Ch 05 PARAM

Thursday, 7 March 2024 2:54 PM

Ch 05
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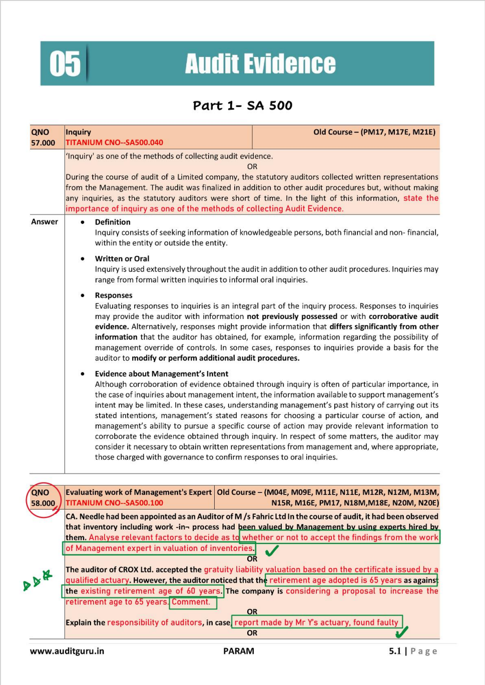


05 Audit Evidence

Part 1- SA 500

QNO 57.000	Inquiry TITANIUM CNO--SA500.040	Old Course – (PM17, M17E, M21E)

'Inquiry' as one of the methods of collecting audit evidence.

OR

During the course of audit of a Limited company, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence.

Answer

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

QNO 58.000	Evaluating work of Management's Expert TITANIUM CNO--SA500.100	Old Course – (M04E, M09E, M11E, N11E, M12R, N12M, M13M, N15R, M16E, PM17, N18M,M18E, N20M, N20E)

CA. Needle had been appointed as an Auditor of M /s Fahric Ltd In the course of audit, it had been observed that inventory including work -in¬ process had been valued by Management by using experts hired by them. Analyse relevant factors to decide as to whether or not to accept the findings from the work of Management expert in valuation of inventories. ✓

OR

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

OR

Explain the responsibility of auditors**, in case** report made by Mr Y's actuary, found faulty ✓

OR

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

Answer

Part I -- Relevant Standards & Laws

- SA 500 "Audit Evidence"

Part II -- Requirements of Relevant Standards & Laws

- **Three Steps before relying on Management's Expert: -**
  - **Evaluate Competence, Capabilities, Objectivity/ Understand field of Expert/ Evaluate appropriateness of Work.**

    The auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes.
    - Evaluate the **competence, capabilities and objectivity** of that expert.
    - Obtain an **understanding of the work** of that expert; and
    - Evaluate the **appropriateness of that expert's work** as audit evidence for the relevant assertion.

Step1

- **Competence, Capabilities and Objectivity– Obtain information from sources / qualification, published papers & books, previous work with expert, discussion with expert, discussion with other who are familiar with expert.**

  The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as
  - **knowledge of that expert's qualifications**;
  - **published papers or books** written by that expert.
  - **personal experience** with previous work of that expert;
  - **discussions** with that expert;
  - **discussions with others** who are familiar with that expert's work;

Document ✓

Experience ✓

Step2

- **Understanding Work of Expert: - Understand aspects of expert's field including assumption and methods.**

  Aspects of the management's expert's field relevant to the auditor's understanding may include what **assumptions and methods** are used by the management's expert, and whether **they are generally accepted within that expert's field and appropriate for financial reporting purposes.**

Step3

- **Evaluating Work of Expert: -**

  The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:
  - If that expert's work involves **significant use of source data**, the relevance, completeness, and accuracy of that source data.
  - If that expert's work involves use of **significant assumptions and methods**, the relevance and reasonableness of those assumptions and methods; and
  - The **relevance and reasonableness** of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

Source Data	+ Assumptions + Method	= Report / Conclusion
a.Relevance *(Suitable: -Time Period / Extraction)* b.Accuracy c.Completeness	a.Relevance *(Suitable: - Industry / Circumstances)* b.Reasonableness	--Relevant *(Suitable as per contract / FRF)* --Reasonable -- Consistent with Other Audit Evidence -- Reflected in FST

Author's Note

If question is silent, we can assume its management expert and such assumption should be clearly written

QNO 58.200	**Evaluating the objectivity of the management expert** TITANIUM CNO-- ~~500.100~~ Unique	**Old Course -- (N23R)**

Mr. Shreyansh, while performing the audit of Red Rock & Silver Sand Limited which was involved in phosphorus mining, decided to appoint an auditor's expert for the valuation of environmental liabilities and site clean-up costs. Red Rock & Silver Sand Limited reappointed Mr. Sheetal as an independent expert for this engagement. For the last five years, management has been re-appointing Mr. Sheetal. Mr. Sheetal calculated the environmental liabilities pertaining to completed mining sites and the sites which will be discarded in the near future and a provision for clean-up costs. This provision was accepted by management. Mr. Shreyansh, after performing the inquiries with management, was of the opinion that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. Hence, there is no need to raise a question on the objectivity of Mr. Sheetal or on his work performed for the company. However, the audit partner was of the opinion that the audit team needs to evaluate the objectivity of an expert engaged by the entity, irrespective of the fact that he was appointed as an independent expert. Kindly guide the audit partner and Mr. Shreyansh with respect to requirements pertaining to evaluating the objectivity of the management expert.

Answer As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, have regard to the significance of that expert's work for the auditor's purposes evaluate the competence, capabilities and objectivity of that expert.

A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures). Although safeguards cannot eliminate all threats to a management expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

- SA500 ✓
- 3 steps ✓
- Objectivity ✓
- Types of Threats → I. am FAIR ✓
- Safeguards → Sources → External Structures ✓
  → Mgt Experts work Environment ✓
- Threat because of being employee ✓

Threat

- Interests or Relationships → Personal ✓
  → Financial ✓
  → Business ✓
  → Other Services ✓

Relationship

In the current case, Red Rock & Silver Sand Limited re-appointed Mr. Sheetal for this engagement as an independent expert. The audit team was of the view that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. However, the audit partner had a contrary view. Case Discussion ✓

Hence, the audit team should evaluate the objectivity of an expert engaged by the entity as the threat to objectivity, created by being an employee of the entity, will always be present. An expert appointed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity. As a result, audit partner is correct in his view. Conclusion ✓

QNO 58.500 | **Expert report inconsistent with other audit evidence** | **Old Course – (N11R, N16R, SM17, PM17, M19R, SM21)**

TITANIUM CNO--~~SA500.100~~

Based upon the legal opinion of a leading advocate, X Ltd made a provision of Rs 5 crores towards Income Tax liability The assessing authority has worked out the liability at Rs 50 crores It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items

OR

Based upon the legal opinion of a leading advocate, X Ltd. made a provision of ₹ 3 crores towards Income Tax liability. The assessing authority has worked out the liability at ₹ 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.

Answer

Part I -- Relevant Standards & Laws

- SA 500 "Audit Evidence"

Part II -- Requirements of Relevant Standards & Laws

✓ Reference
- **SA 500** → Assumed Mgt Expert

  SA 500 on "Audit Evidence" discusses the auditor's responsibility in relation to and the procedures the auditor should consider in, using the work of an expert as audit evidence.

✓ Usage (common Practice)
- **Use of Expert**

  During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert, e.g., legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

✓ Responsibility (3 steps)
- **Responsibility**

  Before relying on advocate's opinion, the auditor should have seen that opinion given by the expert is prima facie dependable. The question states very clearly that the opinion of the advocate was inconsistent with legal position with regard to certain items. It is, perhaps, quite possible that auditor did not seek reasonable assurance as to the appropriateness of the source data, assumptions and methods used by the expert properly.

✓ Case
- **Case Discussion**

  In fact, SA 500 makes it incumbent upon the part of the auditor to resolve the inconsistency by discussion with the management and the expert. In case, the experts' work does not support the related representation in the financial information the inconsistency in legal opinions could have been detected by the auditor if he had gone through the same.

✓ Conclusion
- **Conclusion**

  This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the auditor should have rejected the opinion and insisted upon making proper provision.

QNO 58.900 | **Audit evidence for export revenue** | **New Course – (SM23)**

TITANIUM CNO-- Unique

During the course of the audit of TK Home Private Limited, a recognized export house engaged in manufacturing of T-shirts under brand name of "TK". CA Tripti is verifying export revenues of the company for the year 2022-23. She has verified transactions entered in "Export Sales" account maintained in accounting software from relevant export invoices. The export sales are being made on payment of IGST, for which a refund is automatically credited in the account of the company after the goods are shipped.

On enquiring from internal audit staff regarding the recognition of export revenues, she is told that export sales are recognised for the year on the basis of "Bills of Lading". However, she is not convinced with such a response and feels that the same does not appear to be proper.

She finds that three export invoices bearing dates in the month of March 2023 having a value of ₹ 75.00 lacs have not been recognized in export revenue on the ground that bills of lading for these invoices were issued in the month of April 2023 Discuss from what sources she can obtain reliable audit evidence in this ✓

regard. How can she challenge management's assertion regarding the completeness of export revenues for the year 2022-23?

Answer

She can obtain reliable audit evidence by going through GST returns filed by the company on GST portal and correlating the same with e-way bills. She can obtain audit evidence about how company has reflected its export sales in its GST returns and whether export sales pertaining to three invoices having value of ₹ 75.00 lacs are reflected in such returns.

Further, e-way bills generated on the portal would provide evidence that goods have moved out of the company's premises. The export revenue should have been booked at the time the goods moved out of the company's premises. The company is claiming an IGST refund. The refund is linked to the monthly sales return. This aspect can also be verified.

"Bill of Lading" is only a document issued by the carrier to the shipper of goods that goods have been taken on board. She should challenge and counter management's assertion on the above grounds and point out violations of relevant accounting standards and principles. In this way, she can obtain reliable audit evidence.

Highlighting such digital and other evidence, she can challenge management's assertion regarding the completeness of export revenues and point out that export revenues are understated.

- Ind AS 115/AS 9 ✓
- Revenue Recognition Principle ✓
- If we assume FOB ✓ revenue should be booked when goods move out of factory & not bill of lading.
- Explain bill of lading ✓
- Verification of export sales
  - Customer Order ✓
  - Approval ✓
  - Dispatch Records ✓
  - Sales Invoice ✓
  - E-way Bill ✓
  - GST Return ✓
  - Refund of IGST ✓
  - Receipt ✓

Revenue Recognition ✓

Verification ✓

Part 2 -SA 501

QNO 59.000	Physical Verification on different date TITANIUM CNO--SA501.060	Old Course – (N20E)

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

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

As per SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.
For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes.

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor, JK Associates, shall perform the following procedures:

- ➢ **Physical Verification**
  - ➢ Attendance at physical inventory counting, unless impracticable, to:
    - Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
    - Observe the performance of management's count procedures;
    - Inspect the inventory; and
    - Perform test counts; and
  - ➢ Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
- ➢ **Reconciliation**
  In addition to above, auditor shall also perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

QNO 60.000	Physical Verification & Cases it is Impractical TITANIUM CNO--SA501.040/SA501.080	Old Course – (N09E, M13M, M15R, N15E, M16M, PM17, M17M, M18R, M18M, M18E, M20R, SM21, N22M) New Course – (SM23)

XYZ Ltd supplies navy uniforms across the country The company has 4 warehouses at different locations throughout the India and 5 warehouses at the borders The major stocks are generally supplied from the borders XYZ Ltd appointed M/s MNO & Co to conduct its audit for the financial year 2016-17 Mr O, partner of M/s MNO & Co, attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason. ✓

a & b

You are required to advise M/s MNO & Co,

(a) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained? ✓

(b) How is an auditor supposed to deal when attendance at physical inventory counting is impracticable? ✓

OR

"RIM Private Ltd is engaged in the business of manufacturing of water bottles and is experiencing significant increase in turnover year on year. During the financial year ended 31 March 2019, the company carried out a detailed physical verification of its inventory and property, plant and equipment.

Param (b)

You are the auditor of RIM Private Ltd. The inventory as at the end of the year was ` 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?" ✓

OR

SDA

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

Param (a)

Answer

Part I -- Relevant Standards & Laws

- **SA 501, Audit Evidence- Specific Considerations for Selected Items**

Part II -- Requirements of Relevant Standards & Laws

a)

- Sufficient & Appropriate Evidence: - When inventory is material obtain S&A evidence for Existence & Condition

  As per SA 501 When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the **existence and condition of inventory** by:

- Two steps to obtain evidence
  - Step 1 - Attend physical verification and perform following Evaluate Mgt instructions & procedures, obtain evidence foe reliability of procedures / Observe counting / Inspect inventory / Perform test counts

    Attendance at physical inventory counting, unless impracticable
    - Evaluate **management's instructions and procedures** for recording and controlling the results of the entity's physical inventory counting; Obtaining audit evidence as to the reliability of management's count procedure
    - Observe the **performance of management's count procedures**
    - **Inspect the inventory**; and
    - Perform **test counts**; and
  - Step 2: - Performing audit procedures on final inventory records and comparing them with actual inventory count results

Performing audit procedures over the entity's **final inventory records to determine whether they accurately reflect actual inventory count results.**

- Suitable for both as Test of Controls or Substantive Procedures

  These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

(b)

- Reasons for Impractical Inventory Counting: - Nature & Location of Inventory

  In some cases, attendance at physical inventory counting may be impracticable.

  This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable.

- Example of Alternative Procedures: - Verify Subsequent Sale

  In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

- **Alternative Procedures Doesn't Give S&A Evidence – Modify Opinion as per SA 705**
  In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.
- **SA 501 Specific Principle: - If impractical Perform Alternative Procedures / If not possible then modify as per SA 705**
  If attendance at physical inventory counting is impracticable, the auditor shall perform **alternative audit procedures** to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. **If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.**
- **SA 200 General Principle: - Difficulty / Time / Cost is no itself valid basis to omit audit procedure for which there is no alternative or evidence available is less than persuasive**
  In SA 200, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

QNO 60.050 **Inventory under the Custody and Control of a Third Party** Old Course--(N19R) New Course--(SM23)

TITANIUM CNO -- SA501.100

Your firm has been appointed as the statutory auditors of GBM Private Limited for the financial year 2018-19. While verification of company's inventories as on 31st March 2019, you found that the significant amount of inventories belonging to the company are held by other parties. However, the company has kept all the records of the inventories maintained by other parties. What is your duty as an auditor in order to ensure that third parties are not such with whom the stock should not be held and the stock as disclosed in company's records actually belongs to them?

Answer

- **Basic Principle**
  Basic Principle – If Custody & Control of Third Party then Request Confirmation or Other Audit Procedures
  When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:
  - Request **confirmation from the third party** as to the quantities and condition of inventory held on behalf of the entity.
  - Perform **inspection or other audit procedures** appropriate in the circumstances.
- **Confirmation**

SA 505 establishes requirements and provides guidance for performing external confirmation procedures.

- **Other Audit Procedures**
  Depending on the circumstances, for example where information is obtained **that raises doubt about the integrity and objectivity of the third party,** the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:
  - **Inspecting documentation regarding inventory held by third parties,** *for example, warehouse receipts.*
  - Requesting confirmation from **other parties when inventory has been pledged as collateral.** *(Warehouse Owner)*
  - Obtaining **another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control** for ensuring that inventory is properly counted and adequately safeguarded.
  - **Attending, or arranging for another auditor to attend,** the third party's physical counting of inventory, if practicable.

QNO 60.055 **Direct Communication Without Informing Management** Not revealing New Course – (SM23)

TITANIUM CNO-- SA501.120

On reviewing legal expenses account of Zed Ltd., CA. Sunitha, auditor of company, finds that legal fees amounting to ₹ 10 lac was paid to B. George, a reputed lawyer, during the year 2022- 23. On inquiry with management regarding the purpose of such expenditure, evasive reply was received from management stating that a lot of work is performed by the said lawyer on behalf of the company. However, no specific details were provided.

She finds it proper to correspond directly with the lawyer. She obtains the address and mail id of the lawyer from his professional services bill. She shoots off an inquiry letter asking for the nature and status of litigation claims against the company on her letterhead.

Is her approach proper? Irrespective of the merits of the approach followed by her, what she is trying to achieve by corresponding with lawyer of the company?

Answer SA 501 states that when audit procedures performed indicate that material litigation or claims may exist, the auditor shall seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

Therefore, her approach in communicating with an external lawyer is wrong. She has to make management aware of her intention to communicate directly with the lawyer. The letter of enquiry has to be prepared by management and sent by her.

Her purpose in corresponding with the lawyer of the company is to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. It is due to the reason that litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

QNO 60.060 **Understanding methods used by management for determining segment information** Old Course -- (N20E) New Course – (SM23)

TITANIUM CNO--SA501.140/SA501.160

GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2020 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when

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

Part 3- SA 505

QNO 62.000	**Designing Confirmation Request** TITANIUM CNO--SA505.040	**Old Course – (M16E, N17M, N18R, SM17, SM21)**
	Mr H who is appointed as auditor of EXL Co Ltd wants to use confirmation request as audit evidence during the course of audit What are the factors to be considered by Mr H when designing a confirmation request? Also state the effects of using positive external confirmation request by Mr H.	

Answer

Part I -- Relevant Standards & Laws

- SA 505, External Confirmation

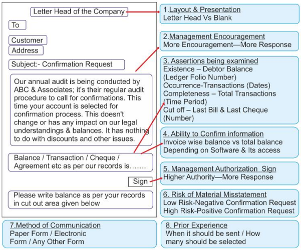
Part II -- Requirements of Relevant Standards & Laws

- As per SA 505, "External Confirmation", factors to be considered 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: - Requests reply in all cases irrespective of whether confirming party agrees to info given or by directly asking information. There is risk that party responds without verifying hence its better don't state info / amount simply ask for it**

A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. **There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.**

FACTORS TO CONSIDER WHEN DESIGNING CONFIRMATION REQUESTS INCLUDE:



Letter Head of the Company

To

Customer

Address

Subject:- Confirmation Request

Our annual audit is being conducted by ABC & Associates; it's their regular audit procedure to call for confirmations. This time your account is selected for confirmation process. This doesn't change or has any impact on our legal understandings & balances. It has nothing to do with discounts and other issues.

Balance / Transaction / Cheque / Agreement etc as per our records is.......

Sign

Please write balance as per your records in cut out area given below

1. Layout & Presentation
Letter Head Vs Blank

2. Management Encouragement
More Encouragement—More Response

3. Assertions being examined
Existence – Debtor Balance (Ledger Folio Number)
Occurrence-Transactions (Dates)
Completeness – Total Transactions (Time Period)
Cut off – Last Bill & Last Cheque (Number)

4. Ability to Confirm information
Invoice wise balance vs total balance
Depending on Software & Its access

5. Management Authorization Sign
Higher Authority—More Response

6. Risk of Material Misstatement
Low Risk-Negative Confirmation Request
High Risk-Positive Confirmation Request

7. Method of Communication
Paper Form / Electronic Form / Any Other Form

8. Prior Experience
When it should be sent / How many should be selected

QNO 62.100	**Factors to be considered before using negative confirmation.** TITANIUM CNO--SA505.040/ SA505.060	**Old Course – (M19E)**
	ABC & Co, LLP are appointed auditors of Sharp Company Ltd for the year ended 31st March 2019. As part of the audit process, they want to use confirmation procedures as audit evidence during the Course of audit. In view of the fact that positive confirmations are not responded favorably **, the firm also intends to use negative confirmation requests.** What are the factors to be considered for the same?	

Answer

- As per SA 505, "External Confirmation", factors to be considered when designing confirmation requests include:
  - Refer QNO 62.0
- Factors to be considered for Negative Confirmation requests:
  - Definition
    - 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.**
  - Situations
    Negative confirmations **provide less persuasive audit evidence than positive confirmations.** Accordingly, the auditor **shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:**
    - 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.**
    - The population of items subject to negative confirmation procedures **comprises a large number of small, homogeneous, account balances, transactions or conditions.**
    - **A very low exception rate is expected;** and

- **The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation** requests to disregard such requests.

- Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.
  - Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

QNO 63.000	External Confirmation (Use of Negative Confirmation Request Inappropriate) TITANIUM CNO -- SA505.060	Old Course – (M14E, PM17, SM17, M18R, SM21,N22E) New Course – (SM23)

During the course of audit of Moon Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables of small balances except one old outstanding of Rs 25 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing.

Answer

Part I -- Relevant Standards & Laws

- SA 505 "External Confirmation"

Part II -- Requirements of Relevant Standards & Laws

- Negative Confirmation Definition: - Confirming party should response only if they disagree with info given in EC request.

  As per SA 505, Negative Confirmation is a request that the **confirming party respond directly to the auditor only if the confirming party disagrees** with the information provided in the request.

- Less Persuasive: - In NCR there is no response if TP agrees to Info. In PCR there is response with confirmation if info agrees. NCR provides less persuasive evidence because if there is no response, it may be because request is not received, Or they may not have replied because information disagreement may be favourable for them. Or they were just careless to reply. Hence no response is not explicitly indicating accuracy of information. NCR should be used for large number of small homogenous balances. It should not be used for big balances.

  Negative confirmations **provide less persuasive audit evidence than positive confirmations. The failure to receive a response** to a negative confirmation request **does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request**. Accordingly, a **failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request**. Confirming parties also **may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.**

- No Response: - No response in NCR does not means misstatement / As NCR requires to respond only if there is disagreement / if Auditor has doubt he can examine subsequent cash disbursements / correspondence with TP / Examine other documents such as GRN etc

  Further non-response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request**. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.**

Part III – Case Discussion

- Use of NCR: - Auditor has used NCR. There are many small credit balances, but one balance is of 25 lakhs and it is old outstanding.

  In the instant case, the auditor sent the **negative confirmation requesting the trade payables** having outstanding balances in the balance sheet while doing audit of Star Limited. **One of the old outstanding of Rs 25 lacs has not sent the confirmation on the credit balance.**

Part IV -- Conclusion

- Doubts: - After using NCR, if auditor still has doubts and need more evidence. He should perform further audit procedures. Specially for old outstanding 25 lakh balance. He can go for PCR such balance.

  But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

QNO 63.500	Doubt Over Reliability of Responses (External Conf) TITANIUM CNO-- SA505.080	New Course – (SM23)

"As auditor of Groom Limited, you have sent positive confirmation requests to 30 creditors of the company in March 2023. All of the creditors in informal sector are small concerns. You choose to send positive confirmation requests to all the above parties at their business addresses stated on respective bills after discussing the matter with CFO of the company. The CFO is cooperative and does not raise any hassles in the matter. Responses to confirmation requests are received within a week's time. Your articled clerk informs you that out of above 30 creditors, GST registrations of 25 concerns have been cancelled during financial year 2022-23 itself by collating information from GST portal. He further informs you that there are no fresh registrations pertaining to PANs of these parties.

How you would proceed to deal with the situation as auditor of the company?"

Answer

SA 505 states that if the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the instant case, GST registrations of 25 concerns have been cancelled in the year 2022- 23. It indicates that businesses on those addresses were closed. Further, there are no fresh registrations pertaining to the PANs of these parties. However, the auditor sent external confirmation requests in March 2023, which were duly responded. It raises questions on the reliability of responses received.

SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form or by electronic or other medium. Factors that may indicate doubts about the reliability of a response include:

- Was received by the auditor indirectly or
- Appeared not to come from the originally intended confirming party.

Keeping in view the circumstances described in the case situation, there is a risk that the response has not come from the originally intended confirming party.

Unreliable responses may indicate a fraud risk factor that requires evaluation.

QNO 65.000	External Confirmation (Refusal) TITANIUM CNO--SA505.100	Old Course – (M05E, M11E, M12M, N12R, M13M, M13E, PM17, M17M, M18E, M20R, SM21)
	The accountant of V Ltd has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court as a Statutory Auditor, how would you deal?	

Answer

Part I -- Relevant Standards & Laws

- SA 505 "External Confirmation"

Part II -- Requirements of Relevant Standards & Laws

- **Refusal to send a Confirmation Request: - Inquire as to management's reasons & Seek audit evidence as to their validity / Evaluate the implications (RMM / ROF) / Perform alternative audit procedures.**

  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 the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
  - **Perform alternative audit procedures** designed to obtain relevant and reliable audit evidence.

- **Refusal is unreasonable & unable to obtain relevant and reliable audit evidence:- Modify opinion as per SA 705**

  If the auditor concludes that management's refusal to allow the auditor to send **a confirmation request is unreasonable**, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260. **The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.**

Part 4- SA 510

QNO 66.000	Audit Procedures for Opening Balance TITANIUM CNO--SA510.020/SA510.040	Old Course – (N04E, N09E, N13R, N14R, M15E, M16M, N16M, SM17, PM17, N17R, M18M, N18R, N19M, N19E, SM21)

a) What are 'Initial Audit Engagements'?

(b) In an initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases: -

(i) when the financial statements are audited for the preceding period by another auditor**; and**

(ii) when financial statements are audited for the first time.

(c) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances' what approach you will adopt **in drafting your** audit report in two situations mentioned in (b) above?

OR

You have been appointed as the auditor of Top Health Ltd. for 2017-18 which was audited by CA Trustworthy in 2016-17. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2016-17 have been brought to account in 2017-18 as Opening Balances and the Opening Balances do not contain misstatements.

Answer

Part I -- Relevant Standards & Laws

- SA 510 "Initial Audit Engagements – Opening Balances

Part II -- Requirements of Relevant Standards & Laws

- **Initial Audit Engagement: - Prior period FST Not Audited or Audited by Predecessor Auditor**

  As per SA 510 "Initial Audit Engagements - Opening Balances", initial audit engagement is an engagement in which either:
  - The financial statements for the prior period were not audited; or
  - The financial statements for the prior period were audited by a predecessor auditor.

- **Audit Procedures: -**
  - **Check whether closing balances have been correctly brought forward from last year ledger. / Agree opening balance with the most recent financial statements / Read predecessor audit report if any. *(If any modification it should be marked as RMM)* / If any adjustment is shown as prior period item, trace to previous period documents. / Whether audit procedures performed in the current period provide evidence relevant to the opening balances**

    The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
    - Determining whether the prior period's **closing balances have been correctly brought forward** to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
    - The auditor shall **read the most recent financial statements**, if any, and **the predecessor auditor's report thereon**, if any, for information relevant to opening balances, including disclosures.
    - Performing one or more of the following:
      - Where the prior year financial statements were audited, perusing the **copies of the audited financial statements** including the other relevant documents relating to the prior period financial statements;
      - Evaluating whether **audit procedures performed in the current period provide evidence relevant to the opening balances**; or
      - Performing **specific audit procedures**_to obtain evidence regarding the opening balances.

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

- **Current Audit Procedures to give evidence about opening balance: -**
  - **For CA & CL: - Collection or Payment of Op balances will give evidence about existence, completeness, valuation, rights & obligation.**

    For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection/ payment of opening accounts receivable/ accounts payable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.
  - **For other Assets & Liabilities: - Documentary evidence regarding opening balance / Confirmation from third parties**

    In respect of other assets and liabilities such as property plant and equipment, investments, long term debts, the auditor will examine the records relating to opening balances. The auditor may also be able to get the confirmation from third parties (e.g., balances of long-term loan obtained from banks can be confirmed from the Bank Loan statement).

- If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

- **Drafting Audit Report**: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.

QNO 66.100 | **No Change, Opening Balance Case** | **Old Course – (N15R, N17M, PM17, N18M, M20M)**

TITANIUM CNO--SA510.020

CA. Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P) Ltd. for the financial year 2017-18. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA. Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting Rs. 150 lakhs continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA. Jack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment.

OR

CA. Mack, a recently qualified practicing Chartered Accountant got his first audit assignment of Captura (P) Ltd. for the financial year 2017-18. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA. Mack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting Rs. 145 lakhs continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA. Mack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment

Answer

Part I -- Relevant Standards & Laws

- SA 510 "Initial Audit Engagements – Opening Balances

Part II -- Requirements of Relevant Standards & Laws

➢ **Opening Balance Procedures**

As per SA 510 "Initial Audit Engagements – Opening Balances", while conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether –

- Opening balances contain misstatements that materially affect the current period's financial statements; and
- Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

objectives of SA 501 ✓

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements.

LY audited FST

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

Possibility of MST

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures, say, the collection of opening accounts receivable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

Example of evidence from current year audit procedures

Audit Procedures

➢ **Written representation**

In addition, according to SA 580 "Written Representations", the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

WR

Part III – Case Discussion

➢ In the given case, the management of Futura (P) Ltd. has restrained CA. Jack, its auditor, from obtaining appropriate audit evidence for balances of Accounts Receivable outstanding as it is from the preceding year. CA. Jack, on believing that the preceding year balances have already been audited and on the statement of the management that there are no receipts and credits during the current year, therefore excluded the verification of Accounts Receivable from his audit programme.

Part IV -- Conclusion

➢ Thus, CA. Jack should have requested the management to provide written representation for their views and expressions; and he should also not exclude the audit procedure of closing balances of Accounts Receivable from his audit programme. Consequently, CA. Jack shall also be held guilty for professional misconduct for not exercising due diligence, or grossly negligence in the conduct of his professional duties as per the Code of Ethics.

QNO 66.500 | **Opening Inventory unaudited** | **New Course – (SM23)**

TITANIUM CNO-- SA510.040

CA M. Hussain is appointed auditor of a firm for year 2022-23 on 31st July 2022. The accounts of firm were unaudited in year 2021-22. The firm had material inventories reflected in its financial statements even as on close of 31st March 2022.

He is performing audit procedures, including attending physical inventory count as on 31st March 2023. However, there is a lingering doubt in his mind regarding opening inventories reflected in financial statements. ✓

Does there exist any responsibility on his part in such a situation? ✓

Answer SA 510 states that in conducting an initial audit engagement, one of the objectives of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements. The auditor has to

evaluate whether audit procedures performed in the current period provide evidence relevant to the opening balances or specific audit procedures are required to be performed to obtain evidence regarding the opening balances.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

Additional Audit procedures

Part 5- SA 530

QNO 74.000	**Sampling Risk** TITANIUM CNO--SA530.020	**Old Course – (M06E, M10E, M12R, M12M, N13R, PM17)**

Sampling Risk

OR

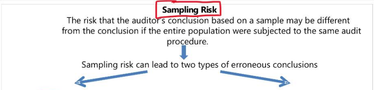
While planning the audit of S Ltd you want to apply sampling techniques What are the risk factors you should keep in mind?

Part I -- Relevant Standards & Laws

- SA 530, Audit Sampling

Part II -- Requirements of Relevant Standards & Laws

- **Sampling Risk:**
  As per SA 530 "Audit Sampling", the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
  - **In the case of a test of controls, that controls are more effective than they actually are**, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
  - **In the case of a test of controls, that controls are less effective than they actually are**, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.



Sampling Risk

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

Sampling risk can lead to two types of erroneous conclusions

Type I – Error	**Type II – Error**
In the case of a test of controls, that controls are more effective than they actually are **(Over Reliance on Controls)**, or in the case of a test of details, that a material misstatement does not exist when in fact it does **(Incorrect Acceptance)**.	In the case of a test of controls, that controls are less effective than they actually are ***(Under Reliance on Controls)*** ,or in the case of a test of details, that a material misstatement exists when in fact it does not. ***(Incorrect Rejection)***
The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. **(Reduces Effectiveness of Audit)**	This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect. ***(Reduces Effeciency of Audit)***

QNO 74.500	**Sampling Risk** **TITANIUM CNO--SA530.020**	**New Course -- (SM23)**

CA. Ritesh Deshpande has drawn some samples during the course of audit of a manufacturing company for testing controls as well as for tests of details. On the basis of the samples selected, he reaches an erroneous conclusion that access controls on applications are less effective. ✓

Further, on the basis of samples selected, he concludes erroneously that work-in progress inventories amounting to ₹ 5 crore in financial statements are materially misstated. ✓

Outlining the above risk involved, discuss how it is going to affect his audit of the company.

Answer The described risk is sampling risk. It is a risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

In the given case, the auditor has arrived at erroneous conclusions on the basis of the samples selected. In the case of a test of controls, he has concluded that access controls are less effective than they actually are. In the case of a test of details, he has concluded erroneously that a material misstatement exists when in fact, it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

QNO 78.000	**Evaluation of Nature & Cause of Misstatement / Deviation** **TITANIUM CNO--SA530.160**	**Old Course – (N09R, PM17)**

"An auditor while analysing the errors in a sample need not consider the qualitative aspects of errors detected" Please comment.

Answer

Part I -- Relevant Standards & Laws

- SA 530, Audit Sampling

Part II -- Requirements of Relevant Standards & Laws

- Qualitative Aspects: - So auditor should go beyond detecting misstatement and deviations and consider qualitative aspects
  Accordingly, the auditor cannot be satisfied by detecting errors only but also would need to consider the qualitative aspects of such errors.
- Nature & Cause: - Investigate deviations or misstatements and evaluate their possible effect on the purpose of audit procedure and on to other areas of audit
  The auditor shall investigate the nature and cause of any deviations or misstatements identified and **evaluates their possible effect on the purpose of the audit procedure and on other areas of the audit.**
- Common Features: - Type of Transactions, Location, Product, Period of time / In such case auditor may identify all items in population with common feature and extend audit procedures
- Anomaly: - Extremely rare circumstances misstatement or deviation can be anomaly / auditor should obtain high degree of certainty that it is not representative of population / perform additional procedures for the same
  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 this 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
- Intentional: - If these are intentional then there is possibility of fraud
  In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, **for example, type of transaction (Counter Sales), location (Mumbai Branch), product line (Old product) or period of time (Peak Season).** In such circumstances, the auditor may decide to identify all items in the population that possess the common feature and extend audit procedures to those items. **In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.**

QNO		
78.500	**Sampling Not Providing Reasonable Basis to Support Conclusion** **TITANIUM CNO--SA530.200**	**Old Course – (N22R)** **New Course – (SM23)**

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

Answer As per SA 530, "Audit Sampling", the auditor shall evaluate:

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

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

(I) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

(II) Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Compare Projected → Expected
→ Tolerable

8% ✓
15% ✓

5%
10%
30%

✓ - Evaluation of Results
✓ - Reasonable Basis
✓ - If not → mgt
→ Auditor
→ Conservative ✓

QNO		
79.500	**Uses of Stratification** **TITANIUM CNO--Unique**	**Old Course – (M23E)**

While conducting audit of PC Ltd., CA. T decided to use sampling technique to test the trade receivables at the planning stage. He directed his team members to divide the whole population of trade receivables balances to be tested in a few separate groups called 'strata'. He directed to treat each stratum as if it was a separate population and divided the trade receivables balances of PC Ltd. for the Financial Year 2022 - 23 into groups on the basis of personal judgment as follows:

Sr. No	Particulars
1	**(a) Balances in excess of ₹ 50,00,000;**
2	**(b) Balances in the range of ₹ 40,00,001 to ₹ 50,00,000;**
3	**(c) Balances in the range of ₹ 30,00,001 to ₹ 40,00,000;**
4	**(d) Balances in the range of ₹ 20,00,001 to ₹ 30,00,000;**
5	**(e) Balances in the range of ₹ 10,00,001 to ₹ 20,00,000;**
6	**(f) Balances ₹ 10,00,000 and below**

From the above mentioned groups, CA. T directed to pick up different percentage of items for examination from each of the group. One of the team members, Mr. Neel, wants to use some other technique of sampling for the above purpose as the concept of stratification is not clear to him. You are required to explain the concept of stratification and its uses to Mr. Neel.

Answer

- **Concept of Stratification:**
  Stratification is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- **Uses of Stratification**
  1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to

reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

  2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

  3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

  4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Part 6- SA 550

QNO 82.000	Related Party (Sources) TITANIUM CNO--SA550.060	Old Course – (M06E, N08R, M11R, M12E, N12E, M14R, N15E, PM17, N18M, M19M, N19E)

The training partner in your office is aware that you have covered SA 550 Related Parties in your professional studies. He has asked you to help him prepare for a training session he is about to give.
Requirements
Prepare notes for a training session for junior staff on how to verify ✓ the existence of related party ✓ transactions.

OR

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

OR

JY & Co is appointed as auditor of Breeze Ltd JY & Co seeks your guidance for reviewing the records and ✓ documentation of the company regarding 'related party transactions in the normal course of business' Describe the steps to be followed

Answer

Part I -- Relevant Standards & Laws

- SA 550, Related Parties

Part II -- Requirements of Relevant Standards & Laws

- ➢ **Inspecting Records or Documents may indicate existence of related party relationships or transactions which were not identified or Mgt didn't disclose it to auditor.**
  During the audit, **the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.**
- ➢ **Compulsory to see following documents: -**
  - **Legal, Bank, TP Confirmations / Minutes of Shareholders, TCWG / Such other documents**
    In particular, the auditor **shall inspect the following for indications** of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:
    - **Bank** *(For guarantees / securities given or taken, arrangements such as minimum balance setoff arrangement / joint holders / nominee)* **legal** *(Contracts / MOUs etc)* and **third-party confirmations** *(From Directors / Subsidiaries)* obtained as part of the auditor's procedures;
    - Minutes of meetings of shareholders and of those charged with governance; and *(Approvals under Sec 177 & Sec 188)*
    - Such other records or documents as the auditor considers necessary in the circumstances of the entity. *(E.g. Company Restructuring Documents)*
- ➢ **Documents which can give information about related parties: -**
  - AS 18 / Schedule III disclosures of Previous Years *(Old Records)*
  - Shareholders register *(Control / SI)*
  - Director's register *(SI)*
  - Contracts with TCWG / Directors / KMP (SI)
  - Life insurance policies (SI)
  - Records of Entity's pension plans (SI)
  - Statements of Conflict of Interest (SI)
  - Investment Register (Control / SI)

(Legal Documents)

- BOD / Shareholder Meeting Minutes
- Sec 189 Register
- Information supplied to Regulatory Authorities
- Filing with SEBI / SEC
- Tax Returns

(Other Documents)

- Internal Auditor's Report
- Invoices & Correspondence with professional advisor
- Contracts not in ordinary course of business
- Contracts re-negotiated

QNO 82.500 | **Examples of Transactions Which are Outside Normal Course Business** | **Old Course – (N20E)**

TITANIUM CNO--SA550.100

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

Answer

In the given case of PQR Ltd, Mr. X, while conducting audit has come across certain significant related party transaction which are identified to be outside the entity's normal course of business. Mr. X wants guidance through examples of such significant transactions which are given in SA 550 As per SA 550 "Related Parties", examples of transactions outside the entity's normal course of business may include:

1. Complex equity transactions, such as corporate restructurings or acquisitions.
2. Transactions with offshore entities in jurisdictions with weak corporate laws.
3. The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
4. Sales transactions with unusually large discounts or returns.
5. Transactions with circular arrangements, for example, sales with a commitment to repurchase.
6. Transactions under contracts whose terms are changed before expiry.

QNO 82.600 | **SRPT Outside Normal Course of Business Without Business Rationale** | **New Course – (SM23)**

TITANIUM CNO--SA550.120

"Living Well Private Limited" is engaged in the manufacturing and export of floor coverings. Such products are labour-intensive and do not require much of capital investment in machinery. The company has no plans to diversify in other product lines. Its directors are also holding significant interest in another company 'My Living Private Limited' engaged in manufacturing of blankets using capital intensive machinery.

During the course of the audit of "My Living Private Limited", it was noticed by you that the company has sold machinery of ₹ 1 crore to "Living Well Private Limited" during the year. The transaction has been done at normal market rates applicable to such used machinery.

How do you view the above transaction as auditor of "My Living Private Limited"?

Answer

In respect of significantly related party transactions outside the normal course of business of an entity, it is the responsibility of the auditor, in accordance with SA 550, to evaluate the business rationale or lack thereof of transactions that may have been entered to indulge in fraudulent financial reporting or conceal misappropriation of assets.

The auditor has to seek to understand the business rationale of such a transaction from a related party's perspective. It would help him understand the economic reality of such a transaction and why it was carried out.

In the given situation, there is no primary rationale for such a transaction. Living Well Private Limited does not manufacture blankets, and the purchase of part of old machinery pertaining to blanket manufacturing has no rationale for it primarily. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

QNO 84.000 | **Related Party Case Study – Approach of Auditor** | **Old Course – (N20M, N21M)**

TITANIUM CNO -- Unique

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

(i) The long-term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.

(ii) Certain computers were received from the parent company free of cost, the value of which is ₹ 0.23 lac and no accounting or disclosure of the same has been made in the notes to accounts.

(iii) An amount of ₹ 3.25 Lakhs per month is paid to M/s. WE CARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹ 0.25 Lakhs per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure of this related party transaction has been made in the notes to accounts forming part of the financial statements highlighting the same as a 'related party' transaction.

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

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

Part I -- Relevant Standards & Laws

- SA 550, Related Parties
- Ind AS 24 / AS 18
- Clauses (xiii) of Paragraph 3 of CARO 2020
- Sections 177 and 188 of Companies Act, 2013

Part II -- Requirements of Relevant Standards & Laws

- **As per SA 550, Related Parties,**
  - Communicating significant matters arising during the audit in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters.
  - Examples of significant related party matters include, non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware; The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud; etc.
  - It may be noted that unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.
  - The auditor is also required to ensure the compliance of Ind AS 24 / AS 18 Related Party Disclosures.

Part III—Case Study & Conclusion

- In view of above in the given scenario, the auditor is required to prepare a brief summary of following items to be reported to those charged with governance in accordance with SA 260 Communication with Those Charged with Governance:
    - Receipt of free of cost Computers and long-term borrowing (on no agreed terms and repayment of interest and principal) from the Parent Company need separate disclosure in financial statements as per Ind AS 24 / AS 18 Related Party Disclosures.

- One of related party transaction amounting 3.25 lac per month i.e., in lieu of marketing services has been noticed of which amount ` 0.25 lac per month is exceeds the arm's length price has not been disclosed highlighting the same as related party transactions as per Ind- AS 24 / AS 18 Related Party Disclosures.
- Refusal by CFO of the company to provide the details of related party transaction amounting to rupees 47 lac on the ground that same is perceived to be confidential and cannot be shared with auditors, is not in order, as denying for the related part details of ` 47 lac is imposing limitation of scope of auditor in view of SA 705.

- Further, in case of all the above cases, the auditor would also need to assess his reporting requirements under the clauses (xiii) of Paragraph 3 of CARO 2020 with respect to related party transactions that whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable Accounting Standards.

QNO 84.500	**Engagement Team Discussion -- Susceptibility of MMST due to Related Party** **TITANIUM CNO -- Unique**	**Old Course – (M22E)**

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

Answer As per SA 550 “Related Parties”, the engagement team discussion that SA 315 and SA 240 require shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity’s related party relationships and transactions.

Accordingly matters that are to be addressed in the discussion by CA Z among the engagement team include:

1. The nature and extent of the entity’s relationships and transactions with related parties (using, for example, the auditor’s record of identified related parties updated after each audit).
2. An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
3. The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organizational structure, use of special - purpose entities for off-balance sheet transactions, or an inadequate information system).
4. The records or documents that may indicate the existence of related party relationships or transactions.
5. The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.
6. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

    (a) how special-purpose entities controlled by management might be used to facilitate earnings management.
    (b) how transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity’s assets.