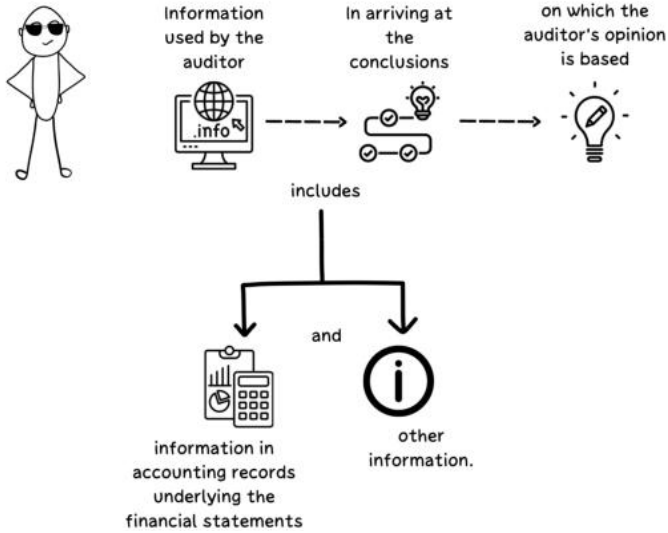


Chapter 4 – Audit Evidence

SA 500 Audit Evidence

Meaning of Audit Evidence



Information contained in the accounting records

Accounting records include

- the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers;
- Invoices;
- Contracts
- the ledgers, journal entries and other adjustments to the financial statements.
- records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

Other information

Other information that authenticates the accounting records and also supports the auditor’s rationale behind the true and fair presentation of the financial statements:

Other information which the auditor may use as audit evidence includes, for example

- minutes of the meetings,
- written confirmations from trade receivables and trade payables,
- manuals containing details of internal control etc

A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Other Points related to Audit Evidence and Its Nature.		
Cumulative in Nature		
Primarily from	Audit Procedures	
Include info	from other sources	Such as previous audit
AE comprises both	Info that supports	
	Info that contradicts	
Absence of info (For ex. Mgt not providing Written Representations)	Also Audit Evidence	
Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.		

Suniti, a CA student, is part of an engagement team conducting an audit of a company TIM Private Limited. According to the audit programme, she is responsible for verifying purchases and PPE items appearing in books of accounts from records/bills of the company. Besides, she has also been entrusted with responsibility to obtain written representation from management regarding carrying out physical verification of inventories during the year. During course of her work, she finds that:

- One purchase bill amounting to ₹ 5.00 lacs pertaining to TIM Industries has been entered in books of TIM Private Limited.
- The management has refused to provide a written representation relating to physical verification of inventories during the year. She has brought it to the knowledge of the engagement partner who has decided to use lack of such a representation as audit evidence.

Discuss whether each of the above constitutes audit evidence. State reasoning for your answer
(ICAI MTP1, May 2024, 4 Marks)

Relation of Audit Evidence and Opinion of the Auditor		
Very important relationship		
Helps auditor to form an opinion		
AE supports Auditor's Opinion and report		
Auditor's objective	Obtain reasonable assurance	Reasonable assurance is obtained when auditor obtains Sufficient and Appropriate evidence To Reduce Audit risk to appropriately low level

Sufficient and Appropriate Audit Evidence

Sufficiency			
measure of the quantity of audit evidence			
Affected by	Materiality	Significance of AB/TPD to the users of FS	Less Material, Less Evidence and Vice versa
	ROMM	risk that the financial statements are materially misstated prior to audit.	Lower ROMM, Less Evidence
	Size of population	number of items included in the population	Smaller, Homogeneous items, Less Evidence
Obtaining more evidence	Cannot compensate for poor quality of audit evidence		

Sales Revenue Verification

High-quality evidence: Sales invoices matched with delivery receipts and customer confirmations. Low-quality evidence: Large number of unsigned internal sales records. Issue: Even if thousands of internal sales records are presented, they lack authenticity without external corroboration.

Appropriateness of Audit Evidence

measure of the quality of audit evidence



In providing support for conclusions for auditors opinion

Relevance / Competence

Relationship of the evidence with audit procedure and the assertion being checked

An Audit procedures may provide evidence for some assertions but not others.

audit evidence from different sources or of a different nature may often be relevant to the same assertion.

Important Examples

Example

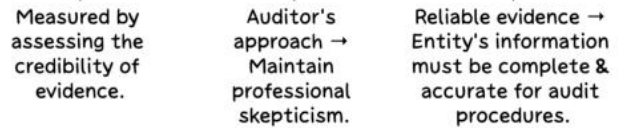
confirmation of balance from a customer
↓
relevant evidence as regards existence of receivable,
↓
not be relevant as regards collectability of the balance due from customer
↓
Subsequent payments, credit history, financial health, and aging analysis are better indicators of recoverability.

physical observation of inventories
↓
relevant evidence relating to existence
↓
not appropriate evidence to ensure that the entity owns the inventories

Checking the terms of the agreement and confirming the same from the third party.

One more example of relevance: To Check if a purchase is complete you don't look at the Purchase contract. For checking the completeness of purchase we will check that goods or services were received. For this we will check various documents and records related to receiving goods like stock registers

Reliability of Audit Evidence



Factors Influencing Reliability

Source & Nature (Direct, indirect, oral, written, original, photocopies).		
Circumstances of Obtaining (Preparation & maintenance controls).		
General Reliability Principles:		
Independent external sources → More reliable as they are free from management bias.		
Internally generated evidence → More reliable if entity's internal controls over preparation and maintenance are effective.		
Documentary evidence → More reliable than oral representations, as written records provide concrete proof.		
Organizational circumstances (e.g., weak controls, conflicts of interest) can reduce reliability.		
Original documents → More reliable than photocopies or digital versions, as alterations or tampering are less likely.		
Direct auditor-obtained evidence → More reliable than evidence obtained indirectly (e.g., observing a control vs. inquiring about it).		
The above general principles are subject to important exceptions.	audit evidence obtained from sources external to the entity, circumstances may exist that could affect its reliability.	For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity.

Audit Procedures to Obtain Audit Evidence

Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing	risk assessment procedures,	
	Further audit procedures, which comprise:	Tests of controls
audit procedures be used as risk assessment procedures, tests of controls or substantive procedures	A	Analytical procedures
	E	Enquiry
	I	Inspection
	O	Observation
	U	Recalculation
	Reperformance	
	External Confirmation	

Inspection		
examining records or documents	internal or external,	
	paper form, electronic form,	
	Provide evidence of varying degree of reliability	Documents created and maintained within the organization might be less reliable compared to those received from independent external sources.
Physical examination of an asset.		
Examples	For Test of Control	Inspecting Documentation related to authorisation.
	Documents like stock or bond certificates directly evidence asset existence	may not necessarily provide audit evidence about ownership or value
	Inspecting a signed contract	can give evidence on an entity's revenue recognition policy application.
	inspecting tangible assets	confirms existence, but may not verify rights, obligations, or value
	Auditor may inspect inventory items during inventory count observation.	

Observation

- Observation consists of **witnessing** a **process** or procedure being performed by others.
 - For example, the auditor may observe the counting of inventories being performed by client's personnel.

External Confirmation – SA 505

- An external confirmation represents audit evidence obtained by the auditor as a **direct written response** to the auditor from a **third party** (the confirming party), in paper form, or by electronic or other medium.
 - External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only.
 - Example: Auditors may request confirmation of terms of agreements or transactions an entity has with third parties.
 - External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions.
 - Example: Absence of a "side agreement" that may influence revenue recognition.

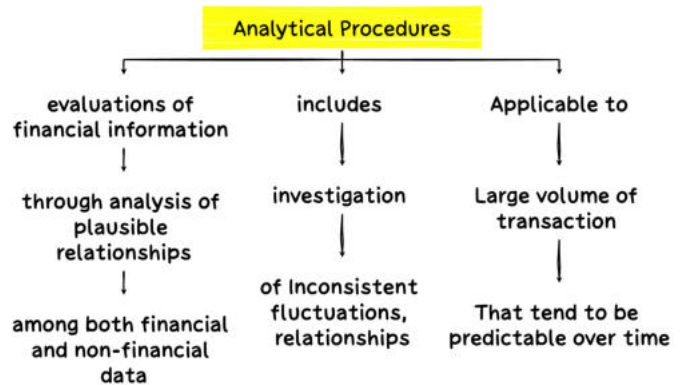
Recalculation

- Recalculation consists of **checking** the **mathematical accuracy** of documents or records. Recalculation may be performed manually or electronically.

- Checking the accuracy of calculation of the conversion of foreign currency into Indian rupees for export invoices

Re-performance

- Re-performance involves the auditor's **independent execution** of **procedures** or controls that were originally performed as part of the entity's internal control.
- Re-performing the reconciliation of bank statement, re-performing the ageing of accounts receivable

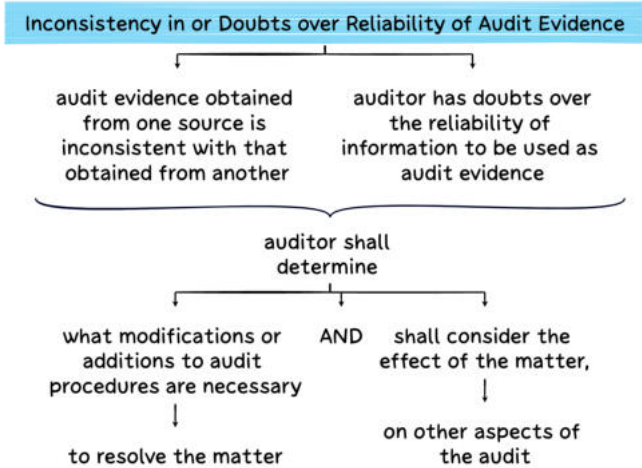


Inquiry

- Seeking information of knowledgeable persons
 - Both financial and non-financial
 - Within the entity or outside the entity
- Used extensively throughout the audit
 - In addition to other audit procedures
- Range from
 - Formal written inquiries
 - Informal oral inquiries
- Responses to inquiries may provide the auditor
 - Information not previously possessed
 - Corroborative audit evidence
 - Information that differs significantly from other information that the auditor has obtained
 - Provide a basis for the auditor to modify or perform additional audit procedures.
 - For example, information regarding the possibility of management override of controls.
- Corroboration
 - Is crucial for inquiry evidence, especially on management intent
 - Plays a crucial role in evaluating the integrity and reliability of the management team
 - Written representations from management or TCWG to confirm oral inquiry responses in certain matters
- Evidence from Inquiry
 - May provide important audit evidence
 - May even produce evidence of a misstatement
 - Does not provide sufficient audit evidence

- Of the absence of a material misstatement at the assertion level
- Nor of the operating effectiveness of controls

DPQ 🍷📄 - CA Kanika audited books of accounts of Engineering Ltd. for the financial year 2022-2023. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor. Comment on reliability of audit evidence obtained by performing such an audit procedure in some situations. (RTP, May 2024, NA)



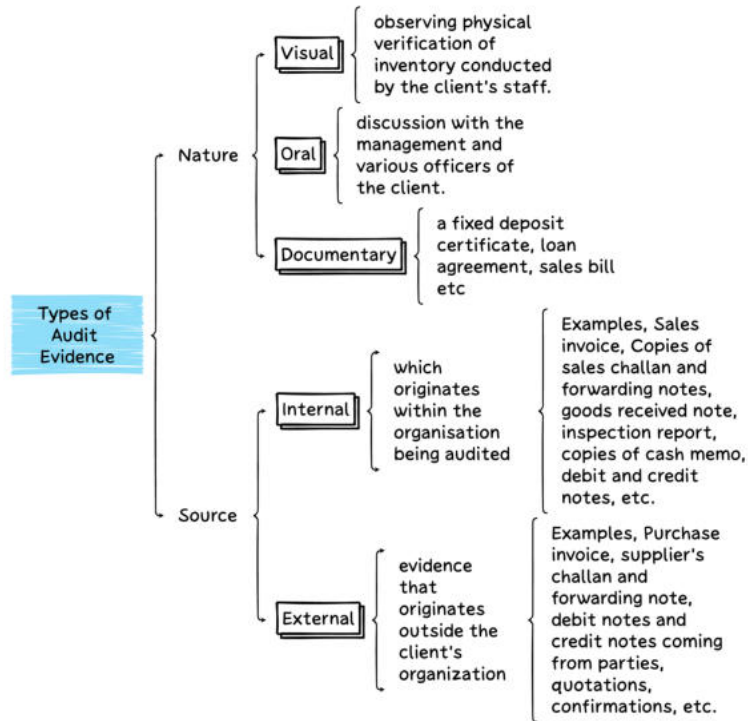
This might involve discrepancies between financial records and physical inventory counts, conflicting testimonies from different employees, or doubts about the authenticity of documentation.

Modifications - if there's a discrepancy in inventory records, the auditor might conduct a surprise inventory count or examine related purchase and sales records more closely.

Effect on other aspects

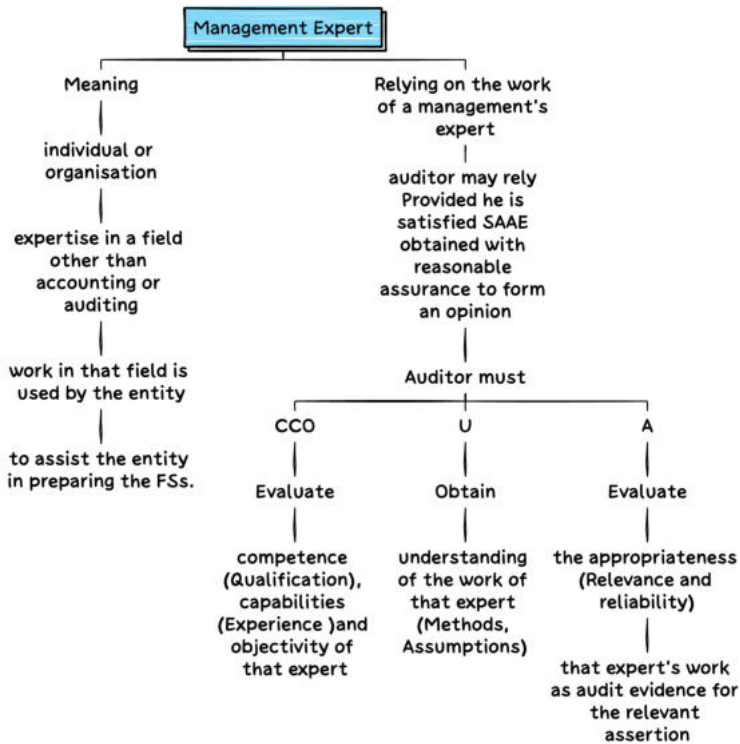
if there are doubts about the reliability of cash flow statements, the auditor might need to reassess the risk of material misstatement in other financial areas like receivables and payables.

Manya Textiles is manufacturer of bed sheets, curtain cloths, other handloom items etc. having its plant at Panipat. Auditors SJ & Co. is having doubts over the reliability of information given to him as audit evidence. Also, auditors observed inconsistent information while conducting audit. Guide the auditor as to how they should proceed in the given situation. (RTP, Nov 2022, NA)



External Vs Internal Audit Evidence

- Auditors receive mostly internal evidence; external evidence is also important.
- Internal evidence is controlled by clients, requiring cautious reliance.
- External evidence is more reliable as it comes from third parties.
- If a third party's independence is doubtful (e.g., associated concern invoices), auditors should be vigilant.
- Auditors should match internal and external evidence where possible.
- If external evidence is unavailable, auditors should assess how internal evidence corroborates.



When an auditor uses information prepared by a management's expert as audit evidence, various factors influence the nature, timing, and extent of the auditor's procedures		
Matter	nature and complexity of the matter	to which the management's expert relates.
	ROMM in the Matter	
	Availability of alternative sources of audit evidence.	
NSO And Employment	nature, scope and objectives of the management's expert's work.	
	management's expert is employed by the entity, or is a party engaged by it to provide relevant services.	
Standards and Control	Management Expert is subject to technical Performance Standards etc	
	nature and extent of any controls	over the management's expert's work
Auditor	auditor's knowledge and experience of	the management's expert's field of expertise
	auditor's previous experience	of the work of that expert.

DPQ 📌👉 Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor? (MTP1, Sep 2024, 4 marks)

In the course of audit of SMP Limited for the financial year ended 31st March, 2024 you have observed as an auditor that the company has provided a sum of ₹ 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing. (MTP2, Nov 2021, 3 Marks)

Audit Trail

A documented flow of a transaction from source document to financial statements. It is used to investigate how a source document was translated into an account entry and from there it was inserted into the FS of an entity.

A company purchases raw materials and receives an invoice (source document). The accountant records it as a purchase entry in the ledger, which then reflects in the financial statements under expenses or inventory. An audit trail ensures this flow is accurate and complete.

Purpose & Benefits

- It is used as audit evidence to establish authentication and integrity of a transaction.
- Maintains records of system and user activity (e.g., bank log-on attempts).
- Helps trace financial data to its source.
- Reduces fraud, errors, and unauthorized use.
- Enhances internal controls and data security.
- Fixes responsibility and helps rebuild events during issues.
- Ensures proper system operation.

Costs & Efficiency:

- Involves system expenses and time for data analysis.
- Automated tools can simplify large data analysis.

Relevance to Auditors:

- Boosts confidence in auditors.
- Verifies management controls' effectiveness.
- Ensures transactions were performed by authorized personnel.
- Enhances reliability of audit evidence.

Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors. (ICAI Study Material - Test Your Knowledge)

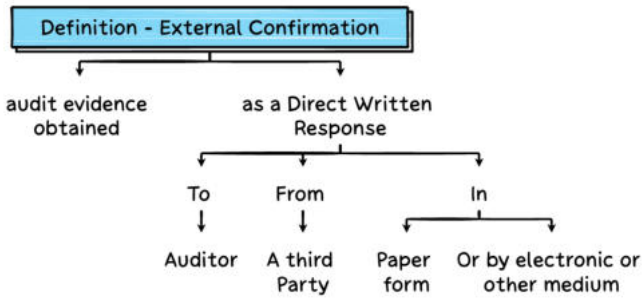
Misc Topics

Sources of Audit Evidence	
Audit Evidence Collection:	Obtained through audit procedures to test accounting records.
	Helps verify that records are internally consistent and match financial statements.
Reliability of Evidence:	More assurance comes from consistent evidence from multiple sources.
	Different types of evidence are more reliable than isolated items.
Independent Sources	Stronger audit evidence includes:
	Third-party confirmations
	Analyst reports
	Competitor data
Audit evidence should be gathered from diverse and independent sources to enhance reliability and ensure financial records' accuracy.	

Evaluation of Audit Evidence	
Applicability	SA 500 applies to all audit evidence obtained during an audit.
Purpose	Ensures sufficient appropriate evidence for forming an audit opinion.
Auditor's Work	Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.
Professional Judgment	Auditor decides if evidence reduces audit risk to an acceptably low level for drawing reasonable conclusions.

Using Entity-Produced Information	
Auditor evaluates if information is sufficiently reliable.	
Obtains audit evidence on accuracy and completeness.	
Checks if information is precise and detailed for audit purposes.	

SA 505 – External Confirmations



Definitions of other terms

Positive confirmation request

A request that the confirming party respond directly to the auditor indicating **whether** the **confirming party agrees or disagrees** with the information in the request, or **providing** the requested **information**.

Negative confirmation request

A request that the confirming party **respond** directly to the auditor **only if** the **confirming party disagrees** with the information provided in the request.

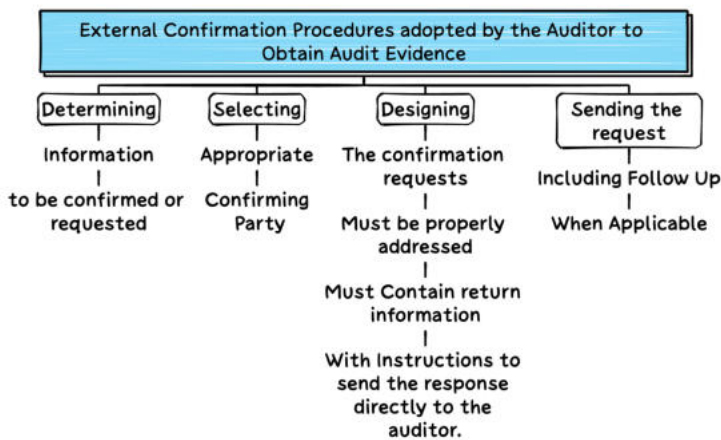
Non-response

A **failure** of the confirming party to **respond** or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception

A response that indicates a **difference** between information **requested** to be confirmed, or contained in the entity's records, and information **provided** by the confirming party.

The exception needs to be assessed to the entire population after analyzing the reason for the difference.



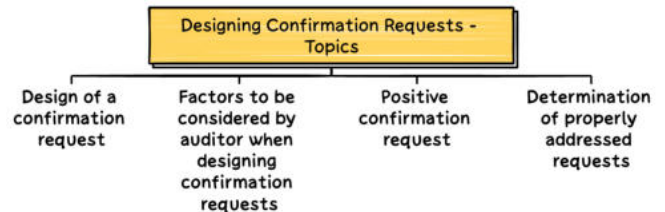
Determining the information to be confirmed or requested	
frequently performed	to confirm or request information regarding account balances and their elements.
may also be used	to confirm terms of agreements, contracts, or transactions
	or to confirm the absence of certain conditions, such as a "side agreement"

Selecting the appropriate confirming party;

- Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is **knowledgeable** about the information to be confirmed.
- For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

The auditor should choose a party that has accurate and direct knowledge of the information being confirmed. Example: A financial institution official familiar with the transactions or arrangements is the best person to confirm.

Designing Confirmation Requests



Design of a confirmation request

- The design of a confirmation request may **directly affect** the **confirmation response rate**, and
- the **reliability** and the **nature** of the audit evidence obtained from response

Factors to be considered by auditor when designing confirmation requests

Factors to consider when designing confirmation requests include:

- The **assertions** being addressed
- Specific identified **risks** of material misstatement, including fraud risks.
- The **layout** and **presentation** of the confirmation request.
- Prior experience** on the audit or similar engagements.
- The **method** of communication (for example, in paper form, or by electronic or other medium)
- Management's **authorisation** or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- The **ability** of the **intended** confirming **party** to **confirm** or provide the requested information (for example, individual invoice amount versus total balance).

Positive confirmation request

Positive Confirmation Request

- Ask Confirming Party to Reply the Auditor in all cases:
 - Either Agreement
 - Disagreement
 - or Providing the info Requested

- It Provides Reliable Audit Evidence
- Risk → Reply without verification
 - To Reduce this risk send Request without stating Amount or a Request to furnish info
 - But it may lead to decline in Confirmation Response Rate

Determination of properly addressed requests

- Ensure Requests are Properly Addressed
- Check Validity of Some Addresses before Sending Confirming Requests

Follow-Up on Confirmation Requests

- The auditor may send an **additional** confirmation request when a reply to a previous request has not been received within a reasonable time.
- For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Management's Refusal to Allow the Auditor to Send a Confirmation Request

If 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 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.

Common reason

Common reason: Legal dispute or ongoing negotiation with the confirming party which may be affected by an untimely confirmation request.

Alternative Audit Procedures

Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements, and other records, such as goods received notes.

If Refusal is Unreasonable or Alternative Procedures Fail

- Auditor must communicate with TCWG (SA 260).
- Determine audit implications and opinion as per SA 705.

DPQ 🍷🍷 CA Rishi is appointed as an auditor of AIR Ltd. for the financial year ending on March 31, 2024. During the audit, he observed that the company's books of accounts reflect a significant number of trade payables and receivables as on the balance sheet date. To verify the accuracy of the trade receivables, CA Rishi decided to send confirmation requests to some

of trade receivables. However, the management refused to permit him to send these confirmation requests to the selected parties. How should the auditor proceed in the given situation? (MTP2, Jan 2025, 5 marks)

Negative Confirmations (When to use?)

- A request that the confirming party **respond** directly to the auditor **only if** the **confirming party disagrees** with the information provided in the request.
- Negative Confirmations: Provide less persuasive audit evidence than positive confirmations.
- Not used as sole substantive procedure unless all conditions are met.
 - a. The auditor has assessed the **risk** of material misstatement as **low** and has obtained **sufficient** appropriate **audit evidence** regarding the **operating effectiveness** of **controls** relevant to the assertion;
 - b. The population of items subject to negative confirmation procedures comprises a large number of **small, homogeneous** account balances, transactions or conditions;
 - c. A very **low exception rate** is expected; and
 - d. The auditor is **not aware** of **circumstances** or conditions that would **cause** recipients of negative confirmation requests to **disregard** such requests.

Negative Confirmations Other points - Limitations

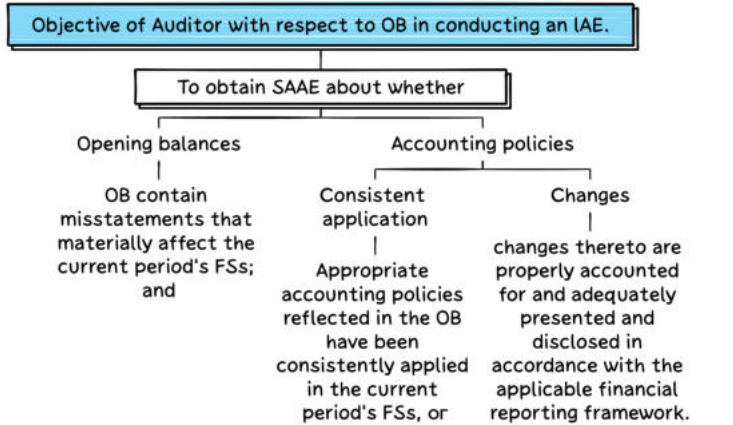
- No response does not confirm receipt or accuracy of information.
- Provides less persuasive evidence than positive confirmations.
- Confirming parties more likely to respond if information is unfavorable to them.
- Example:
 - Bank deposit holders may respond if their balance is understated but not if overstated.
 - In this case, Negative confirmations help detect understatement, but not overstatement.

Evaluating the Evidence Obtained

Auditor assesses if confirmation results are relevant and reliable or if **further audit procedures** are needed. Individual confirmation results may be categorized as follows

- A **response** by the appropriate confirming party **indicating agreement** with the information provided in the confirmation request, or providing requested information without exception;
- A **response deemed unreliable**;
- A **non-response**; or
- A **response indicating** an exception.

SA 510 Initial Audit Engagements – Opening Balances



Definitions	
Initial Audit Engagement	An engagement in which either: The FSs for the prior period were not audited; or The FSs for the prior period were audited by a predecessor auditor.
Opening balances	Those account balances that exist at the beginning of the period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
Predecessor auditor	The auditor from a different audit firm, who audited the FSs of an entity in the prior period and who has been replaced by the current auditor.

Account Balances at Period Beginning

- Example: On April 1, 2024 (the first day of the financial year), ABC Ltd has cash of ₹1,25,00,000, inventory worth ₹2,75,00,000, and equipment valued at ₹4,50,00,000. These amounts represent the opening balances for the 2024–25 financial year.

Also Include Matters Requiring Disclosure

- Example: As of April 1, 2024, XYZ Corp had a pending legal case with a potential liability of ₹75,00,000. Though not on the balance sheet, this contingent liability must be disclosed and is part of the opening balances.

Include Contingencies

- Example: PQR Enterprises begins its fiscal year with a tax dispute of ₹1,80,00,000 that might result in additional payments. This contingency exists at the beginning of the period and forms part of the opening balances.

Include Commitments

- Example: On January 1, 2024, LMN Manufacturing had signed contracts to purchase machinery worth ₹3,50,00,000 in the coming year. This commitment existed at the beginning of the period and is considered part of the opening balances for disclosure purposes.

Example of Accounting Policy

How a company values inventory (e.g., FIFO, LIFO, weighted average), how it depreciates assets, or how it recognizes revenue.

Audit Procedures regarding Opening Balances

Read Recent FS and Audit Report

The auditor shall read the most recent FSs, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

Obtain SAAE Whether OB Contains MS Having Material Affect on FS

The auditor shall obtain SAAE about whether the opening balances contain misstatements that materially affect the current period's FSs by

Correct Brought Forward and Disclosure of adjustment

- Determining whether the prior period's closing balances have been correctly brought forward to the current period or,
- any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss.

Appropriate Accounting Policies

Determining whether the opening balances reflect the application of appropriate accounting policies; and

Performing one or more of the following

- Careful reading of Audited FS and other Docs**
Where the prior year FSs were audited, perusing the copies of the audited FSs including the other relevant documents relating to the prior period FSs;
- Evaluate Audit Procedures**
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. (Example: The auditor of LMN Enterprises performs a bank confirmation specifically requesting information about loan balances as of the beginning of the period, confirming the ₹7,50,00,000 opening loan balance.)

DPQ – The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose? (SA, May 2022, 3 Marks) (HTP2, May 2023, 3 marks) (RTP, May 2024, NA)

Misstatement in Opening Balance

- If auditor obtains evidence that opening balances contain misstatements that could materially affect current period's FSs
- Auditor shall perform such additional audit procedures as appropriate to determine effect on current period's FSs

Example: If the auditor discovers ABC Ltd.'s opening inventory was overstated by ₹50 Lakhs, they perform additional procedures like analyzing inventory movements to determine the impact on current year's cost of goods sold and profit.

Misstatement in Current period's FS

If the auditor **concludes** that such **misstatements exist** in the current period's FSs, the auditor shall communicate the misstatements with the appropriate level of management and TCWG in accordance with SA 450.

Nature and extent of Audit Procedures

The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The **accounting policies** followed by the entity. Accounting policy-audit must have knowledge of the accounting policy so that he can obtain sufficient and appropriate audit evidence. accounting policy used by the client will have an impact on the audit procedure, for example, different audit procedures will be needed if the client is using weighted average method versus the FIFO method for inventory evaluation
- The **nature** of the account balances, classes of transactions and disclosures and the ROMM in the current period's FSs.
- The **significance** of the opening balances relative to the current period's FSs. (Gupta Pharmaceuticals has trade receivables with opening balance of ₹2.25 crore, representing 40% of current assets.)
- Whether the prior period's FSs were audited and, if so, whether the predecessor auditor's opinion was **modified**. - Kumar Manufacturing's auditor gave a qualified opinion on ₹1.8 crore inventory due to inadequate documentation of slow-moving items. The new auditor must verify inventory extensively, review aging reports, test net realizable value, and assess provision adequacy.

If the prior period's FSs were audited by a predecessor auditor

- Auditors can get evidence on opening balances from the predecessor's audited financials and supporting schedules.
- **Ordinarily**, the current auditor can place **reliance** on the closing balances contained in the FSs 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.

Example: If the predecessor determined accounts receivable was ₹75,00,000 at year-end, the new auditor typically accepts this as the opening balance.

During an audit of Sunrise Exports, the new auditor discovers emails suggesting management pressured the previous auditor to accept questionable revenue recognition practices. This raises concerns about the reliability of the ₹3,50,00,000 accounts receivable opening balance.

Example - The closing inventory of the company as on 31.3.2023 amounting to ₹ 100 lacs continued as it is and became closing inventory as on 31.3.2024

For current assets and liabilities

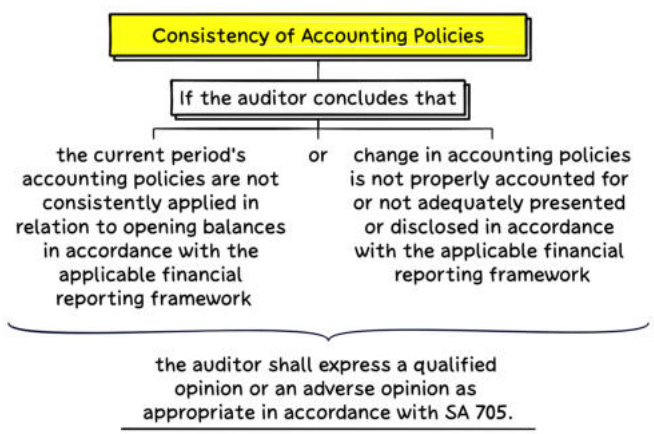
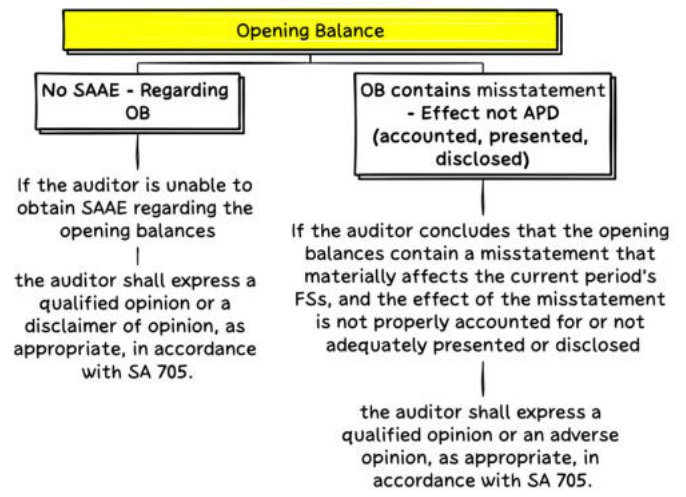
- Audit evidence for opening balances of current assets and liabilities may come from current audit procedures.

- Collecting (paying) opening receivables (payables) in the current period gives evidence of their initial existence, rights, obligations, and value.
- For inventories, the current audit on closing balance offers limited evidence on opening inventory, necessitating additional procedures.
 - 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

For non-current assets like property and long-term liabilities, evidence comes from accounting records and, sometimes, third-party confirmations. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting



Example: At Premier Manufacturing, the auditor cannot verify opening fixed assets of ₹1,20,00,000 (material but not pervasive). The auditor issues a qualified opinion.

Example: At Mega Enterprises, the auditor cannot verify multiple significant opening balances including inventory (₹5,50,00,000), accounts receivable (₹8,75,00,000), and fixed assets (₹12,25,00,000). Because these

represent most of the company's assets, the auditor issues a disclaimer of opinion

Example: If last year's closing inventory was overstated and the company does not adjust it, the auditor may give an adverse opinion.

Example: If last year's revenue was recognized on a cash basis but this year on an accrual basis without proper restatement, consistency is violated.

Example: If the company switches from FIFO to Weighted Average for inventory valuation but does not disclose the impact, it may mislead stakeholders.

Analytical Procedures (SA 520)

Scope of SA 520

SA 520 covers use of analytical procedures by auditor.

Used as substantive procedures (substantive analytical procedures).

Also used near audit end to help form overall conclusion on financial statements.

The auditor compares the monthly sales figures with the previous year's figures to identify any significant variances that might indicate misstatements in revenue.

At the end of an audit, the auditor has gathered a substantial amount of evidence about individual accounts and transactions. However, to form an overall opinion on whether the financial statements present a true and fair view, they need to step back and look at the big picture.

Example – Profitability Trends: Are profits increasing, decreasing, or remaining stable? Does this align with industry trends or the company's own strategic initiatives?

Objective of auditor as per SA 520

obtain audit evidence by using substantive analytical procedures

design and perform analytical procedure near end of the Audit

while forming conclusion, as to whether FS are consistent with auditors understanding of the entity

Need for analytical procedures

Routine check is not sufficient to reveal all misstatements

analytical procedures which includes trend analysis, ratio, analysis, reasonableness test, and are also called overall tests are also necessary

What is the meaning of Analytical Procedures?

Analytical Procedures

evaluations of financial information

includes

Applicable to

through analysis of plausible relationships

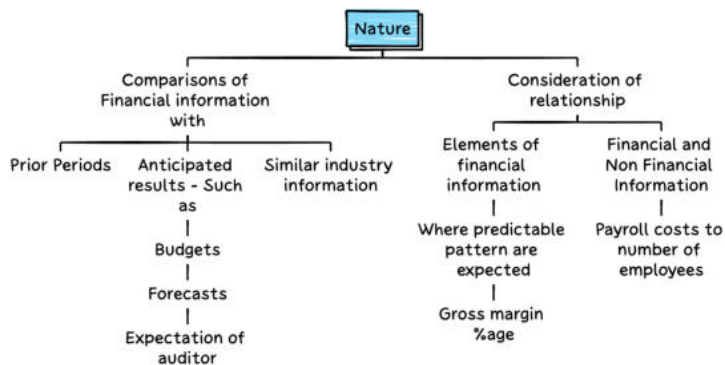
investigation

Large volume of transaction

among both financial and non-financial data

of Inconsistent fluctuations, relationships

That tend to be predictable over time



Purpose of AnPro

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

Helps identify unusual transactions, events, amounts, ratios, or trends with audit implications.

Few Examples

Compare P&L balances with similar entity to find profitability variations.

Compare current and previous P&L to find increase/decrease reasons.

Use expense ratios over years to see changes in expenses vs. sales/trading profit.

The cost of importing goods subject to a uniform ad-valorem duty can be verified through the amount of duty paid.

The quantity of sugar sold by a mill can be independently verified through the amount of GST paid.

Income/expenses linked to profit or sales (e.g., commission) can be verified.

The process of calculating ratios, trends, and comparisons is also known as analytical review.

Timing of Analytical Procedures

Experienced auditors use analytical procedures in all stages of the audit.

Planning

Testing

Completion

Understanding
In the planning stage, analytical procedures assist the auditor in understanding the client's business.

ROMM
identifying areas of potential risk,

NET of FAP
This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.

Used as Substantive Procedures to obtain audit evidence

Assist the auditor when forming an overall conclusion as to whether the FS are consistent with auditor's understanding of the entity

Substantive Analytical Procedures

Auditor's substantive procedures at the assertion level may include:

- Tests of details
- Substantive analytical procedures
- A combination of both

Procedure choice: Based on effectiveness and efficiency in reducing audit risk.

Management data: Auditors may inquire about and use management's analytical data if reliable.

Factors to be considered for using Analytical Procedures as Substantive Audit Procedures

The auditor should consider the following factors for Substantive Audit Procedures:

Availability of Data

The availability of reliable and relevant data will facilitate effective analytical procedures.

Disaggregation

The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.

Account Type

- Substantive analytical procedures – more useful for certain account types.
- Income statement accounts – more predictable – reflect accumulated transactions over a period.
- Balance sheet accounts – less predictable – show net effect at a point in time or involve more management judgement.

Source – Type of class of transactions

Some transaction classes more predictable – consist of numerous, similar transactions. Non-routine and estimation SCOTs (Significant Classes of Transactions) involve management judgement – harder to predict.

- Example: Daily retail sales transactions that follow consistent patterns, like grocery store purchases which are high volume and regular
- Example: One-time business restructuring costs that management decides how to classify and when to record
- Example: Warranty liability provisions where management must estimate future claims based on assumptions about failure rates and repair costs

Predictability

- Substantive analytical procedures suit predictable account balances or data relationships.
- Examples: sales vs. cost of sales, trade receivables vs. cash receipts.
- Predictable relationship: reasonably expected to exist and continue over time.

Example: Sales and cost of sales usually increase or decrease together – this makes the relationship predictable.

Nature of Assertion

- Substantive analytical procedures are more effective for completeness or valuation than rights and obligations.
- Predictive analytical procedures (using data analytics) help check completeness, valuation/measurement, and occurrence.
- Completeness – helps check if all sales are recorded.
- Valuation – shows unusual fluctuations in asset/liability values affecting other items.

Nature of Assertion – Explained with Examples

- Example: Easier to check if all sales are recorded (completeness) than to check ownership of assets (rights).
- Example: Using trends to confirm if all expenses occurred or were recorded correctly.
- Example – if sales trend shows ₹10 lakhs monthly but only ₹6 lakhs recorded – indicates missing sales.
- Example: Sudden drop in inventory value may affect cost of sales or profits – needs investigation.

Inherent Risk or “What Can Go Wrong”

- While designing procedures for inherent risk or “what can go wrong”, assess the nature of risk.
- If suitable, use substantive analytical procedures for audit evidence.
- Higher inherent risk → design tests of details.
- For significant risks, analytical procedures alone are not sufficient.
- Example (Nature of Risk): If management bonuses are linked to profit, there's a risk they may overstate revenue – assess this risk before using analytical procedures.
- Example: Rent expense is fixed monthly – trend analysis can give sufficient evidence.
- Example: For inventory prone to theft, verify physical stock instead of relying on trends.
- Example: For revenue fraud risk, also check invoices and contracts, not just sales trends.

DPQ – CA M, auditor of a company, has planned to use substantive analytical procedures during the course of audit. In this regard, he has decided to use such procedures in following areas: –
For testing relationship between sales and cost of sales
For testing rights over certain assets forming part of account balances
Comment upon his approach along with reasons
(ICAI MTP 2 Sep 24 – 4 Marks)

Techniques Available as Substantive Analytical Procedures

Substantive analytical procedures generally take one of the following forms

Trend analysis

- Commonly used technique.
- **Comparison** of
 - **current data with**
 - the **prior period** balance or
 - with a **trend in two or more prior period balances.**
- The auditor evaluates
 - whether the **current balance** of an account moves in **line** with the **trend established with previous balances** for that account, after adjusting for relevant factors responsible for changes

Example: Sales last 3 years: ₹10L → ₹12L → ₹14L

This year: ₹11L → Auditor investigates why sales dropped, despite an upward trend.

Ratio analysis

- Ratio analysis is useful for analysing

- asset and liability **accounts** as well as revenue and expense accounts.
- An **individual balance sheet account is difficult to predict** on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).
- Ratios can also be compared
 - over **time** or
 - to the ratios of separate entities **within the group** or
 - with the ratios of **other companies in the same industry**.

Reasonableness tests

- Includes reviewing the relationship of certain account balances (FDs) to other balances (Interest) for **reasonableness of amounts**.
- Does **not** rely on data and events of prior periods.
- **Uses non-financial data** for the audit period under consideration
 - Example
 - **occupancy rates** to estimate rental income or
 - **interest rates** to estimate interest income or expense
- These tests are generally **more applicable to income statement** accounts and certain accrual or **prepayment** accounts.

Examples

- Interest expense against interest obligations
- Raw Material Consumption to Production
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises which are rented out.

Structural modelling

A modelling tool **constructs a statistical model**

- from **financial** and/or **non-financial data** of prior accounting periods
- to **predict current** account balances

(Simple words – We use a statistical model to predict current account balance on the basis of prior accounting periods.)

- The most commonly used procedure is regression analysis, which is used for income statements using monthly data for the past three years.
- The 36 or 48 monthly observations are used to establish a relationship that is used to predict current period balances.

Using regression analysis of 36 months of data, an auditor develops a model that predicts monthly electricity costs

CA D, during the course of audit of a company engaged in export business, notices that credit facilities taken by the company during the year from a

bank for ₹10 crores have almost been fully utilized during the year. On going through sanction letter provided by bank to company, it is observed that rate of interest stipulated in sanction letter is 8% p.a. Financial statements of company show bank interest amounting to ₹60.00 lacs. Which type of substantive analytical procedure is being used by CA D?
 (a) Trend analysis
 (b) Ratio analysis
 (c) Reasonableness tests
 (d) Structural modelling
 (MTP2, May 2024, 2 Marks)

Analytical Procedures used as Substantive Tests

When **designing** and **performing** substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall

1. Determine **Suitability for Assertion**
 - 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;
 - Predictability of the amount
2. Evaluate **Reliability** of Data
 - Evaluate the reliability of data
 - from which the auditor's expectation of recorded amounts or ratios is developed,
 - taking account of
 - **Source** of Information
 - **Comparability** of the information
 - **Nature & Relevance** of Information
 - **Controls** over the preparation of the information
3. **Develop** an **expectation**
 - Develop an expectation of recorded amounts or ratios and
 - evaluate whether the expectation is sufficiently precise to **identify a misstatement** that, individually or when aggregated with other misstatements, may **cause** the **financial statements** to be **materially misstated** and
4. Determine **Acceptable Difference**
 - Determine the **amount** of any difference of recorded amounts from expected values that is acceptable without further investigation.

You're an auditor working on SmartBazaar Ltd., which runs over 100 retail stores across India. Applying Analytical Procedures as Substantive Test

- Determine Suitability for Assertion: – You're testing completeness – a good match
- Evaluate Reliability of Data: – Data is from ERP, reconciled with billing system – reliable
- Develop an Expectation: – Based on past 6 months' trends, seasonal patterns, and cost of goods sold, you expect ₹10 crore in March sales.

- **Determine Acceptable Difference:** – You decide a difference up to ₹50 lakhs is acceptable without further investigation.
Compare Actual vs Expected:
Recorded sales: ₹6 crore
Expected sales: ₹10 crore
✗ Difference = ₹4 crore → Exceeds threshold
- **Conclusion** – This large difference triggers further investigation. You plan to perform tests of details – check invoices, goods dispatch, etc.

Investigating results of analytical procedures			
When?	Relationships inconsistent with relevant information identified	Credit sales increasing, Debtors not increasing	
	Actual value differ from expected value by significant amount	Inventory turnover ratio is lower than the expected	
How?	Enquire from Management	management said, new product line launched	
	Obtain Appropriate audit evidence for management's responses	taking into account the auditor's understanding of the entity and its environment	
		and	
		other audit evidence obtained during the course of audit	
Problem with Management's Explanation	Performing other audit procedures as necessary in the circumstances	Explanation not adequate or Explanation not provided	Repairs & Maintenance increased sharply; no proper bills— auditor verifies logs, invoices, and payments.

Analytical procedures that assist when forming an overall conclusion

- Auditors form conclusions for different components or elements of financial statements.
- Using analytical procedures near the end of the audit helps in confirming those conclusions. (FS are consistent with auditor's understanding of the entity)
- This assist the auditor to draw reasonable conclusion on which to base auditor's opinion
- Analytical procedures might uncover a new ROMM, requiring auditors to revise their risk assessment and modify subsequent audit procedures as per SA 315 and SA 330.

Miscellaneous topics – homework

Suitability of Particular Analytical Procedures for given assertions

- Substantive analytical procedures are generally **more applicable to large volumes of transactions** that tend to be **predictable** over time.
- Suitability of a particular analytical procedure will depend upon the **auditor's assessment** of how **effective** it will be in **detecting a misstatement** that may cause the financial statements to be materially misstated, whether individually or in aggregate.
- The determination of the suitability of particular substantive analytical procedure is influenced by the **nature** of the **assertion** and the auditor's assessment of the **risk** of **material**

misstatement: If risk is high due to lack of controls we will use more tests of details and less (or even no) substantive analytical procedure.

- Substantive analytical procedure may also be considered **suitable to support** the **test** of **details**.

The Reliability of Data

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

1. **Source** of the information available. For example, information may be more reliable when it is obtained from **independent** sources outside the entity;
2. **Nature** and **relevance** of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
3. **Comparability** of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
4. **Controls** over the **preparation** of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

Evaluation of whether the Expectation is sufficiently precise

Matters relevant to the auditor's evaluation of **whether the expectation can be developed sufficiently precisely to identify a misstatement** that may cause the financial statements to be materially misstated, include:

1. The **accuracy** with which the **expected results** of substantive analytical procedures can be **predicted**. Higher the accuracy, the more precise the expectations can be. For example, the auditor may expect greater consistency in comparing salaries and wages from one period to another than in comparing discretionary expenses, such as research etc.
2. The **degree** to which **information** can be **disaggregated**. For example, substantive analytical procedures may be more effective when applied to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
3. The **availability** of the **information, both** financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of employees (current, who left, new joiners) etc, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information

Amount of difference of Recorded amounts from expected values that is acceptable

The auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by

- **materiality** and
- the **consistency** with the desired level of assurance,
- taking account of the **possibility** that a **misstatement** may **cause** the **FSs** to be **materially misstated**. As the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence.

SA 501 – Audit Evidence-Specific Considerations For Selected Items

Objective

The objective of the auditor is to obtain SAAE regarding the:

- Existence and condition of inventory
- Completeness of litigation and claims involving the entity and
- Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

Topics related to inventory

- SAAE Regarding Existence and condition of inventory
- Attendance at Physical Inventory Counting
- Matters Relevant in Planning Attendance at Physical Inventory Counting
- Physical inventory counting is conducted at a date other than the date of the FSs
- If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances
- Attendance is impracticable
- Inventory under the custody and control of a third party

SAAE Regarding Existence and condition of inventory			
When?	When Inventory in material		
How?	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
		Perform	Test Counts
	Performing audit procedures	over the entity's final inventory records	

Inventory

SAAE Regarding Existence and condition of inventory

When inventory is material to the FSs, 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:
 - i. Evaluate **management's instructions and procedures** for recording and controlling the results of the entity's physical inventory counting;
 - ii. **Observe** the performance of management's count procedures;
 - iii. **Inspect** the inventory; and
 - iv. 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.

- Auditor reviews the written instructions given to warehouse staff about how to tag and record items.
- Auditor watches employees count boxes of goods to ensure they follow instructions properly.
- Auditor checks expiry dates on perishable goods and notes damaged items.
- Auditor counts 10 items from a rack and compares it with the count recorded by staff.
- Auditor checks if the quantity of laptops in the inventory system matches the physical count done on inventory day.

Matters Relevant in Planning Attendance at Physical Inventory Counting

Matters relevant in planning attendance at physical inventory counting include,

- **Nature** of inventory.
- **Stages** of completion of work in progress.
- The **risks** of material misstatement related to inventory.
- The nature of the **internal control** related to inventory.
- Whether **adequate procedures** are expected to be established and proper instructions issued for physical inventory counting.
- The **timing** of physical inventory counting.
- Whether the entity maintains a **perpetual inventory system**.
- The **locations** at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- Whether the **assistance** of an auditor's **expert** is needed.

A perpetual inventory system is a method of tracking inventory where changes in stock levels are recorded in real-time, as they happen.

Physical inventory counting is conducted at a date other than the date of the FSs

When physical inventory counting is conducted on a date other than the financial statement date, the auditor should:

1. Perform additional audit procedures to obtain evidence about whether changes in inventory between the count date and the date of the FSs are properly recorded
2. Consider the following when designing audit procedures:
 - Proper adjustment of perpetual inventory records
 - Reliability of the entity's perpetual inventory records
 - Reasons for significant differences between physical count information and perpetual inventory records
- If the company counted inventory on, say, March 15th, but their financial year ends on March 31st, the auditor must verify inventory changes in those 16 days. Example: Examining shipping documents for goods sold between March 15th and 31st.
- Checking if new raw materials received on March 20th were correctly added to the inventory system.
- Auditor reviews prior accuracy history of perpetual system - if previous error rates were low (< 1%), may rely more heavily on system
- Auditor finds 500 units less in physical count than in records and checks for theft or misreporting.

If the Auditor is unable to Attend Physical Inventory Counting due to Unforeseen Circumstances

If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an **alternative date**, and perform audit procedures on intervening transactions.

Auditor misses the 31st March count, so attends a fresh count on 5th April. Auditors verify purchases and sales from 31st March to 5th April to adjust stock accurately.

Attendance is impracticable

- If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain SAAE regarding existence and condition of inventory.
- If not possible to do so, the auditor shall modify opinion in accordance with SA 705.
- Alternative procedures may include inspection of documentation of subsequent sale of specific inventory items acquired before counting.
- Auditor couldn't attend due to a natural disaster, so checks stock purchase and sale documents instead.
- Auditor verifies that 100 machines were sold after year-end, confirming they existed on the inventory date.
- When a warehouse fire destroys both inventory and records before auditor can verify, auditor issues a qualified opinion
- For a mining company with inaccessible underground inventory, auditor issues disclaimer of opinion if no reliable alternative procedures exist

Inventory under the custody and control of a third party

When inventory under the custody and control of a third party is material to the FSs, the auditor shall obtain SAAE regarding the existence and condition of that inventory by performing one or both of the following

- a. Request **confirmation** from the third party as to the **quantities** and **condition** of inventory held on behalf of the entity.
- b. Perform **inspection** or other audit procedures appropriate in the circumstances.

- Auditor sends a letter to the warehouse company storing goods to confirm 1,000 units of raw material are held in good condition.
- Auditor visits the third-party warehouse to physically inspect goods for damage or expiry.

Doubtful Third-Party Integrity/Objectivity

Auditor may perform other procedures instead of/in addition to confirmation Examples of other audit procedures include

1. Attending/arranging attendance at third-party's physical count (if practicable)
2. Obtaining **service auditor's report**, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
3. Inspecting documentation (e.g., warehouse receipts).
4. Requesting **confirmation** from other parties when inventory has been pledged as collateral. (Example: Contacting a bank that holds inventory as collateral to confirm quantities and conditions.)

A service auditor is an independent professional who examines and evaluates the internal controls of a service organization like a third-party warehouse, data center, or cloud service provider.

Quality Products Limited is engaged in manufacturing bicycles. As part of manufacturing activities, it sends raw material to some business entities and procures finished components from them. As on 31st March 2024 inventories lying with such business entities are material. Being statutory auditor of Quality Products Limited, how will you obtain sufficient appropriate audit evidence regarding existence and condition of inventories lying with such business entities? (ICAI RTP, Sep 2024, NA)

Coyote Ltd. is dealing in trading of electronic goods. Huge inventory (60% approximately) of the company is lying on consignment (i.e. under the custody of a third party). CA. Star, the auditor of the company, wants to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory lying on consignment. Thus, he requested & obtained confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity, however, it raised doubts about the integrity and objectivity of the third party. Which of the following other audit procedures may be performed by CA. Star to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory under the custody of a third party?

- (a) Attend a third party's physical counting of inventory.
 - (b) Arrange for another auditor to attend a third party's physical counting of inventory.
 - (c) Inspect warehouse receipts regarding inventory held by third parties.
 - (d) All of the above.
- (Sample MCQs) (RTP, May 2019, NA)

Litigation and Claims

Auditor designs/performs procedures to identify litigation/claims involving the entity which may give rise to a ROMM, including:

- a. **Inquiry** of management and, where applicable, others within the entity, including in-house legal counsel;
 - b. Reviewing **minutes** of meetings of TCWG and correspondence between the entity and its external legal counsel; and
 - c. Reviewing **legal expense accounts**.
- Auditor asks the CFO or legal head if any legal case is pending against the company.

- Auditor checks board meeting notes and emails between the company and its external lawyer to find mention of lawsuits.
- Auditor examines accounts showing legal fees paid during the year to spot any ongoing or hidden legal issues.

Communication with the entity's external legal counsel	
If the auditor assesses ROMM from identified or possible litigation/claims	they shall seek direct communication with the entity's external legal counsel (in addition to procedures required by other SAs).
Auditor shall use a letter of inquiry	prepared by management and sent by auditor, requesting external legal counsel communicate directly with auditor
If law, regulation or legal professional body prohibits external legal counsel from direct communication with auditor	auditor shall perform alternative audit procedures

- Example: Auditor finds a pending lawsuit may affect financial statements → Contacts company's external lawyer directly.

Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements. Suggest the auditor with reference to SAs.

(ICAI Study Material – Illustration) (SA, May 2019, 4 Marks) (MTP1, May 2020, 4 Marks) (MTP2, May 2021, 3 Marks)

Letter of Specific Inquiry – Communication with the Entity's External Legal Counsel

If a general inquiry response is unlikely (e.g., a professional body prohibits it), the auditor may use a letter of specific inquiry for direct communication. A letter of specific inquiry includes:

- A list of litigation and claims;
 - Management's assessment of outcome and financial implications (including costs) where available; and
 - Request for counsel to confirm reasonableness of management's assessments and provide further information if list is incomplete/incorrect
- Auditor knows legal counsel won't respond to a general letter due to legal rules → Sends a specific inquiry instead.
 - Auditor attaches a list showing 3 ongoing court cases against the company.
 - Management says Case A may cost ₹5 lakhs in legal fees and likely to be lost.
 - Auditor asks legal counsel to confirm if ₹5 lakhs estimate is reasonable and inform if any case is missing from the list.

CA Z, the auditor of MNO Ltd., during the course of audit, assesses a risk of material misstatements regarding the litigations and claims involving the company. CA Z is not convinced with the management's explanations regarding the status of the litigations or claims. It is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general enquiry. The auditor sent a letter of specific enquiry requesting the entity's external legal counsel to communicate directly with the auditor. List out the inclusions in the letter of specific enquiry. In certain circumstances the auditor may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigations or claims. What will be the auditor's reporting responsibility if

the management refuses to give permission to the auditor to communicate or meet with the external legal counsel? (SA, May 2024, 4 Marks)

Meeting with entity's external legal counsel

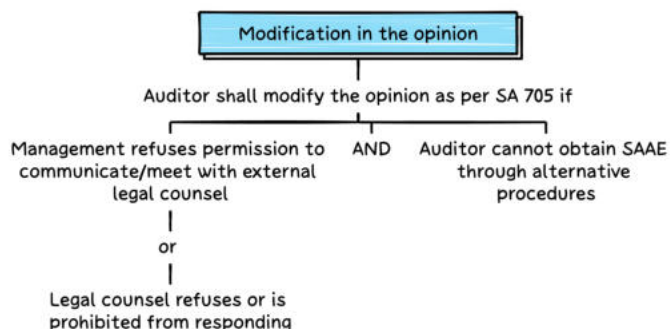
Auditor may judge it necessary to meet with external legal counsel to discuss likely outcome of litigation/claims when

- The auditor determines that the matter is a **significant** risk.
- The matter is **complex**.
- Disagreement exists between management and legal counsel.

Such meetings need management's permission and are usually attended by a management representative.

- A ₹10 crore lawsuit could impact going concern → Auditor meets legal counsel to understand possible outcomes.
- Legal cases involve foreign laws and multiple parties → Auditor needs legal expert's clarity.
- Management says the case is minor, but legal counsel calls it serious → Auditor arranges a meeting to clarify.
- Auditor requests meeting with lawyer → Company allows it and sends CFO to attend.

SPR Ltd has been into the media business since 1990. During the F.Y 2023–2024 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances? (SA, May 2022, 3 Marks) (RTP, May 2024, NA)



- Management doesn't allow the auditor to talk to the company's lawyer about an ongoing case.
- Lawyer declines to reply to the auditor's inquiry due to confidentiality rules of the legal body.
- Auditor tries checking court records and emails but still can't gather enough evidence.
- Due to lack of sufficient appropriate audit evidence, auditor issues a qualified or disclaimer opinion.

Written Representations		
The auditor shall request MGT. and, where appropriate, TCWG to provide written representations that	All known actual or possible litigation and claims Affecting financial statements Have been	disclosed to the auditor and appropriately accounted for and disclosed in accordance with the AFRF.

Segment Information

Segment Information refers to information about different types of products and services of an enterprise and its operations in different geographical areas

ITC has segments like FMCG (e.g., Aashirvaad, Bingo), Paperboards, and Agri Business → Each is reported separately. ITC exports agri products to multiple countries and operates hotels in different Indian regions → Segment info is shown by region.

Under Indian Accounting Standards, particularly Ind AS 108, segment reporting is essential for entities with diverse operations across different business lines or geographical areas. This disclosure helps provide a clear understanding of the different areas contributing to the company's overall performance, which is crucial for investors, analysts, and other stakeholders in making informed decisions.

Obtain SAAE regarding the presentation and disclosure of segment information.

The auditor shall obtain SAAE regarding the presentation and disclosure of segment information in accordance with the AFRF by

- **Obtaining an *understanding*** of the ***methods*** used by management in determining segment information, and
 - Evaluate if methods result in disclosure as per AFRF
 - Where appropriate, testing the application of such methods; and
 - Performing ***analytical procedures*** or ***other*** audit procedures appropriate in the circumstances.
- Auditor checks how ITC identifies its segments—based on business lines like FMCG, Hotels, etc.
 - Auditor verifies if ITC's segment reporting follows Ind AS 108 correctly.
 - Auditor checks if ITC correctly grouped all FMCG-related revenue and expenses under the "FMCG segment."
 - Auditors compare this year's FMCG segment profits with last year to identify unusual changes.

Understanding of the Methods Used by Management

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 AFRF include
1. ***Sales***, transfers and charges between segments, and elimination of inter-segment amounts.
 2. ***Comparisons*** with ***budgets*** and other expected results, for example, operating profits as a percentage of sales.
 3. The ***allocation*** of assets and costs among segments.
 4. ***Consistency*** with ***prior periods***, and the ***adequacy*** of the disclosures with respect to inconsistencies.
- ITC's agri-business sells raw material to its FMCG unit → Auditor checks if internal sales are eliminated in consolidated segment reporting.
 - FMCG segment had a 20% profit margin in budget but actual is 10% → Auditor investigates the reason.

- Auditor checks if hotel buildings are properly assigned to the "Hotels" segment and not to "FMCG."
- ITC reclassified some operations from FMCG to a new segment → Auditor checks if change is disclosed and reasons are given.

Auditor's responsibility regarding the presentation and disclosure of segment information

- Auditor's responsibility for segment information presentation/disclosure relates to FS as a whole
- Auditor not required to perform procedures necessary to express stand-alone opinion on segment information

SA 610 “Using the work of Internal Auditors”

Definition of Internal Audit Function

Internal audit function refers to

- a function of an entity that
- performs assurance and consulting activities designed
- to evaluate and improve the effectiveness of the
- entity’s governance, risk management and internal control processes

Objectives and scope of internal audit functions

Same as given in the definition.

Activities Related to Governance

Assess Governance Process & its Accomplishment of objectives on Ethics, Values, Accountability, communicating risk to appropriate areas of the organization

Activities Related to Risk Management

Assist by identifying & assessing Risk
Improving Risk Mgt & IC

Activities Related to IC

Evaluation of IC

Review – Control
Evaluate – Operation
Recommend – Improvement

Examination of Fin. & operation info

How Entity identify, recognize, measure, classify, and report its financial and operational data

Review of operating Activities

Review economy, efficiency and effectiveness of activities

Review of compliance with L/R

Review compliance with law and regulation and with management policies

Ways in which the external auditor may make use of the internal audit function

Risk Assessment

- Gather information relevant to evaluating risks of material misstatement.

Using the work of the internal audit function in obtaining audit evidence

- Consider internal audit’s work as part of audit evidence. following legal and regulatory guidelines.

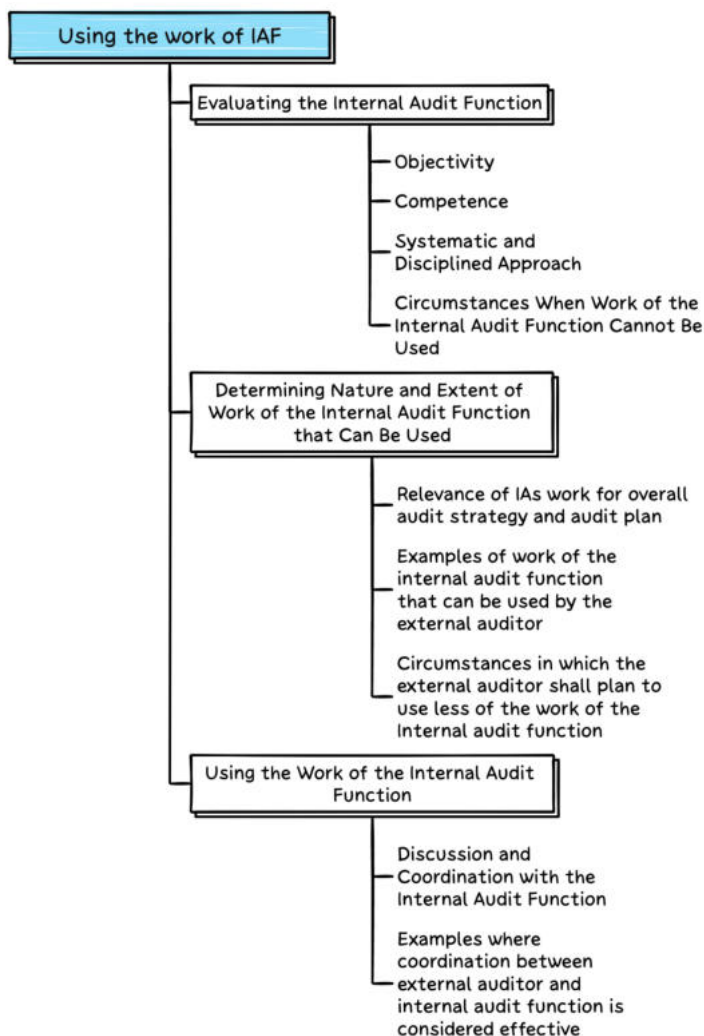
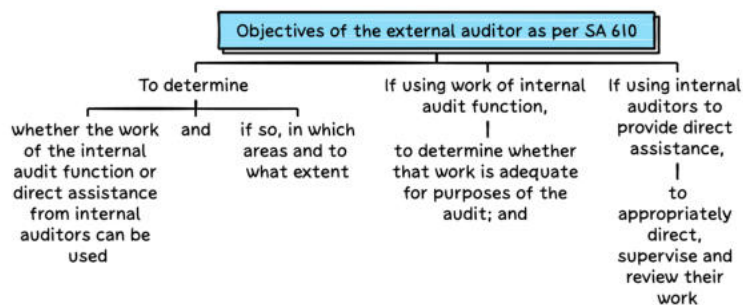
Direct Assistance

- Unless prohibited, or restricted by law or regulation, external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (“direct assistance”)

Using internal auditor’s work does not require external auditor to modify nature, extent and timing of audit procedures to be performed It remains the decision of the auditor

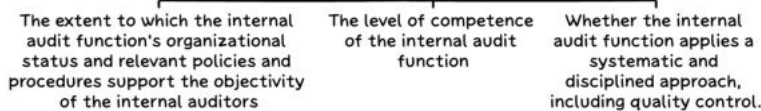
External Auditor’s Responsibility for the Audit

- Sole Responsibility: The external auditor alone is responsible for the audit opinion and this responsibility is not reduced by using the internal audit function or direct.
- Internal auditors are not independent as required by sa 200.
- Work of an internal auditor can be used but only subject to the conditions specified in SA 610.



Evaluating the Internal Audit Function

Determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following



Objectivity and its evaluation

Meaning

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

Factors that may affect the external auditor's evaluation in relation to Objectivity

- Whether the organizational status of the internal audit function supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments.
 - For example, whether internal audit function reports to TCWG
- Whether TCWG oversees employment decisions related to the internal audit function.
 - For example, determining the appropriate remuneration policy.
- Whether there are any constraints placed on the internal audit function by MGT or TCWG
 - For example, communicating internal audit function's findings to external auditor.
- Whether internal audit function is free of any conflicting responsibilities,
 - For example, having managerial duties or responsibilities that are outside of the internal audit function.

Competence and its evaluation

Meaning

Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.

Factors that may affect the external auditor's determination in relation to competence

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether there are established policies for hiring, training and assigning internal auditors
- Whether internal auditors have adequate technical training and proficiency in auditing.

- Whether internal auditors possess required knowledge relating to the entity's financial reporting and AFRF

Application of a Systematic and Disciplined Approach

Meaning

Internal audit's systematic, disciplined approach to planning, performing, supervising, reviewing, and documenting activities sets it apart from other monitoring controls within the entity

Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach

- Existence, adequacy, and use of documented procedures/guidance (risk assessment, work programs, documentation, reporting) commensurate with entity size and circumstances.
- Whether the internal audit function has appropriate quality control policies and procedures.

Circumstances When Work of the Internal Audit Function Cannot Be Used

The external auditor shall not use the work of the internal audit function if he determines that:

- The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- The function lacks sufficient competence; or
- The function does not apply a systematic and disciplined approach, including quality control.

DPQ – PQR & Co., Chartered Accountants, has been appointed as statutory auditor of MGM Ltd. The financial statements of the company have material amounts outstanding as debtors. Ageing of debtors is being done by the internal auditors and is given by them in their monthly report. This issue was also discussed with the management. The engagement partner from PQR & Co. decided to give the age wise debtors as per the report of the internal auditor due to shortage of time. After the audit report was released, the engagement partner realized that the disclosure of the debtors is misleading and the ageing was not done by the internal auditor on correct principles due to which the provision made against old debtors was wrong. The engagement partner held the internal auditor responsible for this. Is he correct in making the statement that the internal auditor is responsible for false provisioning? What considerations PQR & Co. should have undertaken before relying on the work of the internal auditor?

Determining Nature and Extent of Work of the Internal Audit Function that Can Be Used

Consider the nature and scope of internal audit work (performed or planned) for relevance to the external audit strategy and plan.

Examples of work of the internal audit function that can be used by the external auditor

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.

- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.

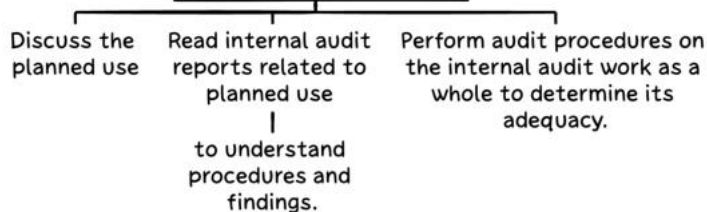
Internal auditor traces a sales invoice from order placement, billing, to entry in financial statements to ensure accuracy.

Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function

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

- The **more judgment** is involved in:
 - Planning and performing relevant audit procedures; and
 - Evaluating the audit evidence gathered;
- The **higher** the **assessed risk of material misstatement** at the assertion level, with special consideration given to risks identified as significant;
- The **less** the internal audit function's organizational **status** and relevant policies and procedures adequately support the **objectivity** of the internal auditors; and
- The **lower** the level of **competence** of the internal audit function

Using the Work of the IAF



- External auditor discusses with internal auditor that they plan to use internal audit's control testing over the sales process.
- External auditor reads the internal audit's report on inventory count to understand procedures followed and discrepancies noted.
- External auditor re-performs some of the internal audit's control tests on payroll to check their accuracy and adequacy.

Discussion and Coordination with the Internal Audit Function

In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The **timing** of such work.
- The **nature** of the work performed.
- The **extent** of audit coverage.
- **Materiality** for the financial statements as a whole and performance materiality.
- Proposed **methods** of item selection and sample sizes.
- **Documentation** of the work performed.
- **Review** and **reporting procedures**.
- Internal auditor tests controls in November; external auditor uses that work in December for planning.

- Internal auditor reviews payroll controls; external auditor relies on that for payroll audit.
- Internal audit reviewed 20% of all customer accounts receivable
- External auditor sets overall materiality at ₹10 Lakhs; internal audit uses similar benchmarks for control testing.
- Both agree to use random sampling for purchase orders and test 50 items each.
- Internal auditor maintains working papers with control test results; external auditor reviews them for reliability.
- Internal auditor sends weekly reports to the CFO and shares them with the external auditor for review.

Examples where coordination between external auditor and internal audit function is considered effective

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- External auditor is advised of and has access to relevant internal audit reports and significant matters affecting their work.
- Monthly meetings are held where the internal auditor updates the external auditor about the progress of internal audits.
- External auditor finds suspected fraud in inventory—he informs the internal auditor so they can re-check internal controls over inventory.
- Internal auditor finds a serious control weakness in cash disbursement. They share the report with the external auditor, who then plans extra procedures for cash payments

M/s PSR & Associates are the auditors of The Saturn Hotel, a chain of five-star hotels. Since the nature of their business is prone to frauds, the company has appointed internal auditors at various locations. The company has also devised a system of effective and efficient internal controls. The auditors, M/s PSR & Associates, want to use the work of the internal auditors. In order to ensure effectiveness, what kind of coordination should be there between the external auditor and the internal audit function? (SA, May 2024, 3 Marks)

Determining whether, in which areas, and to what extent Internal Auditors can be used to provide direct assistance

Direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Determining whether Internal Auditors can be used to provide direct assistance for purposes of the audit

- Law/regulation may prohibit direct assistance from internal auditors.
- **If not prohibited**, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall **evaluate** threats to objectivity and competence of internal auditors.
- The external auditor shall not use an internal auditor to provide direct assistance if:
 - a. There are significant threats to the objectivity of the internal auditor; or
 - b. The internal auditor lacks sufficient competence to perform the proposed work.

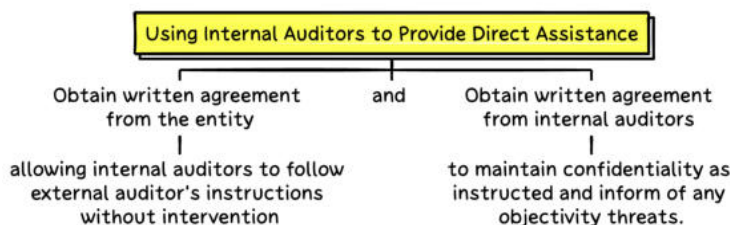
Areas where Internal Auditor cannot provide direct assistance

- Involve making significant judgments in the audit;
- Relate to higher assessed ROMM where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited
- Relate to work with which the internal auditors have been involved
- Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

CA Z is appointed as statutory auditor of BETA Private Limited for the year 2023–24. There exists an internal audit function in the company headed by its Chief Internal Auditor, CA K. Valuation of trade receivables of the company is assessed as area of higher risk by statutory auditor. He wants to take direct assistance from the Chief Internal Auditor in respect of the above matter. Discuss along with reasons whether it would be proper for statutory auditor to: -

- assign checking of accuracy of aging of trade receivables to Chief Internal Auditor?
- assign evaluation of adequacy of provision based on aging of trade receivables to Chief Internal Auditor?

(MTP1, May 2024, 4 Marks)



CA Mukul is the external auditor of Beige Ltd., a large company, engaged in the manufacturing of fast-moving consumer (FMCG) goods. After assessing the internal audit function of the company, CA Mukul decided to use the internal auditor of the company to provide direct assistance. In this context, what is meant by direct assistance under the relevant Standard on Auditing? Also comment whether prior to using an internal auditor for direct assistance for the purpose of audit, CA Mukul is required to obtain any written agreements or not. Give examples of procedures in which CA Mukul shall not use an internal auditor to provide direct assistance

Distinction between Internal Financial Control and Internal Control over financial reporting

- The term Internal Financial Controls (IFC) refers to the policies and procedures put in place by companies for ensuring
 - reliability of financial reporting,
 - effectiveness and efficiency of operations,
 - compliance with applicable laws and regulations,
 - safeguarding of assets and
 - prevention and detection of frauds.
- On the other hand, Internal controls over financial reporting is required where auditors are required to express an opinion on the effectiveness of an entity’s internal controls over financial

reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on FS.

- Therefore, “internal financial control” is a wider term whereas “internal controls over financial reporting” is a narrower term restricted to an entity’s internal controls over financial reporting only.

Internal financial controls can be seen as broad policies related to financial reporting covering aspects, other than financial reporting as well. For example, comprehensive information, technology security will help in preventing unauthorised access of data. On the other hand, internal control over financial reporting can be termed as specific controls limited to financial reporting only for example, control over review and approval of manual journal entries

SA 550 Related Parties

Scope

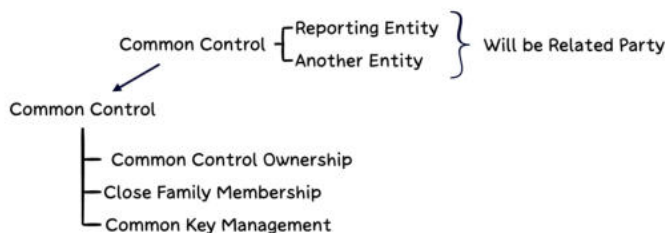
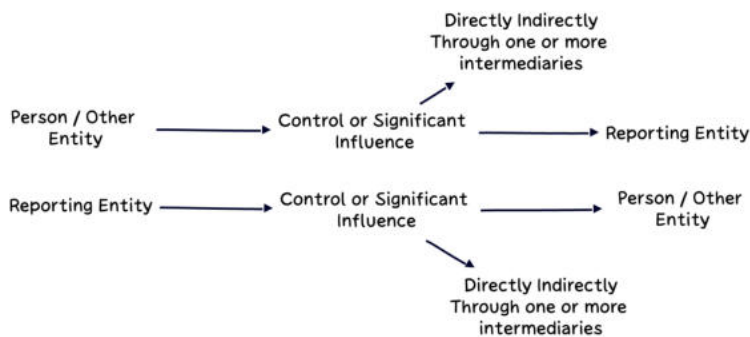
This SA addresses the auditor's responsibilities for related party relationships and transactions, expanding on SA 315, SA 330, and SA 240 regarding related risks of material misstatement.

Definition of Related Party

A party that is either

- i. A related party as **defined** in the applicable financial reporting framework; or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a) A **person** or **other** entity that has **control** or **significant influence**, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b) **Another entity** over which the reporting entity has **control** or **significant influence**, directly or indirectly through one or more intermediaries; or
 - c) Another entity that is under **common control** with the reporting entity through having:
 - i) Common controlling ownership;
 - ii) Owners who are close family members; or
 - iii) Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another



Meaning of control and significant influence in reference to related party

- Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:
 - i. Control is the **power to govern** the **financial and operating policies** of an entity so as to obtain benefits from its activities; and

- ii. Significant influence (which may be gained by share ownership, statute or agreement) is the **power to participate** in the **financial and operating policy decisions** of an entity, but is not control over those policies.
- The existence of the following relationships may indicate the presence of control or significant influence:
 - i. Direct or indirect equity holdings or other financial interests in the entity.
 - ii. The entity's holdings of direct or indirect equity or other financial interests in other entities.
 - iii. Being part of TCWG or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
 - iv. Being a close family member of any person referred to in subparagraph (iii).
 - v. Having a significant business relationship with any person referred to in subparagraph (iii).

What do you mean by control and significant influence? Give some examples of the relationship, the existence of which indicate control and significant influence.

Meaning of Related Parties with Dominant Influence

Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert **dominant influence** over the entity or its management. Consideration of such behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud.

Example: If a major shareholder (who is a related party) pressures the company to manipulate financial statements to show higher profits, this is dominant influence.

Why is it Important for the Auditor?

Such influence may increase the risk of fraud or manipulation, especially if the related party wants to achieve personal gain.

Meaning of Special-Purpose Entities as Related Parties

In some circumstances, a special-purpose entity may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity's equity.

Mr. Mehta runs a company called Mehta Constructions Ltd.

He wants to borrow ₹100 crores to build a new township, but he doesn't want this big loan to appear on his company's balance sheet – it might scare investors.

So, he sets up a new company called Urban Build SPV Pvt. Ltd. – a special-purpose entity (SPE).

He tells a few friends to become shareholders of this new SPE so that Mehta Constructions officially owns only 1% of it.

On paper, it looks like Mehta Constructions has nothing to do with Urban Build SPV.

But in reality:

All major decisions of the SPE are taken by Mr. Mehta.

The project is planned, executed, and funded by Mehta Constructions. All profits or losses ultimately affect Mr. Mehta's business. So even though Mehta Constructions is not the legal owner of the SPE, it controls it "in substance," and therefore SPE is a related party

Nature of Related Party Relationships and Transactions

- Many related party transactions in the normal course of business may not carry higher misstatement risk than those with unrelated parties.
- However, related party relationships and transactions may sometimes pose higher misstatement risk than those with unrelated parties.
- For example,
 - Related parties may use **complex relationships and structures**, increasing the complexity of their transactions.
 - **Information systems** may be **ineffective** at identifying or summarising transactions and outstanding balances between an entity and its related parties.
 - Related party transactions may **not** be **conducted** under **normal market terms** and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Many related party transactions are in the normal course of business. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Give a few examples of such areas. (ICAI Study Material – Test Your Knowledge)

Understanding the Entity's RPRT

The auditor **shall inquire of management** regarding:

- The **identity** of the entity's related parties, including **changes** from the prior period;
- The **nature** of the relationships between the entity and these related parties; and
- Whether the entity entered into any **transactions** with these related parties during the period and, if so, the **type** and **purpose** of the transactions.
- The auditor shall **inquire** of management and others within the entity, and perform **other risk assessment procedures** considered appropriate, to obtain an **understanding** of the **controls** if any in that management has established to
 - **Identify, account** for, and **disclose** related party relationships and transactions in accordance with the applicable financial reporting framework.
 - **Authorise** and **approve** significant transactions and arrangements with related parties; and
 - **Authorise** and **approve** significant transactions and arrangements outside the normal course of business.

Considerations specific to smaller entities by the auditor

- Control environment in smaller entities may differ as TCWG might not include outsiders, and governance may be handled by the owner-manager.
- Control activities in smaller entities may be less formal with no documented processes for related party relationships and transactions.
- An owner-manager may reduce or increase risks from related party transactions through active involvement in all key aspects.
- For such entities, the auditor understands related party transactions and controls via management inquiry, oversight observation, and document inspection.

Records or documents that may provide information about related party relationships and transactions

During audit, auditor should stay alert for related party info while reviewing records, and may inspect documents revealing related party relationships and transactions, e.g.

1. Entity **Income tax returns**.
2. **Information** supplied by the entity to **regulatory authorities**.
3. **Documents** associated with the entity's filings with a **securities regulator** e.g. prospectuses)
4. **Statements** of conflicts of interest from management and TCWG.
5. **Contracts** and **agreements** with key management or TCWG.
6. Significant **contracts** and **agreements** not in the entity's ordinary course of business.
7. Significant **contracts re-negotiated** by the entity during the period.
8. Specific **invoices** and correspondence from the entity's professional advisors.
9. **Internal auditors' reports**.
10. **Shareholder registers** to identify the entity's principal shareholders.
11. **Life insurance policies** acquired by the entity.
12. **Records** of the entity's investments and those of its pension plans.

While performing audit of financial statements of a listed company, statutory auditor needs to maintain an attitude of professional skepticism for related party information. State examples of the records or the documents that may provide information about related party relationships and transactions. (MTP1, Sep 2024, 5 Marks)

SA 530 “Audit sampling”

Limitations of Traditional Approach

- Economically wasteful.
- Inefficient because of checking all transactions.
- Emphasises routine checking which is time-consuming and costly.
- Routine errors and frauds have diminished due to formal internal controls.
- Extensive checking often does not reveal material issues.

Risk-Based Approach

- Modern audit approach focuses on principles and controls.
- Reduces non-consequential routine checking.
- Allows auditors to focus on areas of higher risk and importance.

Meaning of Sampling

- Audit sampling refers to application of audit procedures to less than 100% of items within a population of audit relevance such that every sampling unit has a chance of selection.
- The objective of the auditor is to draw conclusions about the population from which the sample is selected.

Precautions to be taken while applying test check techniques.

1. Thorough study of **accounting system** should be done before adopting sampling
2. Proper study of internal **control systems**.
3. **Areas** which are **not suitable** for **sampling** should be carefully considered. Eg: compliance with statutory provisions, transactions of unusual nature etc.
4. Proper **planning** for Sampling methods to be used and explaining the staff,
5. Transactions and balances have to be properly **classified** (stratified)
6. Sample **size** should be appropriately determined.
7. Sample should be chosen in **unbiased** way,
8. **Errors** found in the sample should be analysed properly.

Population

Meaning

Population refers to the entire set of data from which

- a sample is selected and
- about which the auditor wishes to draw conclusions.

Characteristics

Appropriateness

- Appropriate means the population from which the samples are drawn shall be **relevant** for the specific **objective**.
- Appropriateness will include consideration of the direction (**Book to source** or **source to book**) of testing or assertion to be checked
- For example, if the auditor’s objective is to test for overstatement of accounts payable (Occurrence/Existence),

the relevant population could be defined as the accounts payable listing.

- Basically if we are checking overstatement, we are actually checking occurrence assertion.
- On the other hand, when testing for understatement of accounts payable (Completeness), the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers’ statements, etc that provide audit evidence of understatement of accounts payable;
 - When testing for understatement, the auditor looks for liabilities that should have been recorded but weren’t. The accounts payable listing won’t show these missing liabilities because it only includes what has already been recorded. Instead, by examining payments made after the year-end, unpaid invoices, and other documents, the auditor can find evidence of liabilities that should have been included in accounts payable but were omitted, hence identifying understatement.

Completeness.

- **Conclusion** about the entire population can be **drawn only** when the **population** is **complete**
- Example: Auditor can’t draw conclusions about all vouchers unless satisfied all vouchers are filed

Reliable

Auditors should obtain **evidence** about the **reliability** of the population. If the population is **not reliable** with respect to accuracy and source, the sample drawn will definitely **not** be **relevant** for the specific audit objective.

Sampling Unit

- The individual items constitute a population.
- For example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors’ balances, or a monetary unit.
- The conclusion on the population is based on the audit procedures applied on the sampling unit.

Population Example: If an auditor aims to test the existence and accuracy of sales transactions for a company during the financial year 20XX-YY, the population would be all sales transactions recorded by the company in that period. In the context of the above population, a sampling unit could be an individual sales invoice. Each invoice represents a single unit within the overall population of sales transactions that the auditor might select for testing.

Sampling Process

1. Sample Design
2. Sample Size
3. Sample Selection
4. Audit Procedures
5. Nature and Cause of Deviation and Mistatements
6. Projecting
7. Evaluating Results of Audit

Sample Design, Size And Selection of Items For Testing

Sample Design

💡 - Sample design means planning how to choose sample

While designing an audit sample auditor should consider the

- **purpose** of audit **procedure** and
- **characteristic** of **population** from which the sample will be drawn
- The auditor first considers
 - the specific objectives to be achieved and
 - the combination of audit procedures which is likely to best achieve those objectives.
- Auditor has to clearly define what will be considered as a misstatement. It will help the auditor in projecting the misstatement in the population.
 - For example – In a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement.
- Assessment of characteristic of population in Tests of Controls
 - Involves estimating the expected Rate of deviation (i.e., how often the control is expected to fail) based on control design and implementation.
- Assessment of characteristic of population in Tests of Details
 - Involves estimating the expected amount of error in the population.
- Such assessments Influences the decision on examination extent; high expected errors may warrant 100% examination or large sample size.

Sample Size

- The auditor shall determine a sample size sufficient to **reduce** sampling **risk** to an **acceptably low level**.
- The level of sampling risk that the auditor is willing to accept affects the sample size required.
- The **lower** the **risk** the auditor is willing to accept, the **greater** the **sample size** will need to be
- The sample size can be determined by the application of a statistics-based formula or through the exercise of professional judgement. In both the cases various factors can have an impact on size of sample

Examples of Factors Influencing Sample Size for Tests of Controls –

The following are factors that the auditor may consider when determining the sample size for **tests of controls**.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the extent to which the auditor’s risk assessment takes into account relevant controls <i>When the auditor plans to rely more on controls, they need to be more confident that the controls are working properly. To gain that confidence, they must test more samples. So, the sample size increases.</i>	Increase
An increase in the tolerable rate of deviation	Decrease
An increase in the expected rate of deviation of the population to be tested	Increase

An increase in the auditor’s desired level of assurance	Increase
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Examples of Factors Influencing Sample Size for Tests of Details

The following are factors that the auditor may consider when determining the sample size for **tests of details**.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the auditor’s assessment of the risk of material misstatement	Increase
An increase in the use of other substantive procedures directed at the same assertion.	Decrease
An increase in the auditor’s desired level of assurance .	Increase
An increase in Tolerable misstatement.	Decrease
An increase in the amount of misstatement the auditor expects to find in the population	Increase
Stratification of the population when appropriate	Decrease

Selection of Items for Testing (Selecting the sample)

- The auditor should select items for the sample in way that all sampling units must have equal chance of selection
- Statistical sampling requires random selection so each unit has a selection chance.
- With non-statistical sampling, an auditor uses professional judgement to select the items for a sample.
- Biasness must be avoided in sample selection
- The sampling units might be **physical** items (such as invoices) or **monetary** units.
- The sample **must** be **representative**.
 - This means that it must be closely **similar** to the whole population although **not necessarily** exactly the **same**.
- Sample should be **large enough** for meaningful results.

As the number of transactions of WY Limited for the financial year 2023-24 were very large, the auditor of WY Limited decided to use the technique of Audit Sampling. Before selecting the sample from Repair and Maintenance Expenses, the auditor of WY Limited wished that the entire data of Repair and Maintenance Expenses of WY Limited for financial year 2023-24 should have three characteristics. These three characteristics are:

- (a) Simple, Completeness, Relevant.
- (b) Appropriateness, Simple, Relevant.
- (c) Reliable, Simple, Relevant.
- (d) Appropriateness, Completeness, Reliable

Sample Selection Methods

Some of the important methods of selecting the sample are discussed below –

Random Sampling

- Random selection ensures that all items in the population have an equal **chance** of selection.
- It may involve use of **random number tables**.
- Random sampling includes two very popular methods which are discussed below

Simple Random Sampling

- Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected.
- Samples are selected through a random number table.
- Random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
- Each item in a population is selected by use of a random number table either with the help of a computer or picking up a number in a random way.

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range. Example

The population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 50,000 to ₹ 2,00,000 and not in the range between ₹500 to ₹ 11,50,000.

Stratified Sampling

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
- 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 judgement.

Example-

The population in the range between ₹500 to ₹ 11,50,000 say for trade receivables balances may be divided into groups as follows:-

1. balances in excess of ₹ 10,00,000;
2. balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
3. balances in the range of ₹ 5,50,001 to ₹ 7,75,000
4. balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and
5. balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentages of items from each of the group.

- From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items;
- from the second group 25 per cent of the items;
- from the third group 10 percent of the items; and
- from the lowest group 2 percent of the items may be selected.

Random sample is chosen from each stratum using random number tables.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences.

It can be seen that the stratified sampling is simply an extension of simple random sampling.

Stratification means

- **dividing a heterogeneous** (Diversified) population
- into a **Homogeneous** (having similar characteristics) sub population,
- where samples are drawn from each subpopulation.

Interval Sampling or Systematic Sampling

- Systematic selection is a selection method in which the number of sampling units in the population is **divided** by the **sample size** to **give a sampling interval**, for example 50,
- and having determined a starting point within the first 50,
- each 50th sampling unit thereafter is selected.
- The starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables.
- When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- Example
 - If in a population of branch sales, particular branch sales occur only as every 50th item and the sampling interval selected is also 50. The result would be that either the auditor would have selected all or none of the sales of that particular branch.
- Therefore, systematic sampling when chosen as a method should be carefully applied to bring together every type of transaction within its purview. More than one starting point can be considered to minimise such risk.

Monetary Unit Sampling

It is a type of

- **value-weighted selection** in which
 - sample size,
 - selection and
 - evaluation results in a conclusion in monetary amounts.
- In this individual monetary units are identified as sampling units.

Haphazard sampling

- Haphazard selection, in which the
 - auditor selects the sample

- **without following a structured technique.**
- The auditor should try to avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection.
- Haphazard selection is not appropriate when using statistical sampling. (Because statistical sampling requires random selection, where each item in the population has a known probability of being selected, which is not guaranteed in haphazard sampling.)
- Haphazard sampling has
 - no structured approach,
 - does not involve judgement and
 - does not even use the random number tables.

When using haphazard sampling, an auditor might walk through a warehouse and select inventory items that catch their eye, or flip through a file of invoices and select documents at various points without any specific system.

Block Sampling

- This method involves
 - **selection** of a **block(s)** of
 - Contiguous ^(in sequence) items from within the population.
- Not typically suitable for audit sampling because
 - Items in sequence often have similar characteristics
 - Differs from characteristics elsewhere in population
 - Not appropriate when drawing conclusions about entire population
- Risk: If client knows auditor's block selection pattern, material misstatements can be manipulated
- Example
 - Take the first 100 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 25 sales invoices.
- Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.
- Similar to non-statistical sampling.
 - Consequently it has similar characteristics,
 - Simplicity and economy.
 - Risk of bias and establishing predictable selection patterns noticed by auditees

Performing Audit Procedures

- The auditor shall perform audit procedures on each item selected.
- If a selected item is not appropriate for the application of the audit procedure, the audit procedure is ordinarily performed on a replacement item.
 - Example: A cancelled cheque may be replaced.
- If neither the procedure nor an alternative can be applied, treat the item as
 - A deviation (in tests of controls), or
 - A misstatement (in tests of details).

- An example of a suitable alternative audit procedure might be the examination of subsequent receipts when no reply has been received in response to a positive confirmation request.

Nature And Cause Of Deviations And Misstatements

- When the auditor finds deviations (in controls) or misstatements (in amounts) Auditor must investigate each deviation or misstatement to find the underlying cause.
- Then, evaluate how it impacts the purpose of the audit test and other related areas.
- If several misstatements share a common feature (e.g., location, product line), the auditor should extend testing to the full group.
- These patterns could also signal intentional errors, meaning possible fraud.
- In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a **high degree of certainty** that such misstatement or **deviation** is **not representative of the population**.
- The auditor shall obtain a high degree of certainty by performing **additional audit procedures** to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.
- Anomaly may be defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population. (one-off event)

Projecting Misstatements

When the auditor finds misstatements in a sample:

- They must project those misstatements to the entire population to estimate the full error.
- But this projection gives a broad view – it may not be used as the exact adjustment amount.
- If any misstatement is an anomaly
 - It can be excluded from the projection,
 - But its impact must still be evaluated separately.
- For the test of details → projection is mandatory.
- For a test of controls → no projection needed. Sample deviation rate = population deviation rate.

(if there are 8% deviation in the sample, this will also become the rate of deviation in the population)

Evaluating Results Of Audit Sampling

The auditor shall evaluate:

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

Sampling Risk

This arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion reached if the entire population was subjected to the same audit procedure.

Sampling Risk in Test of Details			
		The recorded value of population is	
		OK	Not OK
The sample indicates that the population is	OK	<ul style="list-style-type: none"> Correct Decision 	<ul style="list-style-type: none"> Incorrect Decision Risk of Incorrect Acceptance Not effective
	Not OK	<ul style="list-style-type: none"> Incorrect Decision Risk of Incorrect Rejection Not Efficient 	<ul style="list-style-type: none"> Correct Decision

Sampling Risk in Test of Control			
		The actual operation of control is	
		OK	Not OK
The sample indicates that the control in operation in	OK	<ul style="list-style-type: none"> Correct Decision 	<ul style="list-style-type: none"> Incorrect Decision Risk of Over reliance Risk of assessing the CR too low Not effective
	Not OK	<ul style="list-style-type: none"> Incorrect Decision Risk of under reliance Risk of Assessing the CR too high Not Efficient 	<ul style="list-style-type: none"> Correct Decision

Non-Sampling Risk

“Non-sampling risk” arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample.

For example,

- ordinarily the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive,
- the auditor might use inappropriate audit procedures, or

- the auditor might misinterpret audit evidence and fail to recognize an error.
- Human Mistakes

Tolerable Misstatement and Deviation

Tolerable misstatement

A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation

A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Approaches To Sampling

- Non-statistical or
- Statistical sampling approaches.

Statistical Sampling

- Based on random selection and probability theory
- Uses mathematical methods to decide sample size
- More scientific, avoids personal bias
- Best suited when population has many similar items
- Commonly used in:
 - Compliance testing
 - Trade receivables confirmation
 - Payroll checking
 - Vouching invoices & petty cash
- Reliable projections can be made from sample to population.

Advantages of Statistical Sampling

- The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested. (Smaller sample size gives a better representation of the population, in judgemental or non statistical sampling sample size is large still it does not give a fair representation of the population) – Tickmark Tiwari tests 120 vouchers from 10,000 and only 140 from 20,000, as statistical sampling focuses on audit risk and expected error, not just population size. Once a certain sample size is reached, adding more items provides diminishing returns in terms of statistical reliability.
- The sample selection is more objective and thereby more defensible.
- The method provides a means of estimating the
 - minimum sample size associated with a specified risk. (Basically helps in determining the sample size depending upon audit risk)
- Allows calculation of sampling error (calculated risk)

5. Gives a better representation of large data sets when compared to a non-statistical approach of sampling.
6. Results of sampling can be evaluated and projected in a better way

Non-Statistical Sampling

- A sampling approach that does not have characteristics of random selection and use of probability theory is considered as non-statistical sampling.
- Based on auditor's experience and judgement
- This approach is simple.
- The sample may not be a true representative of the total population because of personal bias and no scientific method of selection.
- For example,
 - April, August and March may be selected in year one and different months would be selected in the next year,
- An attempt would be made to **avoid establishing a pattern** of selection year after year.
- An **element of surprise** is maintained.
- It is a common practice to check large numbers of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.
- Also, because year end transactions are prone to high risk of misappropriation.

Problems with Non-Statistical Sampling

- Not objective or scientific
- Personal bias can't be eliminated
- Projection may not be accurate
- Less defensible, as there's no mathematical backing
- Auditor depends more on experience than on calculated methods

Misc Topic

Factors that should be considered for deciding upon the extent of checking on a sampling plan

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

1. **Size** of the organisation under audit.
2. **State** of the internal **control**.
3. **Adequacy** and **reliability** of books and records.
4. **Tolerable error** range.
5. **Degree** of the desired **confidence**.

Selecting Items for Testing to Obtain Audit Evidence

- When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.
- The means available to the auditor for selecting items for testing are:
 - Selecting **all** items (100% examination);

- Selecting **specific** items; and
- Audit **sampling**.

- The application of any one or combination of these means may be appropriate depending on the auditors' judgement to obtain audit evidence.

Selecting All Items

- The auditor **may decide** that it will be **most appropriate** to **examine** the **entire population** of items that make up a class of transactions or account balance (or a stratum within that population).
- 100% examination is unlikely in the case of tests of controls;
- However, it is more common for tests of details.
- 100% examination may be appropriate when
- For example
 - The population constitutes a small number of large value items;
 - There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
 - The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

- The auditor may decide to select specific items from a population.
- In making this decision, factors that may be relevant include the auditor's **understanding** of the entity, the **assessed risks** of material misstatement, and the **characteristics** of the **population** being tested.
- The judgmental selection of specific items is subject to non-sampling risk.
- Specific items selected may include:
 - High value or key items.
 - The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.
 - For example, items that are suspicious, unusual, particularly risk-prone or that have a history of error
 - All items over a certain amount.
 - The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
 - Items to obtain information.
 - The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Stratification (More Details)

1. Definition

- Stratification is the process of dividing a population into sub-populations (strata)
 - Each stratum is a group of sampling units with similar characteristics (often monetary value)
2. Objective
 - To reduce the variability of items within each stratum
 - Allows sample size to be reduced without increasing sampling risk
 3. Application in Tests of Details
 - Population is often stratified by monetary value
 - Greater audit effort is directed to larger value items, which may contain the greatest potential misstatement in terms of overstatement
 4. Stratification Based on Risk
 - A population may be stratified according to a particular characteristic that indicates a higher risk of misstatement
 5. Projecting and Combining Results
 - Results of samples drawn under each sub-population are projected to that respective stratum
 - To draw an opinion on the overall population, the auditor needs to:
 - Combine the results of all the strata
 - Check for possible deviation or Risk of Material Misstatement (RoMM)
- Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.
 - One benefit of this approach is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.
 - This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

Adopting Standards while using Sampling

- The extent of the checking to be undertaken is primarily a matter of **judgment** of the auditor, there is **nothing statutorily** stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done.
- It is also **not obligatory** that the auditor must adopt the sampling technique.
- To ensure a good and **reasonable** standard of work, he should adopt **standards** and **techniques** that can lead him to an informed **professional opinion**. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis.
- Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.
- This enables the auditor to make conclusions and express **fair** opinion without having to check all of the items within the financial statements.

Value-Weighted Selection

- Values are given weight.
- This selection is done in such a way that high value items for example invoice have high chance of selection.

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