request him not to seek external confirmation** from certain parties because of some reasons,
- For example, **due to a dispute with the particular creditor or debtor.**

**(iv) Conclusion:** -If the auditor concludes that **management's refusal to allow the auditor to send a confirmation request** is unreasonable or the auditor is **unable to obtain relevant and reliable audit evidence** from alternative audit procedures, the auditor shall **communicate with TCWG** and also determine its **implication for the audit and his opinion.**

**107. Management Refusal to allow Auditor to Send Confirmation Request**

Your firm has been appointed as the statutory auditors of AGM Private Limited for the financial year 2021-22. While verification of company's trade receivables as on 31<sup>st</sup> March 2022, accountant of AGM Ltd. has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal in this situation? **(Study Material)(RTP-May-2020)**

**Ans.**


**SA 505 "External Confirmations"**, establishes standards on the auditor's **use of external confirmation** as a means of obtaining audit evidence. If the **management refuses** to allow the auditor to send a confirmation request, the auditor shall:

- Inquire as to **Management's reasons for the refusal**, and **seek audit evidence** as to their validity and reasonableness,
- Evaluate the **implications of management's refusal** on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and
- Perform **alternative audit procedures** designed to obtain relevant and reliable audit evidence.

If the auditor concludes that **management's refusal to allow the auditor** to send a confirmation request is **unreasonable** or the auditor is **unable to obtain relevant and reliable audit evidence** from alternative audit procedures, the auditor shall communicate with **those in charge of governance** and also determine its **implication** for the audit and his opinion.

**108. Confirmation Requests Design – Factors**

Mr. Z who is appointed as auditor of Elite Co. Ltd. wants to use confirmation request as audit evidence during the course of audit. What are the factors to be considered by Mr. Z when designing a confirmation request? Also state the effects of using positive external confirmation request by Mr. Z. **(Study Material)(May-2016)**



**Ans.**


As per **SA 505 "External Confirmations"** factors to consider when **designing confirmation requests** include

- Assertion** being addressed.
- Specific **identified ROMM**.
- Layout & presentation** of request.
- Prior experience** on the audit of similar engagements.
- Method of **communication**.
- Management **authorisation/encouragement** to Confirming Party to respond to auditor.
- Ability of Confirming Party to **provide/confirm** requested information.

**Effects of Positive Confirmation Requests:**

- A **positive external confirmation** request asks the confirming party **to reply to the auditor in all cases**, either by indicating the **confirming party's agreement** with the given information, or by **asking the confirming party** to provide information.
- A response to a **positive confirmation request** ordinarily is expected to provide **reliable audit evidence**.
- **There is a risk, however**, that a confirming party may reply to the confirmation request **without**

	<p>verifying that the information is correct.</p> <ul style="list-style-type: none"> <li>• <b>The auditor may reduce this risk</b> by using positive confirmation requests that <b>do not state the amount</b> (or other information) on the confirmation request, and <b>ask the confirming party</b> to fill in the <b>amount or furnish other information</b>.</li> <li>• <b>On the other hand</b>, use of this type of “<b>blank</b>” confirmation request may result in <b>lower response rates</b> because <b>additional effort</b> is required of the confirming parties.</li> </ul>
109.	<p><b>Use of Negative Confirmations</b></p> <p>M/s ABC &amp; Co. LLP are appointed auditors of Sharp Company Ltd. for the year ended 31<sup>st</sup> March. 2022. As part of the audit process. They want to use confirmation procedures as audit evidence during the course of audit. In view of the fact that positive confirmations are not responded favourably, the firm also intends to use negative confirmation requests. What are The factors to be considered for the same ? <b>(May-2019-Old)</b></p>
<b>Ans.</b> 	<p><b>Factors to be considered for Negative Confirmation requests:</b></p> <ul style="list-style-type: none"> <li>➤ As per <b>SA 505, “External Confirmation”</b>, Negative Confirmation is a request that the <b>confirming party respond directly to the auditor</b> only if the confirming party <b>disagrees with the information</b> provided in the request.</li> <li>➤ Negative confirmations provide <b>less persuasive audit evidence</b> than positive confirmations.</li> <li>➤ Accordingly, <b>the auditor shall use negative confirmation</b> requests as the sole substantive audit procedure <b>only when all of the following conditions are present:</b> <ol style="list-style-type: none"> <li>(a) <b>Low Risk of material misstatement</b> and auditor has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls.</li> <li>(b) The population comprises a <b>large number of small, homogeneous, account balances or transactions</b>.</li> <li>(c) A <b>very low exception rate</b> is expected.</li> <li>(d) The auditor is <b>not aware of circumstances</b> or conditions that would <b>cause recipients of negative confirmation</b> requests to disregard such requests.</li> </ol> </li> </ul>
110.	<p><b>Response to Negative Confirmation Request</b></p> <p>During the course of audit of Star Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables of small balances except one, old outstanding of ₹ 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing. <b>(Study Material)(RTP-May-2018)</b></p>
<b>Ans.</b> 	<ol style="list-style-type: none"> <li>(i) As per <b>SA 505, “External Confirmation”</b> <ul style="list-style-type: none"> <li>• Negative Confirmation is a request that the <b>confirming party respond directly to the auditor</b> only if the confirming party <b>disagrees with the information</b> provided in the request.</li> <li>• Negative confirmations provide <b>less persuasive audit evidence</b> than positive confirmations.</li> <li>• <b>In case of negative confirmation request</b>, confirming parties may be <b>more likely to respond</b> indicating their disagreement with a <b>confirmation request</b> when the information in the request is <b>not in their favor</b>, and <b>less likely</b> to respond otherwise.</li> </ul> </li> <li>(ii) <b>In the instant case:</b> - The auditor sent the negative confirmation <b>requesting the trade payables having outstanding balances</b> in the balance sheet while doing <b>audit of Star Limited</b>. One of the old outstanding of <b>rupees 15 lacs has not sent the confirmation</b> on the credit balance.</li> <li>(iii) Non-response for negative confirmation request <b>does not means that there is some misstatement</b> as negative confirmation request <b>itself is to respond to the auditor only if the confirming party disagrees</b> with the information provided in the request.</li> <li>(iv) <b>Further Audit Procedure:</b> -In the present case, <b>considering the materiality</b> of the account balance, the auditor may examine <b>subsequent cash disbursements</b> or correspondence <b>from third parties</b>, and other records, such as <b>goods received notes</b>.</li> </ol>

111.

**Auditor's Duties in case of Non-Availability of External Confirmation**

Moon Limited replaced its statutory auditor for the Financial year 2021-22. During the course of audit, the new auditor found a credit item of ₹ 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The trade payable had neither approached for the payment nor he is traceable. Under the circumstances no confirmation of the credit balance is available.

Ans.


**(i) SA 505 "External Confirmations" provides that:**

- If the auditor has determined that a **response to a positive confirmation** request is necessary to obtain **sufficient appropriate audit evidence**, and
- Alternative **audit procedures** will not provide the audit evidence the auditor requires, he should **determine the implications** for the audit and the **auditor's opinion** in accordance with **SA 705**.

**(ii) In the present case:** - The identities of **trade payables are not traceable** to confirm the credit balance as appearing in the financial statement of the company. It is also **not a case of pending litigation**. It might be a case that an **income of ₹ 5 lakhs** had been hidden in previous year/s.

**(iii) Audit Procedure:**

- The statutory auditor should examine the **validity of the credit balance** as appeared in the company's financial statements.
- He should **obtain sufficient evidence** in support of the balance.
- **He should apply alternative audit procedures** to get documentary proof for the transaction/s and should **not rely entirely on the management representation**.
- Finally, he should include the matter **by way of a qualification** in his audit report to the members.

112.

**External Confirmation Procedures be performed as SAP**

Mr. Agarwal, in the course of audit of PQ Limited, wants to perform external confirmation procedures to obtain audit evidence. Guide Mr. Agarwal, listing out the factors that may assist him in determining whether external confirmation procedures are to be performed as substantive audit procedures. **(Dec-2021-New)**

Ans.



**Factors that may assist Mr. Agarwal, the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:**

- (i) The confirming party's knowledge of the subject matter** – responses may be **more reliable if provided by a person** at the confirming party who has the requisite knowledge about the information being confirmed.
- (ii) The ability or willingness of the intended confirming party to respond** – for example, the **confirming party:**
- May not accept responsibility for responding to a **confirmation request**;
  - May consider responding too **costly or time consuming**;
  - May have concerns about the **potential legal liability** resulting from responding;
  - May account for transactions in **different currencies**; or
  - May operate in an environment where responding to confirmation requests is **not a significant aspect of day-to-day operations**.

**In such situations**, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

**(iii) The objectivity of the intended confirming party** – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

## SA-510

## Initial Audit Engagements-Opening Balances

113.

**Correctness of Opening Balances - Audit Procedure**

In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow, when financial statements are audited for the first time. If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances', what approach you will adopt in drafting your audit report?

(Study Material)(RTP-May-2018) (May-2015)

OR

In an initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Advise, the auditor about the audit procedures to be followed, when financial statements are audited for the first time. If, after performing the procedure, as an auditor you are not satisfied about the correctness of 'Opening Balances', what approach you will adopt in drafting your audit report?

(MTP-May-2018)(MTP-Nov-2019)

Ans.



- As per SA 510 "Initial Audit Engagements-Opening Balances", the auditor shall obtain **sufficient appropriate audit evidence** about whether the opening balances contain **misstatements that materially affect** the current period's financial statements by -
  - (i) Determining whether the **prior period's closing balances** have been **correctly brought forward** to the current period or, when appropriate, **any adjustments** have been disclosed as prior period items in the **current year's** Statement of Profit and Loss;
  - (ii) Determining whether the opening balances **reflect the application of appropriate accounting policies**; and
  - (iii) By evaluating whether **audit procedures performed** in the current period provide evidence relevant to the **opening balances**; or performing **specific audit procedures** to obtain evidence regarding the opening balances.
- **If the auditor obtains audit evidence** that the opening balances contain **misstatements** that could **materially affect the current period's financial statements**, the auditor shall perform **such additional audit procedures** as are appropriate in the circumstances to determine the effect on the current period's financial statements.
- **If the auditor concludes that such misstatements exist** in the current period's financial statements, the auditor shall **communicate the misstatements** with the appropriate level of **management and TCWG**.
- **Approach for drafting Audit Report:**
  - SA 705 **establishes requirements and provides guidance** on circumstances that may result in a **modification to the auditor's opinion** on the financial statements, the **type of opinion** appropriate in the circumstances, and the **content of the auditor's report** when the auditor's opinion is modified.
  - **The inability of the auditor** to obtain **sufficient appropriate** audit evidence regarding **opening balances** may result in **one of the following modifications** to the opinion in the auditor's report:
    - **A qualified opinion** or a **disclaimer of opinion**, as is appropriate in the circumstances; or
    - **Unless prohibited by law or regulation**, an opinion which is **qualified or disclaimed**, as appropriate, regarding the results of operations, and cash flows, where relevant, and unmodified regarding State of Affairs.



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

114.

**Initial Audit Engagement**

- (a) What are 'Initial Audit Engagements'?
- (b) In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases:
- (i) when the financial statements are audited for the preceding period by another auditor; and
- (ii) when financial statements are audited for the first time. **(RTP-May-2021)**
- (c) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances'; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above? **(RTP-May-2021)**

Ans.



- (a) As per SA 510 "Initial Audit Engagements - Opening Balances", initial audit engagement is an engagement in which **either**:
- The financial statements for the prior period **were not audited**; or
  - The financial statements for the prior period **were audited by a predecessor auditor**.
- (b) (i) **Financial Statements Audited by another Auditor – Audit Procedure:**
- The auditor may be able to obtain **SAAE** regarding the **Opening balances** by perusing the **copies of the audited FSs** including the **other relevant documents** relating to the prior period FSs **such as supporting schedules** to the audited financial statements.
  - Ordinarily, the **current auditor can place reliance** on the **closing balances** contained in the financial statements for the **preceding period**,
  - **Except when during the performance** of audit procedures for the current period the **possibility of misstatements** in opening balances is indicated.
- (ii) **Audit of Financial Statements for the First Time – Audit Procedure:**
- The auditor has to **perform auditing procedures** to obtain **SAAE**
  - Since **opening balances represent** effect of transaction and events of the **preceding period** and **accounting policies applied** in the preceding period.
  - The auditor need to obtain evidence having regard to **nature of opening balances**, materiality of the opening balances and accounting policies.
  - **Since it will not be possible for auditor to perform certain procedures**, e.g., observing physical verification of inventories, etc. the auditor **may obtain confirmation, etc.** and perform suitable procedures **in respect of fixed assets, investments, etc.**
  - The auditor **can also obtain management representation** with regards to the opening balances.
- (c) **Drafting Audit Report:**
- If the auditor is **unable to obtain SAAE** regarding the opening balances, the auditor shall express a **qualified opinion** or a **disclaimer of opinion**, as appropriate.
  - Further, If the auditor concludes that the **opening balances contain a misstatement** that materially affects the **current period's FSs**, and
  - The effect of the misstatement is **not properly accounted for** or **not adequately presented or disclosed**, the auditor shall express a **qualified opinion** or an **adverse opinion**.

115.

**Verification of Accounts Receivable**

CA. Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P) Ltd. for the financial year 2014 -15. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA. Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting ₹ 150 lakhs, continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA. Jack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment.

**(MTP-May-2020) (MTP-Nov-2019)**

Ans.



- **As per SA 510 “Initial Audit Engagements – Opening Balances”**, while conducting an **initial audit engagement**, the objective of the auditor with respect to **opening balances** is to obtain **sufficient appropriate audit evidence** about whether-
  - Opening balances contain **misstatements that materially affect** the current period’s financial statements; and
  - **Appropriate accounting policies reflected** in the opening balances have been **consistently applied** in the current period’s financial statements, or **changes thereto** are properly accounted for and **adequately presented** and disclosed in accordance with the applicable financial reporting framework.
- **When the financial statements for the preceding period were audited by another auditor**
  - The current auditor may be able to **obtain sufficient appropriate audit evidence** regarding **opening balances** by perusing the **copies of the audited FS**.
  - **Ordinarily, the current auditor can place reliance** on the closing balances contained in the financial statements for the preceding period, **except** when during the performance of audit procedures for the current period the **possibility of misstatements** in opening balances is indicated.
  - **For current assets and liabilities**, some audit evidence about opening balances may be obtained as part of the **current period’s audit procedures**, say, the collection of **opening accounts receivable** during the current period will provide **some audit evidence** of their **existence, rights and obligations, completeness and valuation** at the beginning of the period.
- **In addition, according to SA 580 “Written Representations”**
  - The auditor may consider it necessary to **request management to provide written representations** about **specific assertions** in the financial statements; in particular, to **support an understanding** that the auditor has obtained from other audit evidence of **management’s judgment or intent in relation** to, or the **completeness** of, a specific assertion.
  - Although such written representations provide necessary audit evidence, **they do not provide sufficient appropriate audit evidence** on their own for that assertion.
- **In the given case:** - The **management of Futura (P) Ltd.** has restrained **CA . Jack, its auditor**, from obtaining appropriate audit evidence for balances of **Accounts Receivable outstanding** as it is from the preceding year. CA . Jack, on believing that the preceding year balances have **already been audited** and on the statement of the **management** that there are **no receipts and credits during the current year**, therefore excluded the verification of Accounts Receivable from his audit programme.
- **Conclusion:** -Thus, CA. Jack **should have requested the management to provide written representation** for their views and expressions; and he should **also not exclude the audit procedure of closing balances of Accounts Receivable** from his audit programme. **Consequently, CA. Jack shall also be held guilty for professional misconduct** for not exercising due diligence, or grossly negligence in the conduct of his professional duties as per the Code of Ethics.

116.

#### **Correctness of Opening Balances - Audit Procedure**

You have been appointed as statutory auditor of M/s Moon Ltd. for the financial year 2021- 22. As the auditor of the Company you want to ensure that closing balances of previous year have been correctly brought forward as opening balances in the current year. State the audit procedures for the same to ensure that there is no misstatement.

**(Nov-2019-Old)**

OR

Comment on the following: You have been appointed as the auditor of Good Health Ltd. for 2021-22 which was audited by CA Trustworthy in 2020-21. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2020-21 have been brought to account in 2021-22 as Opening Balances and the Opening Balances do not contain misstatements.

(MTP-Nov-2018)(RTP-Nov2018)

Ans.



As per SA 510 "Initial Audit Engagements-Opening Balances"

- The auditor shall **read the most recent financial statements**, if any, and the **predecessor auditor's report** thereon, if any, for information relevant to opening balances, including disclosures.
- **The auditor shall obtain sufficient appropriate audit evidence** about whether the opening balances **contain misstatements that materially affect** the current period's financial statements by–
  - Determining whether the **prior period's closing balances** have been **correctly brought forward** to the current period or, when appropriate, **any adjustments have been disclosed as prior period items** in the current year's Statement of Profit and Loss;
  - Determining whether the **opening balances reflect** the application of **appropriate accounting policies**; and
  - **Performing one or more of the following:**
    - Where the **prior year financial statements were audited**, perusing the **copies of the audited financial statements** including the other relevant documents relating to the prior period financial statements;
    - Evaluating whether **audit procedures performed** in the current period provide **evidence relevant to the opening balances**; or
    - **Specific audit procedures**
- **Performing specific audit procedures** to obtain evidence regarding the **opening balances**. If the auditor obtains audit evidence that the **opening balances contain misstatements** that could **materially affect the current period's FSs**,
- The auditor shall perform **such additional audit procedures** as are appropriate in the circumstances to determine the **effect on the current period's FS**.
- **If the auditor concludes that such misstatements exist** in the current period's financial statements, the **auditor shall communicate** the misstatements with the **appropriate level of management and TCWG**.

Alternative Answer (as given in suggested answer)

- **Audit Procedure for ensuring correctness of Opening Balances:** As per SA 510 "Initial Audit Engagements—Opening Balances", if the prior period's financial statements were **audited by a predecessor auditor**, the auditor may be able to obtain **sufficient appropriate audit evidence** regarding the **opening balances by perusing the copies of the audited financial statements** including the **other relevant documents** relating to the **prior period financial statements** such as supporting schedules to the audited financial statements.
- Ordinarily, the current auditor can place **reliance on the closing balances** contained in the **financial statements** for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.
- For **current assets and liabilities**, some audit evidence about opening balances may be obtained as part of the **current period's audit procedures**. For example, the **collection (payment) of opening accounts receivable** (accounts payable) during the current period will provide some audit evidence of their **existence, rights and obligations, completeness and valuation** at the beginning of the period.
- **In the case of inventories**, however, the current period's audit procedures on the **closing inventory balance** provide little audit evidence regarding **inventory on hand at the beginning** of the period. **Therefore**, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a **current physical inventory count** and **reconciling** it to the opening inventory quantities.
- Performing audit procedures on the **valuation of the opening inventory** items.
- Performing audit procedures on **gross profit** and **cut-off**.
- **For non-current assets and liabilities**, such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances.
- **In certain cases**, the auditor may be able to obtain some audit evidence regarding **opening balances through confirmation with third parties, for example**, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

117.

**Initial Audit Engagement - Audit Procedures**

Mr. X has been appointed as an auditor of M/s ABC Ltd., Mr. X wants to be satisfied about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements. Lay down the audit procedure, Mr. X should follow, in the initial audit engagement of M/s ABC Ltd. Also suggest the approach to be followed regarding mention in the audit report if Mr. X is not satisfied about the correctness of 'Opening Balances'?

(Nov-2019-New)

Ans.



- **As per SA 510** the auditor shall obtain **sufficient appropriate audit evidence** about whether the **opening balances contain misstatements** that materially affect the current period's financial statements by:
  - Determining whether the **prior period's closing balances** have been **correctly brought forward** to the current period or, when appropriate, **any adjustments have been disclosed** as **prior period items** in the current year's Statement of Profit and Loss;
  - Determining whether the **opening balances reflect** the application of **appropriate accounting policies**; and
  - **Performing one or more of the following:**
    - Where the prior year financial statements were audited, **perusing the copies of the audited financial statements** including the other relevant documents relating to the prior period financial statements;
    - Evaluating whether **audit procedures performed** in the current period provide evidence relevant to the opening balances; or
- **Approach to be followed regarding mention in the Audit Report:**  
**Performing specific audit procedures** to obtain evidence regarding the **opening balances:**
  - If the auditor is **unable to obtain sufficient appropriate audit evidence** regarding the opening balances, the auditor shall **express a qualified opinion** or a **disclaimer of opinion**, as appropriate.
  - Further, **If the auditor concludes** that the opening balances **contain a misstatement that materially affects** the current period's financial statements, and the **effect of the misstatement is not properly accounted for or not adequately presented or disclosed**, the auditor shall **express a qualified opinion** or an **adverse opinion**.

**SA-520****Analytical Procedures**

118.

**Analytical Procedures - Meaning & Usefulness**

Explain, what do you mean by Analytical procedures. How such procedures are helpful in auditing?

Ans.

**(i) Meaning of Analytical Procedures**

- As per SA 520 the term "**analytical procedures**" means **evaluations of financial information through analysis of plausible relationships among both financial and non-financial data**.
- Analytical procedures also encompass such **investigation as is necessary of identified fluctuations or relationships that are inconsistent** with other relevant information or that differ from expected values by a significant amount.



- The auditor's choice of **procedures, methods and level of application** is a matter of **professional judgment**.
- Analytical procedures include the **consideration of comparisons** of the entity's financial information with, **For example**:
  - comparable information for **prior periods**,
  - **anticipated results** of the entity, such as **budgets or forecasts**, or expectations of the auditor, such as an estimation of depreciation and
  - **similar industry information**, such as a comparison of the entity's **ratio of sales to accounts receivable** with industry averages or with other **entities of comparable size** in the same industry.
- Analytical procedures also include **consideration of relationships**, for example: among elements of **financial information** that would be expected to **conform to a predictable pattern** based on the **entity's experience**, such as **gross margin percentages** and between **financial information** and **relevant non-financial information**, such as payroll costs to number of employees.
- **Various methods may be used to perform analytical procedures.**
  - These methods range from performing **simple comparisons** to performing **complex analyses using advanced statistical techniques**.
  - Analytical procedures may be applied to **consolidated financial statements**, components and individual elements of information.

**(ii) Analytical procedures are used for the following purposes:**

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

**119. Analytical Procedures - Auditor's Considerations**

What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?



**Ans.**



As per "**SA 520 (Revised) Analytical Procedure**" when the auditor intends to **perform analytical procedures** on data prepared by the client, **he should consider the following**:

- (i) **Determine the suitability of particular substantive analytical procedures**
  - For given assertions, taking account of the **assessed risks of material misstatement** and **tests of details**, if any, for these assertions;
- (ii) **Evaluate the reliability of data**
  - From which the **auditor's expectation** of recorded amounts or ratios is developed, taking account of **source, comparability, and nature and relevance** of information available, and controls over preparation;
- (iii) **Develop an expectation of recorded amounts or ratios**
  - evaluate whether the **expectation is sufficiently precise** to identify a **misstatement** that, individually or when aggregated with other misstatements, **may cause the financial statements to be materially misstated**; and
- (iv) **Determine the amount of any difference of recorded amounts**
  - From expected values that is **acceptable without further investigation** and **if analytical procedures performed** in accordance with this SA **identify fluctuations or relationships** that are inconsistent with **other relevant information** or that differ from expected values by a significant amount, **the auditor shall investigate such differences by**:
    - **Inquiring of management** and obtaining appropriate audit evidence relevant to management's responses; and
    - **Performing other audit procedures** as necessary in the circumstances.



120.	<p><b>Relevant Criteria for Determining Reliability of Data</b></p> <p>The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, what are the relevant criteria which determine whether the data is reliable for the purposes of designing substantive analytical procedures? <b>(Nov- 2015)</b></p> <p style="text-align: center;"><b>OR</b></p> <p><b>Write short notes on:</b> Relevant Criteria for determining Reliability of Data as per SA 520 'Analytical Procedures'</p>
Ans. 	<p>(i) <b>SA 520 on 'Analytical Procedures'</b> provides that the reliability of data is <b>influenced by its source and nature</b> and is dependent on the <b>circumstances</b> under which it is obtained.</p> <p>(ii) Accordingly, <b>the following are relevant criteria</b> when determining whether <b>data is reliable for purposes of designing</b> substantive analytical procedures-</p> <ul style="list-style-type: none"> <li>• <b>Source of the information available.</b>  <b>For example</b>, information may be more reliable when it is obtained from <b>independent sources</b> outside the entity;</li> <li>• <b>Comparability of the information available.</b>  <b>For example</b>, <b>broad industry data</b> may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;</li> <li>• <b>Nature and relevance of the information available.</b>  <b>For example</b>, whether <b>budgets</b> have been established as results to be expected rather than <b>as goals to be achieved</b>; and</li> <li>• <b>Controls over the preparation of the information</b>        That are designed to ensure its <b>completeness, accuracy and validity</b>. <b>For example</b>, controls over the <b>preparation, review and maintenance</b> of budgets.</li> </ul>
121.	<p><b>Investigating Results of Analytical Procedures</b></p> <p>In audit of DEF Limited, the Auditor had made use of certain analytical procedures with regard to certain key data in the Statement of Profit and Loss. The results obtained showed inconsistencies with other relevant information. State the course of action that the Auditor should take to ensure that the risk of material misstatement would be contained to a low level fixed as per materiality level. <b>(Nov-2018-New)</b></p>
Ans. 	<ul style="list-style-type: none"> <li>• <b>As per SA 520, "Analytical Procedures"</b>, if analytical procedures performed in accordance with this SA <b>identify fluctuations or relationships</b> that are <b>inconsistent with other relevant information</b> or that <b>differ from expected values</b> by a significant amount,</li> <li>• The auditor <b>shall investigate such differences by:</b> <ul style="list-style-type: none"> <li>➤ <b>Inquiring of management</b> and obtaining <b>appropriate audit evidence</b> relevant to management's responses; and</li> <li>➤ <b>Performing other audit procedures</b> as necessary in the circumstances.</li> </ul> </li> <li>• <b>Audit evidence relevant to management's responses</b> may be obtained by evaluating those responses <b>taking into account the auditor's understanding</b> of the entity and <b>its environment</b>, and <b>with other audit evidence</b> obtained during the course of the audit.</li> <li>• <b>The need to perform other audit procedures</b> may arise when,  <b>For example</b>, management is <b>unable to provide an explanation</b>, or the <b>explanation</b>, together with the <b>audit evidence obtained</b> relevant to management's response, <b>is not considered adequate</b>.</li> </ul>
122.	<p><b>Analytical Procedures as Substantive Procedures</b></p> <p>You have been appointed as an auditor of M/s Excellent Hotels Ltd. As a senior partner, you want to use analytical procedures in respect of room rentals as well as payroll expenses. Discuss. <b>(May-2019-Old)</b></p> <p style="text-align: center;"><b>OR</b></p> <p>In the audit of Hotel Great Stay Ltd., its auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as payroll costs. Guide him as to how it can be done.</p>

Ans.


 (i) **Analytical Procedures:**

- SA 520 “Analytical Procedures” deals with the **auditor’s use of analytical procedures** as **substantive procedures** and as procedures near the **end of the audit** that assist the auditor when **forming an overall conclusion** on the financial statements.
- in some cases, even an **unsophisticated predictive model may be effective** as an analytical procedure.

 (ii) **Analytical Procedures in case of Payroll cost:**

- Where an entity has a **known number of employees** at **fixed rates of pay** throughout the period, it may be possible for the **auditor to use this data** to estimate the **total payroll costs for the period** with a **high degree of accuracy**,
- Thereby providing **audit evidence for a significant item** in the financial statements and **reducing the need to perform tests of details** on the payroll.

 (iii) **Analytical Procedures in case of Room Rental Income of Hotel-**

- Different **types of analytical procedures** provide **different levels of assurance**.
- **Analytical procedures** involving the prediction of **total rental income** in case of Hotel taking the **room tariff rates, the number of rooms** and **vacancy rates** into consideration, can provide **persuasive evidence** and may eliminate the need for **further verification** by means of **tests of details**, provided the elements are appropriately verified.

123.

**Analytical Procedures for Verification of Inventories**

State the different types of Analytical Review carried out in verification of inventories.

Ans.


 The auditor can adopt the **following analytical procedures** to verify the inventory of inventories-

- **Quantitative reconciliation** of opening inventories, purchases, production, sales and closing inventories;
- **Comparison of closing inventory** quantities and amounts with those of the previous year.
- **Comparison of the inventory turnover ratios** for the current year with that of the previous year and with industry standards if available.
- **Comparison of the closing inventory** (Raw materials, closing work-in-progress and finished goods are percentage of total inventories) with the **corresponding figures** of the previous year.
- **Comparison** of current year **gross profit ratio** of the previous year.
- **Comparison of actual inventory, purchase and sales figures** with the **budgeted figures** if available.
- **Comparison of raw-material yield/wastage** with previous year figures.

## SA-530

### Audit Sampling

124.

**Risk Factors while applying Sampling Techniques**

Write short note on: Sampling Risk.

OR

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

Ans.


 (i) **As per SA 530 “Audit Sampling”**

- Sampling risk is **the risk that the auditor’s conclusion** based on a sample may be **different from the conclusion** if the entire population were **subjected to the same audit procedure**.

 (ii) **Sampling risk can lead to two types of erroneous conclusions-**

- **Controls are more effective than they actually are**

- **In the case of a test of controls**, that controls are **more effective than they actually are**, or in the case of tests of details, that a **material misstatement does not exist** when in fact it does.
- The auditor is **primarily concerned with this type of erroneous conclusion** because it affects **audit effectiveness** and is more likely to lead to an **inappropriate audit opinion**.
- Controls are **less effective than they actually are**
  - **In the case of test of controls**, the controls are **less effective than they actually are**, or in the case of tests of details, that a **material misstatement exists** when in fact it does not.
  - This type of erroneous conclusion **affects audit efficiency** as it would usually lead to **additional work** to establish that **initial conclusions were incorrect**.

125.

**Meaning of Audit Sampling, Sample Design, Sample Size and Selection of Items for Testing**

As per SA 530, requirements of audit sampling, sample design, sample size and selection of items for testing.

(MAY-2016)( May-2018)

Ans.

**(i) Audit Sampling**

- “Audit Sampling” means the **application of audit procedures to less than 100% of items** within a population of audit relevance such that **all sampling units have a chance of selection** in order to provide the auditor with a **reasonable basis** on which to **draw conclusions** about the entire population.

**(ii) According to the said SA, requirements relating to Sample design, sample size and selection of items for testing are explained below-**

- **Sample Design** - When designing an audit sample, the auditor shall consider the **purpose of the audit procedure** and the **characteristics of the population** from which the sample will be drawn.
- **Sample Size** - The auditor shall determine a sample size **sufficient to reduce sampling risk** to an acceptably low level.
- **Selection of Items for Testing** - The auditor shall select items for the sample in such a way that **each sampling unit in the population has a chance of selection**.

126.

**Statistical and Non-statistical Sampling**

Write short notes on Statistical and Non -Statistical Sampling.



Ans.

**(i) Audit Sampling**

- “Audit Sampling” means the **application of audit procedures to less than 100% of items** within a population of audit relevance such that **all sampling units have a chance of selection** in order to provide the auditor with a **reasonable basis** on which to **draw conclusions** about the entire population.

**(ii) As per SA 530, “Audit Sampling”, the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.****(iii) There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.**

- **Statistical sampling:**
  - This is a method of audit testing which is **more scientific than testing based** entirely on the auditor’s own judgment because it **involves use of mathematical laws of probability** in determining the appropriate sample size in varying circumstances.
  - **Statistical sampling** has reasonably **wide application** where a population to be **tested consists of a large number of similar items** and more in the case of **transactions involving compliance testing, trade receivables’ confirmation, payroll checking, vouching of invoices and petty cash vouchers**.
- **Non-statistical sampling:**

	<ul style="list-style-type: none"> <li>➤ Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor.</li> <li>➤ This method has been in common application for many years because of its simplicity in operation.</li> <li>➤ Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked.</li> <li>➤ For example, March, June &amp; September may be selected in year one and different months would be selected in the next year.</li> <li>➤ An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.</li> </ul>
127.	<b>Advantages of Statistical Sampling</b> Write short notes on the advantages of statistical sampling in auditing.
Ans. 	The advantages of using statistical sampling technique in auditing are- <ul style="list-style-type: none"> <li>• Sample size does not increase in proportion to the increase in the size of population.</li> <li>• Sample selection is more objective and based on law of probability.</li> <li>• This provides a means of estimating the minimum sample size associated with a specified risk and precision level.</li> <li>• It also provides a means for deriving a calculated risk and corresponding precision.</li> <li>• It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistake are not large.</li> </ul>
128.	<b>Selection of Samples on Random Basis</b> "In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed". Comment.
Ans. 	(a) <b>Audit Sampling</b> means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population. (b) <b>The audit sample collection on a random basis</b> ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. (c) <b>This method is considered appropriate</b> , provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. (d) Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample. In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. (e) However, certain methods such as <b>Haphazard Sampling</b> and <b>Block Sampling</b> may result in selection of a sample which is not free from bias. <b>Conclusion:</b> -Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.
129.	<b>Characteristics of Sampling Errors</b> "An auditor while analysing the errors in a sample need not consider the qualitative aspects of errors detected." Please comment.
Ans.	(i) <b>SA 530, "Audit Sampling"</b> , requires that while evaluating sample results, the auditor should : <ul style="list-style-type: none"> <li>• Analyse any errors detected in the samples having regard to appropriateness of the audit objective</li> </ul>



- An **auditor while evaluating the errors** detected in a sample selected by him should analyse the **nature of the errors, the projected errors** in the total population **and the sampling risk** attached to it.
- While **designing an audit sample**, the auditor would also need to **define the conditions** that constitute the **error keeping in view** the audit objectives.

(ii) **The auditor also need to consider the qualitative aspects of the errors detected by him**

- This will include the **nature and reasons for the error and its possible effect on other phases**.
- In case a repetitive **pattern emerges** from such analysis, **for example, type of transaction, location, product line** or period of time, the auditor would **need to identify all items in the population**, which contain such errors, resulting in a total population.
- The auditor would then **need to carry out a separate analysis** based on the examination carried out by him for each such sub -population.

(iii) **Conclusion:** -Accordingly, the auditor **cannot be satisfied by detecting errors only** but **also would need to consider the qualitative aspects** of such errors.

130.

**Stratified Sampling**

Write short note on stratified sampling.

Ans.



- This method involves **dividing the whole population to be tested in a few separate groups** called strata and taking a sample from each of them.
- Each **stratum is treated as if it was a separate population** and if proportionate of items are **selected from each of these stratum**.
- The **number of groups** into which the whole population has to be divided is **determined on the basis of auditor judgment**.
- **The reason behind the stratified sampling** is that for a **highly diversified population**, weights should be allocated to reflect these differences.
- This is achieved by **selecting different proportions from each strata**. It can be seen that the stratified sampling is **simply an extension of simple random sampling**.

130A.

**Audit Sampling**

Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2021 - 2022. Chintan & Mani seem to have different opinions on Audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population. Chintan is concerned that whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530. **(RTP-Nov-2022)**

Ans.



(a) **As per SA 530, "Audit Sampling", the auditor shall evaluate:**

- The **results of the sample**; and
- Whether the use of **audit sampling** has provided a **reasonable basis** for conclusions about the population that has been tested.

(b) If the auditor concludes that **audit sampling** has not provided a **reasonable basis for conclusions** about the population that has been tested, **the auditor may:**

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



**SA-540**
**Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures**
**131.**
**Evaluation of Financial Statement Assertions**

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

(Study Material)

**OR**

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

(MTP-May-2021)

**Ans.**


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

- The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
- How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
- The estimation making process adopted by the management including-
  - The method, including where applicable the model, used in making the accounting estimates.
  - Relevant controls.
  - Whether management has used an expert?
  - The assumption underlying the accounting estimates.
  - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
  - Whether and, if so, how the management has assessed the effect of estimation uncertainty.

**132.**
**Accounting Estimates – Meaning & Examples**

What are accounting estimates according to the Standards on Auditing 540? Give examples.

**OR**

“Accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement”. Discuss explaining the accounting estimates according to SA-540.

**Ans.**


As per SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure”

**(i) Meaning of term Accounting Estimates**

- This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.
- SA 540 addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.
- Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item.

- **Some financial reporting frameworks prescribe** specific methods of measurement and the disclosures that are required to be **made in the financial statements**, while other financial reporting frameworks are **less specific**.

**(ii) Examples of Accounting Estimates**

- a) Some accounting estimates involve relatively **low estimation uncertainty** and may give rise to **lower risks of material misstatements, for example:**
  - Accounting estimates arising in entities that engage in **business activities that are not complex**.
  - Accounting estimates that are **frequently made and updated** because they **relate to routine transactions**.
- b) For some accounting estimates, however, there may be relatively **high estimation uncertainty**, particularly where **they are based on significant assumptions, for example:**
  - Accounting estimates relating to the **outcome of litigation**.
  - Fair value accounting estimates for **derivative financial instruments** not publicly traded.
- c) **Additional examples of accounting estimates are:**
  - Allowance for **doubtful accounts**.
  - **Inventory obsolescence**.
  - **Warranty obligations**.
  - **Depreciation method** or asset useful life.
  - **Provision against the carrying amount** of an investment where there is uncertainty regarding its recoverability.
  - Outcome of **long term contracts**.
  - **Financial Obligations / Costs** arising from litigation settlements and judgments.

133.

**High Estimation Uncertainty - Examples**

With reference to the Standards on Auditing state the examples of accounting estimates that may have a high estimation uncertainty. (Nov-2016)

Ans.



- (i) **Provision:** -As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures", the auditor shall determine whether, **in the auditor's judgment**, any of those accounting estimates that have been identified as **having high estimation uncertainty** give rise to significant risks.
- (ii) **Examples of accounting estimates that may have high estimation uncertainty:**
  - **Accounting estimates that are highly dependent upon judgment**,  
**For example**, judgments about the **outcome of pending litigation** or the amount and **timing of future cash flows** dependent on uncertain events many years in the future.
  - Accounting estimates that are **not calculated using recognised measurement techniques**.
  - Accounting estimates where the **results of the auditor's review** of **similar accounting estimates** made in the prior period financial statements **indicate a substantial difference** between the original accounting estimate and the actual outcome.
  - Fair value accounting estimates for which a **highly specialised entity-developed model is used** or for which there are **no observable inputs**.

134.

**Lower Level of ROMM - Accounting Estimates**

During the Audit of Data Solutions Ltd., a listed company, your audit manager observed that several estimates are made by the Company. He seeks your guidance to know areas of accounting estimates that may give rise to lower level of risk of material misstatement. Guide him with examples. (Nov-2019-Old)

Ans.



- (i) **Provision:** -As per SA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, some accounting estimates involve **relatively low estimation uncertainty** and may give rise to **lower risks** of material misstatements,
- (ii) **Examples of accounting estimates that may give rise to lower level of risk of material misstatement.**
- **Accounting estimates** arising in entities that engage in **business activities that are not complex**.
  - **Accounting estimates** that are **frequently made and updated** because they relate to routine transactions.
  - **Accounting estimates** derived from data that is **readily available**, such as **published interest rate data** or **exchange-traded prices of securities**. Such data may be referred to as “observable” in the context of a fair value accounting estimate.
  - **Fair value accounting estimates** where the method of measurement prescribed by the **applicable financial reporting framework** is simple and applied easily to the asset or liability requiring measurement at fair value.
  - **Fair value accounting estimates** where the **model used to measure the accounting estimate** is **well-known** or **generally accepted**, provided that the assumptions or inputs to the model are observable.

135.

**Accounting Assumptions & Estimates - Written Representations**

Mr. L while conducting the audit of ABC Ltd., observed that a substantial amount is recognized in respect of obsolescence of inventory and warranty obligation in the financial statements. Mr. L wants to obtain written representation from the management to determine whether the assumptions and estimates used are reasonable. Guide Mr. L with reference to the relevant Standard on Auditing. **(Study Material)(Nov-2019-New)**

Ans.



- (i) **Provision:** -As per SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”,
- The auditor shall obtain **written representations** from **management** and, where appropriate, **TCWG**
  - **Whether they believe significant assumptions** used in making **accounting estimates** are **reasonable**.
- (ii) **SA 580, “Written Representations”** discusses the use of **written representations**.
- **Depending on the nature, materiality and extent of estimation uncertainty**, written representations about accounting estimates **recognised or disclosed in the financial statements may include representations:**
    - a) **About the appropriateness of the measurement processes**, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
    - b) That the **assumptions appropriately reflect management’s intent** and **ability to carry out specific courses of action** on behalf of the entity, where relevant to the accounting estimates and disclosures.
    - c) That disclosure related to accounting estimates are **complete and appropriate** under the **applicable financial reporting framework**.
    - d) That **no subsequent event requires adjustment** to the accounting estimates and disclosures included in the financial statements.

136.

**Review of Outcome of Accounting Estimates**

A Pvt Ltd is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc) included in the prior period financial statements and their subsequent re-

estimation for the purpose of the current period. The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise.

(Study Material)(RTP-May-2019)(MTP-Dec-2021)

Ans.



(i) **Provision: - As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**

- The auditor shall review the **outcome of accounting estimates** included in the prior period financial statements, or, where applicable, their **subsequent re - estimation** for the purpose of the current period.
- **The nature and extent of the auditor's review** takes account of the **nature of the accounting estimates**, and whether the information obtained from the review would be relevant to **identifying and assessing risks of material misstatement** of accounting estimates made in the current period financial statements.

(ii) The **outcome of an accounting estimate** will often differ from the **accounting estimate recognised in the prior period** financial statements.

**By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:**

- Information regarding the **effectiveness of management's prior period estimation process**, from which the auditor can judge the **likely effectiveness** of management's current process.
- Audit evidence that is **pertinent to the re-estimation**, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as **estimation uncertainty**, that may be required to be disclosed in the financial statements.

(iii) **The review of prior period accounting estimates may also assist the auditor**

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

(iv) **In the given case: - The management is not correct in refusing the relevant information to the auditor.**

137.

#### **Accounting Estimate - Significant Risk**

M/s. HK & Co. was appointed as an auditor of GSB Limited, a company operating its business in telecom sector. As per spectrum allocation agreement with Government, GSB Limited is required to pay certain percentage of its annual revenue as license fee. GSB Limited paid the license fee on its core business for last two years. At the end of third year, the communication was received from Government that it needs to pay agreed percentage on its total revenues and not only on core business revenues. Matter was disputed and went to court of law. On prudence basis, GSB Limited made a provision on estimated business in its books of accounts of agreed percentage on non-core business receipts also. The amount of provision was of such huge amount that the GSB Limited's profit and loss account for that quarter reflected loss due to that provision. How you as an auditor can evaluate this accounting estimate which involves significant risk and what if Management has not addressed the effects of estimation uncertainty on provision made?

(MTP-May-2022)(Jan-2021-New)

Ans.

(i) **In the given case: - HK & Co. was appointed as an auditor of GSB Ltd., operating in Telecom sector. GSB Ltd paid the license fee on its core business revenue whereas Govt. required it to pay on non-core business receipts as well. Consequently, the amount of provision was of such a huge amount that GSB Ltd.'s profit and loss account reflected a loss due to that provision. As an auditor evaluation would be done as under:**



- (ii) For **accounting estimates that give rise to significant risks**, in addition to other **substantive procedures performed** to meet the requirements of SA 330, the auditor shall **evaluate the following**:
- How management has considered **alternative assumptions or outcomes**, and why it has rejected them, or
  - How management has **otherwise addressed estimation uncertainty** in making the accounting estimate.
  - Whether the **significant assumptions** used by management **are reasonable**.
  - Where **relevant to the reasonableness** of the significant assumptions used by management or
  - The **appropriate application** of the **applicable financial reporting framework**, management's intent to carry out **specific courses of action** and its ability to do so.
  - **If, in the auditor's judgment**, management has **not adequately addressed** the effects of estimation uncertainty on the **accounting estimates** that give rise to significant risks, the auditor shall, **if considered necessary**, develop a range with which to **evaluate the reasonableness** of the accounting estimate.

138.

**Assumptions in Accounting Estimates**

Assumptions are integral components of accounting estimates. State the matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates with reference to relevant SAs. (July-2021-Old)

Ans.



As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures",

- (a) How management makes the **accounting estimates**, and an **understanding of the data** on which they are based, including assumptions underlying the accounting estimates.
- (b) Assumptions are **integral components of accounting estimates**. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, **for example**:
- The **nature of the assumptions**, including which of the assumptions are likely to be significant assumptions.
  - How management assesses **whether the assumptions are relevant and complete** (that is, that all relevant variables have been taken into account).
  - Where applicable, how management determines that the **assumptions** used are internally consistent.
  - Whether the **assumptions relate** to matters within the **control of management** (for example, assumptions about the **maintenance programs** that may affect the estimation of an asset's useful life), and **how they conform to the entity's business plans** and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
  - The **nature and extent of documentation**, if any, supporting the assumptions.

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

**SA-550**
**Related Parties**

139.

**Possible Sources of Related Party Information**

JY & Co. is appointed as auditor of Breeze Ltd. JY & Co. seeks your guidance for reviewing the records and documentation of the company regarding 'related party transactions in the normal course of business'. Describe the steps to be followed. (MTP-May-2019)(Nov-2015)



OR

In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information.

(MTP-Nov-2018)

Ans.



- (i) **Provision:** -As per SA 550 “Related Parties” the auditor shall remain alert, when **inspecting records or documents** with respect to **arrangements or information** indicating the existence of related party **relationships or transactions**, not previously **identified or disclosed** to the auditor.
- (ii) **During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:**
- Entity **income tax returns**.
  - Information supplied by the entity to **regulatory authorities**.
  - **Shareholder registers** to identify the entity’s principal shareholders.
  - **Statements of conflicts of interest** from management and TCWG.
  - Records of the **entity’s investments** and those of its pension plans.
  - **Contracts and agreements** with key management or TCWG.
  - **Significant contracts and agreements** not in the entity’s ordinary course of business.
  - Specific invoices and correspondence from the **entity’s professional advisors**.
  - **Life insurance policies** acquired by the entity.
  - **Significant contracts** re-negotiated by the entity during the period.
  - **Internal auditors’ reports**.
  - Documents associated with the **entity’s filings with a securities regulator** (for example, prospectuses).
- (iii) **Further Audit Procedure:**
- Auditor should **also obtain further information** on significant transactions **outside the entity’s normal course of business**. It enables him to evaluate whether **fraud risk factors**, if any, are present.
  - **In addition, the auditor needs to be alert** for transactions which appear **unusual in the circumstances** and which may indicate the **existence of previously unidentified related parties**.
  - **For example: Complex equity transactions** such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises etc.
- (iv) **Written Representation:** - Finally, the auditor should also **obtain a written representation** from the management concerning the **completeness of information provided** regarding the identification of **related parties**.

140.

**Related Party Transaction –Biased**

In the course of your audit you have come across a related party transaction which prima facie appears to be biased. How would you deal with this?

Ans.



- (i) **Provision of AS-18/Ind-AS-24 & SA 550**
- In the course of your audit you have come with regard to **reporting of transactions** with related parties as required by **Accounting Standard 18** are given in **SA 550 on Related Parties**.
  - **As per SA 550 on, “Related Parties”**, the auditor should **review information provided by the management** of the entity identifying the names of **all known related parties**.
  - **Since it is the management**, which is **primarily responsible** for identification of related parties, SA 550 requires that to **identify names of all known related parties**, the auditor may **inspect records or documents** that may provide information about **related party relationships and transactions**.

- (ii) **In the given case:** - The auditor is **finding a related party transaction** which prima facie **appears to be biased**. So the auditor is required to **confirm the same**.
- (iii) **For identified significant RPTs outside the entity's normal course of business**  
 The auditor shall inspect the **underlying contracts or agreements**, if any, and evaluate whether:
- The **business rationale (or lack thereof) of the transactions** suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets,
  - The **terms of the transactions are consistent** with management's explanations; and
  - The **transactions have been appropriately accounted for and disclosed** in accordance with the applicable financial reporting framework.
  - The auditor should **also obtain audit evidence** that the transactions have been **appropriately authorised and approved**.
- (iv) **Written Representation:**  
 The auditor shall obtain **written representations** from **management** and, where appropriate, **those charged with governance** that they have disclosed to the auditor the **identity of the entity's related parties** and all the related party **relationships and transactions** of which they are aware; and they have **appropriately accounted for and disclosed** such relationships and transactions in accordance with the requirements of the framework.
- (v) **Reporting:**  
 Finally, the auditor should **report on the basis of this fact that the related party relationships and transactions:**
- prevent the financial statements from achieving true and fair presentation **(for fair presentation frameworks); or**
  - cause the financial statements to be misleading **(for compliance frameworks)**.

141.

**Disclosure of Related Party Transaction**

Mr. D is a director of X Ltd. and Y Ltd. On 30th June, 2021, Mr.D resigned from directorship of Y Ltd. X Ltd. sold goods to Y Ltd., during the entire year at the same price and conditions as to any other customer. X Ltd. discloses only the sales for the first quarter ending 30th June, 2021 as related party transactions.

Ans.



- (i) **As per SA 550 'Related Parties':** - In examining the identified related party transactions, the auditor should obtain **sufficient appropriate audit evidence** as to whether these **transactions have been properly recorded and disclosed**.
- (ii) **As per AS 18 'Related Party Disclosures':** - Transactions of **X Ltd. for the first quarter with Y Ltd. up to 30th June, 2015** only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship **did exist need not to be disclosed** as related party transactions.
- (iii) **Reporting under CARO-2020:** -Even though X Ltd. **has correctly identified and disclosed the related party transactions**, the auditor need to report under
- Clause (xiii) of CARO, 2020** about whether **all transactions with the related parties** are in compliance with **sections 177 and 188 of Companies Act, 2013** where applicable and the details have been **disclosed in the Financial Statements** etc., as required by the applicable accounting standards.

142.

**Verification of Existence of Related Parties**

The financial statements of Beta Ltd. have been prepared by the Management with due disclosures for related parties and transactions with them. However, as the auditor of the Company, you are not sure of the reliability of the said disclosures. Mention the documents and records that may be helpful in gathering information about related party relationships and transactions.

**(Nov-2019-Old)**

Ans.



- (i) **Provision: -As per SA 550 “Related Parties”, during the audit, the auditor shall remain alert:**
- When **inspecting records or documents**, for arrangements or other information that may indicate the existence of **related party relationships or transactions** that management has **not previously identified or disclosed** to the auditor.
- (ii) **Examples of documents and records :**
- Entity **Income Tax Returns**.
  - Information supplied by the entity to **regulatory authorities**.
  - **Shareholder registers** to identify the entity’s principal shareholders.
  - **Statements of conflicts of interest** from management and those charged with governance.
  - Records of the **entity’s investments** and those of its **pension plans**.
  - **Contracts and agreements** with **key management** or those charged with governance.
  - **Significant contracts and agreements** not in the entity’s ordinary course of business.
  - **Specific invoices and correspondence** from the entity’s professional advisors.
  - **Life insurance policies** acquired by the entity.
  - Significant **contracts re-negotiated** by the entity during the period.
  - **Internal auditors’ reports**.
  - **Documents associated** with the entity’s filings with a **securities regulator** (e.g., prospectuses). Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.
- (iii) **Inspection by Auditor:** In particular, the **auditor shall inspect the following for indications of the existence** of related party relationships or transactions that management has **not previously identified or disclosed** to the auditor:
- **Bank, legal and third party confirmations** obtained as part of the auditor’s procedures;
  - **Minutes of meetings** of shareholders and of those charged with governance; and
  - **Such other records or documents** as the auditor considers necessary in the circumstances of the entity.

143.

### Reporting of Significant Related Party Matters

Whilst the Audit team has identified few matters, they need your advice to conclude on the same. Engagement Partner have asked them to review the Board minutes and other secretarial/ regulatory records based on which the following additional matters were brought to the attention of the Partner:-

- The long term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.
- Certain computers were received from the parent company free of cost, the value of which is ₹ 0.23 lac and no accounting or disclosure of the same has been made in the notes to accounts.
- An amount of ₹ 3.25 Lakhs per month is paid to M/s. WE CARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹0.25 Lakhs per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure of this related party transaction has been made in the notes to accounts forming part of the financial statements highlighting the same as a 'related party' transaction.

Audit Manager has reported that she had asked certain information relating to another 'related party' transaction (amounting to approx. ₹ 47 lac) but the CFO refused to provide the same since the same is perceived to be confidential and cannot be shared with the Auditors.

You are required to advise about items to be reported to those charged with governance, where applicable, based on your audit findings in the given situation.

(MTP-Nov-2020)

Ans.


**(i) Provision: -As per SA 550, Related Parties:**

- Communicating **significant matters arising** during the audit in connection with the **entity's related parties** helps the auditor to **establish a common understanding** with those charged with governance of the **nature and resolution of these matters**.
- **Examples of significant related party matters include:**
  - **Non-disclosure** (whether intentional or not) **by management** to the auditor of **related parties** or **significant related party transactions**, which may alert those charged with governance to **significant related party relationships** and **transactions** of which they may not have been previously aware;
  - **The identification of significant related party transactions** that have not been **appropriately authorised and approved**, which may give rise to suspected fraud; etc.

**(ii) Involvement of TCWG in MGT:** -It may be noted that **unless all of TCWG are involved in managing the entity**, the auditor shall communicate with **TCWG significant matters** arising during the audit in connection with the entity's related parties.

**(iii) Compliance of AS/Ind-AS:** - The auditor is also required to ensure the **compliance of Ind AS 24 / AS 18 Related Party Disclosures**.

**(iv) Reporting:** -In view of above in the **given scenario**, the auditor is required to prepare a **brief summary of following items** to be **reported to TCWG** in accordance with SA 260 Communication with TCWG:

- **One of related party transaction amounting 3.25 lac per month** i.e. in lieu of marketing services has been noticed of which amount ₹ 0.25 lac per month is exceeds the arm's length price has not been disclosed highlighting the same as related party transactions as per Ind- AS 24 / AS 18 Related Party Disclosures.
- **Refusal by CFO of**, as denying for the related part details of ₹ 47 lac is imposing limitation of scope of auditor in view of SA 705.
- **Receipt of free of cost Computers and long-term borrowing** (on no agreed terms and repayment of interest and principal) **from the Parent Company** need separate disclosure in financial statements as per Ind AS 24 / AS 18 Related Party Disclosures.
- **Further, in case of all the above cases:** - The auditor would also need to assess his **reporting requirements under the clauses (xiii) of Paragraph 3 of CARO 2016** with respect to related party transactions that whether **all transactions with the related parties are in compliance** with **sections 177 and 188 of Companies Act, 2013** where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable Accounting Standards.

144.

**Significant Related Party Transactions**

Mr. X, while conducting audit of PQR Ltd, comes across certain transactions which according to him are significant transactions with related parties and identified to be outside the entity's normal course of business. Guide Mr. X with examples of such transactions and to understand the nature of significant transactions outside the entity's normal course of business.

(Nov-2020-New)

Ans.



**(i) In the given case:** - PQR Ltd, Mr. X, while conducting audit has **come across certain significant related party transaction** which are identified to be **outside the entity's normal course** of business. Mr. X wants **guidance through examples** of such significant transactions which are given in SA 550

**(ii) As per SA 550 "Related Parties":** - **Examples of transactions** outside the entity's normal course of business may include:

- **Complex equity transactions**, such as corporate restructurings or acquisitions.
- **Transactions with offshore entities** in jurisdictions with weak corporate laws.
- **The leasing of premises** or the rendering of management services by the entity to another party if no consideration is exchanged.

- Sales transactions with **unusually large discounts** or returns.
- Transactions with **circular arrangements**, for example, sales with a commitment to repurchase.
- Transactions under **contracts whose terms are changed before expiry**.

145.

**Audit Procedure - Operative Effectiveness of Control related to RPT**

While formulating the audit plan and responding to the risks of material misstatement identified and assessed in related party transaction and relationships, Ms. K the engagement manager of the audit team of ABC Limited, decided to rely upon the internal controls placed for identification and disclosure of related party relationships and transactions in accordance with the applicable financial reporting framework.

You are requested to guide Ms. K regarding the necessity to test the controls to obtain sufficient and appropriate audit evidence. Also guide, whether Ms. K can use the audit evidence obtained, regarding operative effectiveness of control on identification and disclosure of related party relationships and transactions, in the interim period.

(RTP-Dec-2021)

Ans.

**(i) As per SA 550, "Related Parties", according to para on "Responses to the risks of material misstatement associated with related party relationships and transactions"**

- The auditor should **design and performs further audit procedures** to obtain sufficient appropriate audit evidence about the assessed **risks of material misstatement** associated with related party relationships and transactions.
- **Further, as per SA 330, "The Auditor's Responses to Assessed Risks", the auditor shall design and perform tests of controls** to obtain sufficient appropriate audit evidence as to the **operating effectiveness of relevant controls** when:
  - (a) the auditor's assessment of risks of material misstatement **at the assertion level** includes an expectation that the **controls are operating effectively** (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
  - (b) **Substantive procedures** alone cannot provide sufficient appropriate audit evidence at the assertion level.

**(ii) In designing and performing tests of controls**

- The auditor shall obtain **more persuasive audit evidence** the greater the reliance the auditor places on the effectiveness of a control.
- Moreover, the **auditor shall test controls** for the particular time, or throughout the period, for which the auditor **intends to rely on those controls**, subject to when the auditor obtains audit evidence about the **operating effectiveness of controls during an interim period**, and the timing of test of controls over significant risks, in order to provide an appropriate basis for the auditor's intended reliance.

**(iii) When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:**

- (a) Obtain audit evidence about **significant changes to those controls** subsequent to the interim period; and
- (b) Determine the **additional audit evidence** to be obtained for the remaining period.

**(iv) Conclusion**

- In the current case Ms. K shall **design and perform tests of controls to obtain sufficient appropriate audit evidence** as to the operating effectiveness of relevant controls as she intends to rely on the **operating effectiveness of controls** in determining the **nature, timing and extent** of substantive procedures.
- Further, she is also required to **obtain the audit evidence about significant changes to those controls subsequent to the interim period** along with the additional audit evidence to be obtained for the remaining period in accordance with the requirements of Standards on Auditing as discussed above.



**146. RPT –Risk Assessment Procedure & Related Activities**

JKL Limited is engaged in the business of Construction and real estate having various projects across states. M/s YT & Co, Chartered Accountants have been appointed as Statutory Auditors. Audit Team from M/s YT & Co for audit of JKL Limited comprises of CA Z - Engagement Partner, CA Q, a paid assistant and 3 Articled Assistants. During preliminary verification, CA Z observed that huge amount of sub-contract payments were made to M/s JB Associates, a partnership firm in which Director of JKL Limited is a managing partner. The engagement team discussed that SA 315 and SA 240 shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the JKL Limited's related party relationships and transaction. Highlight the matters that are to be addressed in the discussion by CA Z with team members with reference to the relevant standard on Auditing. **(May-2022)**

**Ans.**

**(a) Understanding the Entity's Related Party Relationships and Transactions**

The engagement team discussion that **SA 315 and SA 240 require** shall include specific consideration of the susceptibility of the financial statements to **material misstatement due to fraud or error** that could result from the entity's **related party relationships and transactions**.

**(b) Matters that may be addressed in the discussion among the engagement team include:**

- The **nature and extent** of the entity's **relationships and transactions** with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
- An emphasis on the **importance of maintaining professional skepticism** throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The **circumstances or conditions** of the entity that may indicate the **existence of related party relationships or transactions** that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).
- The **records or documents** that may indicate the existence of related party relationships or transactions.
- The importance that **management and TCWG** attach to the **identification, appropriate accounting for, and disclosure** of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

**(c) In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:**

- How **special-purpose entities controlled by management** might be used to facilitate earnings management.
- How **transactions between the entity and a known business partner** of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

*Note: - Suggested Answer of ICAI may be different.*

**SA-560**
**Subsequent Events**
**147. Meaning of Subsequent Events**

Explain the meaning of term "Subsequent Events" as used in the SA 560. Should all types of subsequent events be considered by the auditor in his attest functions?

**Ans. (i) Provision: -SA 560 on "Subsequent Events",**

- Defines the term '**subsequent events**' as events occurring between the **date of the financial statements** and the **date of the auditor's report**, and facts that become **known** to the auditor **after the date of the auditor's report**.



- “Subsequent events” also refer to **significant events** which occurred up to the **date of report** of the auditor of that component.
- **Thus, subsequent events are** those events which occur after the **date of the balance sheet** till the **audit report is signed** by the auditor.

(ii) **Consideration of Subsequent Events by the Auditor:**

- **SA 560 requires** that the auditor should consider the **effect of subsequent events on the financial statements** and the **auditor’s report**.
- However, the **exact manner of treatment** would depend upon whether the **event falls in the category** of ‘**adjusting event**’ or ‘**non-adjusting event**’.

(iii) **As per Accounting Standard (AS) 4: - Events occurring after the date of the balance sheet** are of **two types, viz., adjusting events** which provide **further evidence of conditions** that existed at the date of the balance sheet; and, **non-adjusting events** are those which are indicative of conditions that arose subsequent to the date of the balance sheet. (Note:- reference of **IND AS 10 – Events After The Reporting Period** may also give)

(iv) **Conclusion: -**Therefore, an auditor is required to **consider all subsequent events** while discharging his duties and determine whether **those shall have to be adjusted** or **simply required to be disclosed**. However, the auditor should perform **work as near as practicable to the date of the auditor’s report**.

148.

**Audit Procedures on Subsequent Events**

You are the auditor of PQR Ltd. which is in the business of supplying food products to various airline companies operating aircrafts in domestic circle only. As per terms of agreement with airlines, the company needs to stock various non- perishable food items for coming one month (average holding of inventory to the tune of INR 75 Crores). Also the payment terms have been settled and the company receives payment in 45 days after the supply of goods. Everything was going-on well till the end of March 2020 when pandemic Covid hit the world and everything came to a standstill. Aviation sector was hit hard and there were no flights from April 2020 onwards. Consequently, the business of PQR Ltd. also got severely affected and the scheduled supplies of goods to airlines also were not made. Also, the liquidity position of airline companies got hit and the schedule d payments were also not received on due dates. As the auditor of PQR Ltd. what audit procedures would you perform to ensure that all subsequent events are considered, so that financial statements for the year ended 31.03.2020 represent true and fair view? **(Nov-2020-New)**

**OR**

Briefly explain Audit procedures on subsequent events.

**Ans.**



(i) **Subsequent Events**

- As per **SA 560 “Subsequent Events”**, the auditor shall perform **audit procedures designed** to obtain **sufficient appropriate** audit evidence that all **events occurring between the date of the financial statements** and the **date of the auditor’s report** that require **adjustment** of, or **disclosure** in, the financial statements have been identified.
- The auditor is not, however, expected to **perform additional audit procedures** on matters to which previously applied audit procedures have provided satisfactory conclusions.
- The auditor shall perform the procedures required in above paragraph so that they cover the period **from the date of the financial statements** to the **date of the auditor’s report**, or **as near as practicable** thereto.

(ii) **Audit Procedure:** Being the auditor of PQR Ltd, to **ensure that all subsequent events are considered** so that financial statements for the year ending 31.03.2020 represent true and fair view, the auditor shall take into account the **auditor’s risk assessment** in determining the **nature and extent of such audit procedures**, which shall include the following:

- Obtaining an understanding of any procedures** management has established to ensure that subsequent events are identified.
- Inquiring of management** and, where appropriate, **those charged with governance** as to whether any subsequent events have occurred which might affect the financial statements.