# Chapter 5: Audit Evidence

## SA 500 – Audit Evidence

**Q1.** 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** **<u>on the ground that bills of lading for these invoices were issued in the month of April 2023.</u>**

*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?* ***(SM)***

**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.

---

**Q2.** Gap Ltd. possesses **some investment for** which there is no ready market and **to assess its fair market value it hires an expert**, the result of which it can use in preparing its financial statement. Being an Auditor of the Company, **state the matters which may affect the nature, timing and extent of audit procedure to be adopted** by you in the instant case. ***(PYQ-M18)***

**Answer**

As per SA 500 "Audit Evidence", the **nature, timing and extent of audit procedures to be adopted** by an auditor in case of management's expert, may be affected by such matters as:

1) **Nature & complexity** of matter to which Mgt. expert relates.
2) **Risk of material misstatement** in the matter.
3) **Nature, scope & objectives** of Mgt. expert's work.
4) Whether **Mgt. expert is employed by entity**, or is a party engaged by it to provide relevant services.
5) **Extent to which Mgt.** can exercise control or influence over work of Mgt. expert.
6) **Auditor's previous experience** of work of that expert.
7) Availability of alternative sources of audit evidence.
8) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
9) Nature and extent of any controls within the entity over the management's expert's work.
10) Auditor's knowledge and experience of the management's expert's field of expertise.

---

**Q3.** 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**. **(PYQ-M18)**

**OR**

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

**OR**

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

**OR**

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

**Answer**

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

(a) Evaluate the **competence, capabilities and objectivity** of that expert;
(b) Obtain an **understanding** of the work of that expert; and
(c) Evaluate the **appropriateness of that expert's work** as audit evidence for the relevant assertion.

The auditor may **obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as**

- **personal experience with previous work** of that expert;
- **discussions with that expert**;
- **discussions with others** who are familiar with that expert's work;
- **knowledge** of that **expert's qualifications**;
- **published papers** or **books written** by that expert.

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

The auditor may also **consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:**

1) **Relevance & reasonableness** of expert's findings or conclusions, **their consistency** with other audit evidence & whether they **have been appropriately reflected** in FS;
2) If expert's work involves **use of significant assumptions & methods**,
3) **Relevance & reasonableness** of those assumptions & methods; &
4) If **expert's work involves significant use** of source data, relevance, completeness, & accuracy of source data.

In the instant case, CROX Ltd. accepted the gratuity liability valuation based on the certificate issued by an expert i.e., a qualified actuary who is management's expert. Here basis for computation and valuation is taken as age 65 years by the actuary, which is **not correct as company** is considering proposal to increase the retirement age from existing age to 65 years. Therefore, **assumptions and methods used by the management's expert are not appropriate** for financial reporting purposes. Hence, **auditor may qualify** the report accordingly.

---

**Q4.** 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**

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

1) **Inquiry consists of seeking information of knowledgeable persons,** financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures, Inquiries may **range from formal written inquiries to informal oral inquiries**. Evaluating responses to inquiries is an integral part of the inquiry process.

2) **Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.** Alternatively, **responses might provide information that differs significantly from other information that the auditor has obtained**, for example, information regarding the possibility of management override of controls. In some cases, **responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.**

3) **Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited.** In these cases, understanding management's past history of carrying out its stated Intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

4) In respect of some matters, the auditor may consider it necessary to **obtain written representations** from management and, where appropriate, those charged with governance **to confirm responses to oral inquiries**

Q5. 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 re- appointed 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 cleanup 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. **(RTP N-23)**

**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 & relationships creating threats may include:**

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

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.

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.**

## SA 501 – Audit Evidence: Specific Considerations for Selected Items

**Q6.** CA Prabhjot has planned **observing the physical count of inventories** at the plant of a company **located in remote area** in the state of Uttarakhand as part of a statutory audit exercise as at close of year ending 31st March 2023. He has already **informed** the **management** of his **intention to reach the plant site by evening of 29th March 2023**. He plans to inspect inventories, observe the counting process and perform test counts among other matters.

The management has made all necessary arrangements to facilitate the above exercise. However, an **agitation in Himalayan hills has started** on 28th March 2023 for the promulgation of a strict law relating to the conversion of agricultural land for commercial use. Many civil society groups are participating in the agitation. **NH-7 leading to the plant site is blocked by protestors.** The plant is not accessible through any other mode. The **blockade is lifted after one month** when state government announced the formation of a committee to look into protestors' demands.

Does the above case highlight to a situation of **"impracticability of attendance"** at inventory counting in terms of requirements of SA 501?

How **should the auditor proceed** in above situation? ***(SM-TYU)***

**Answer**

The **above situation does not highlight the impracticability of attendance at inventory counting**. It only **shows that the auditor is unable to attend physical inventory counting due to unforeseen circumstances arising out of agitation by protestors**. It has led to the inaccessibility of the plant site for a month. The blockade is lifted after a month.

SA 501 states that 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**. Therefore, the **audit should attend to the physical inventory count after the blockade is lifted** and perform audit procedures on intervening transactions.

---

**Q7.** 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? **(SM)**

**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.

---

**Q8**. On going through financial statements and records of "TS Ltd.," during the course of **statutory audit, CA Tanmaya finds that substantial inventories of the company consisting of mast lighting poles remain with "Super Industries"** for certain finishing works. While planning audit procedures, he had **planned about seeking confirmation** from "Super Industries" regarding existence and condition of such mast lighting poles belonging to TS Ltd. lying with them as on 31st March, 2023.

However, the **premises of "Super Industries" were raided by DGGI officials** (Director General of GST Intelligence) in connection with the **busting of a fake billing scam.** The **proprietor** of the firm was **arrested** in November 2022 and came out on bail in the month of March 2023. The details of proprietor and his firm were flashed prominently in local newspapers of the city where company is located. CA. Tanmaya also belongs to the same place. **Discuss how he should proceed in the above matter as auditor of TS Ltd**. **(SM-TYU)**

**Answer**

**SA 501** states that **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:

a) **Request confirmation** from the **3rd** party as to the quantities & condition of inventory held on behalf of the entity.
b) Perform **inspection** or **other audit procedures** appropriate in the circumstances.

It further states that where **information is obtained that raises doubt about the integrity and objectivity of the third party**, the auditor may consider it appropriate to **perform other audit procedures** instead of, or in addition to, confirmation with the third party.

**Examples of other audit procedures include:**

- **Attending, or arranging** for another auditor to attend, 3rd party's physical counting of inventory, if practicable.
- Obtaining **another auditor's report,** or a service auditor's report **on the adequacy of the 3rd party's IC** for ensuring that inventory is properly counted & adequately safeguarded.
- **Inspecting documentation** regarding inventory held by **3rd** parties, for example, **warehouse receipts.**
- Requesting **confirmation** from other parties when inventory has been pledged as collateral.

In the **given case, the integrity of the third party appears to be doubtful** in view of DGGI raids and his possible involvement in a fake billing scam. He has already been behind bars.

Keeping in view above, **besides obtaining confirmation from such party, he may attend a third party's physical counting or ask some other auditor to attend physical counting as on reporting date**, depending upon practical considerations. He can also inspect the record of goods sent and received back from such party by tracing it to challans, e-ways bills etc. and correlate the above information.

---

**Q9**. Cocyx Ltd. supplies navy uniforms across the country. The company has **3 warehouses at different locations throughout the India** and **5 warehouses at the borders**. The major stocks are generally supplied from the borders. Coccyx Ltd. appointed M/s OPAQE & Co. to conduct its audit for the financial year 2022-23. Mr. P, partner of M/s OPAQE & Co., attended all the **physical inventory counting conducted** throughout the India but **could not attend the same at borders** due to some unavoidable reason.

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

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

(ii) How is an auditor supposed to deal when **attendance at physical inventory counting is impracticable? (SM-TYK)**

**Answer**

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

**1) Attendance at physical inventory counting, unless impracticable**

- **Evaluate** Mgt. instructions & procedures for *recording & controlling results of entity's physical inventory counting;*
- **Observe performance** of Mgt. count procedures;
- **Inspect inventory**;
- **Perform test counts**; &

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

II. **Attendance at Physical Inventory Counting Not Practicable:** In some cases, attendance at physical inventory counting may be impracticable.

- Due to factors such as the **nature and location of the inventory,** ex: location may pose threats to safety of auditor
- **As per SA 200**, matter of difficulty, time, or cost involved is **not in itself a valid basis** for auditor **to omit audit procedure** or **satisfied with AE that is less than persuasive**.
- He shall perform **alternative audit procedures** to obtain **SAAE** regarding existence & condition of inventory.
- If **not possible** to do so, auditor shall **modify opinion** in the auditor's report in accordance with SA **705**.

---

**Q10**. GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2023 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. **(SM-TYK)**

**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 & charges** between segments, and elimination of inter-segment amounts.

(ii) **Comparisons with budgets & other expected results,** for ex: operating profits as a % of sales.

(iii) The **allocation of assets and costs** among segments.

(iv) **Consistency** with prior periods, & adequacy of disclosures with respect to inconsistencies.

---

**Q11**. 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" wil! 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.

**Answer**

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

**(i) Attendance at physical inventory counting, unless impracticable, to**

- **Evaluate** Mgt. instructions & procedures for *recording & controlling results of entity's physical inventory counting;*
- **Observe performance** of Mgt. count procedures;
- **Inspect inventory**;
- **Perform test counts**; &

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

**Attendance at physical inventory counting involves:**

- ☺ **Inspecting inventory** to ascertain its existence & **evaluate its condition & perform test counts**.
- ☺ **Observing compliance with management's instructions** and the performance of procedures for recording and controlling the results of the physical inventory count; and
- ☺ **Obtaining audit evidence as to the reliability of management's count procedures.**

Hence in given case, **approach of Engagement Partner is not appropriate** as when inventory is material to the financial statements, **auditor shall obtain sufficient appropriate audit evidence** regarding existence and condition of inventory. **This should be done by performing various audit procedures which also includes attending physical count, observing the count, inspecting inventory and reperforming physical counts.**

---

**Q12**. Moon Ltd. is a dealer in electronic appliances. The Company has a centralised warehouse at the outskirts of Mumbai. The Auditors of the company M/s JK Associates normally attend the physical verification of stocks carried out by the Management at the end of the financial year. However, **on account of certain disturbances in the region, the physical inventory counting could not be carried out at the year end**. The stock taking is decided to be done by management at some other date subsequently, after a month.

In the light of the above facts:

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

**Answer**

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.**

**Physical Inventory Counting at a date other than date of FS**

- For **practical reasons**, may be conducted.
- **This may be done irrespective of whether Mgt. determines inventory quantities** by an annual physical inventory counting or maintains a perpetual inventory system.
- In either case, effectiveness of the design, implementation & maintenance of controls over changes in inventory **determines** whether conduct of physical inventory counting at a date, or dates, other than date of FS is **appropriate for audit purposes.**
- Auditor shall **perform audit procedures** to obtain AE about **whether changes in inventory** b/w count date & date of FS are **properly recorded.**

'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:

**(i) Attendance at physical inventory counting, unless impracticable, to**

- **Evaluate** <u>Mgt. instructions & procedures</u> for *recording & controlling results of entity's physical inventory counting;*
- **Observe performance** <u>of Mgt. count procedures</u>;
- **Inspect inventory**;
- **Perform test counts**; &

**2) Performing audit procedures over entity's final inventory records** *<u>to determine whether they accurately reflect actual inventory count results.</u>*

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 auditor's consideration when designing audit procedures to obtain AE about **whether changes in inventory amounts** <u>between count date, or dates, & final inventory records</u> **are properly recorded** include:

a) Whether **perpetual inventory records** are properly adjusted.

b) **Reliability** of entity's perpetual inventory records.

c) **Reasons for significant differences** b/w info. obtained during physical count & perpetual inventory records.

---

**Q13**. Honest Speciality Chemicals Private Limited is a % 1,000 crore turnover company having plants in Khopoli, Mahad, and Ankleshwar for manufacturing various products for fertilizer units, cosmetics and paint industry, etc. The company has built up a good reputation, and apart from the domestic market, it exports to the European market and the Middle East. The company is a closely held company owned by three friends and their family members. The types of materials handled and produced are hazardous.

Following further latest information relating to the company is as under: -

- The company needs to import the key raw materials and is exposed to high risk of price fluctuations and currency risks.
- The company carries high inventory due to the long import cycle and seasonal sales pattern.
- The working capital is almost 60% blocked in inventory and rest in receivables.
- Company has huge investments in plant & machinery financed through term loans from financial institutions.
- Since the company has large imports, it buys import licenses from the open market.
- Company has received customs notices about using fake licenses for importing materials without paying duty. Company has filed appeal against said notice and the same is pending with the Appellate Tribunal. The amount involved is material and, along with interest and penalty, could be more than 10% of turnover.
- The company has liquid chemicals stored in huge tanks. :
- The powdered form of chemicals is stored in standard-sized drums
- Few items of stocks like coal, sulphur are lying in the open area.
- The company has huge domestic sales on a consignment basis, and vast quantities of finished inventories are lying with the consignees across India.
- The company has received an order from NGT to pay a fine of INR 1.5 crores for the emission of toxic chemicals in the air and water. The company has filed an appeal against the said order.

- The type of plant is such that it has to be a continuous process, and at any time, huge quantities of materials are in process.
- Raw Materials are stored in huge tanks located 2 kilometres from the plant, and to transport the chemicals (liquid), there is a network of pipes connecting them, and at any point in time, there are huge quantities of materials lying in the pipeline.
- The company has prepared its inventory details by involving a management expert.
- During the year, the previous auditor resigned, and a new auditor got appointed.

**Required**

Based on the case study, please advise the auditor on the important aspects of carrying out the audit procedures to obtain sufficient appropriate audit evidence in respect of the following: -

1) Which **audit procedures are required for verifying existence and condition of company's inventories** with specific reference to its nature of operations?
2) The company has **prepared inventory details by involving a management's expert.** Elaborating upon its rationale, **discuss responsibilities of auditor in regard** to information prepared by company involving such an expert.
3) What **additional procedures** does the auditor need to carry out in respect of **stocks lying with consignees** all over the country?
4) What **procedures** should the auditor need to **undertake for litigation matters**?

***Answer***

1) The auditor needs to obtain sufficient appropriate audit evidence regarding existence and condition of inventory. For the above, the auditor needs to do all the following: -

   a) **Attendance at physical inventory counting to**:

      **Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting like**:
      - Existence of appropriate control activities: collection of used physical inventory count records, accounting for unused physical inventory count records, count and recount procedures.
      - Accurate identification of stage of completion of work-in-progress, of slow moving, obsolete, or damaged items and of inventory lying in tanks, in pipes and in open areas.
      - Procedures used to estimate physical quantities, for liquid. chemicals lying in
      - process, tanks, pipelines, in open areas like coal pile, sulphur pile, etc.
      - Control over the moment of inventory between areas and the shipping and receipt of inventory before and after cut off date.

   b) **Observe** the **performance of Management's count procedure** by observing the control over the movement of inventory before, during and after the count to determine adequacy and effectiveness of count procedure.

   c) **Inspect** the **inventory** to assist in identifying obsolete, damaged or ageing of inventory.

   d) **Perform** the **test counts** to obtain the sufficient appropriate audit evidence.
      i. By tracing items selected from physical inventory to management's count records,
      ii. By obtaining copies of Management's completed physical inventory count records

   e) Cross matching the final inventory records with the actual inventory count results.

2) The company deals with speciality chemicals which are in liquid condition, powdered condition, lying in the huge tanks or in plants under process, lying in pipelines or lying in open areas like coal and sulphur. The unit of measurement for each of the above categories may be different and could involve technical and mathematical principles involving technical and scientific expertise. Keeping these matters in view, inventory details have been prepared by involving management's expert.
   When information to be used as audit evidence has been prepared using the work of a mgt's expert, auditor shall, having regard to significance of that **expert's work** for the auditor's purposes:
   a) Evaluate the **competence**, **capabilities** and **objectivity** of that expert
   b) Obtain an **understanding of the work of that expert** and
   c) **Evaluate** the **appropriateness of that expert's work** as audit evidence for relevant assertion.
3) **Apart from obtaining the confirmation from the third party** as to the quantities and condition of the inventory held on behalf of the entity, the **auditor may perform the following other audit procedures:**
   - **Attending, or arranging** for another auditor to attend, 3rd party's physical counting of inventory, if practicable.
   - Obtaining **another auditor's report,** or a service auditor's report **on the adequacy of the 3rd party's IC** for ensuring that inventory is properly counted & adequately safeguarded.
   - **Inspecting documentation** regarding inventory held by 3rd parties, for ex, **warehouse receipts.**
   - Requesting **confirmation** from other parties when inventory has been pledged as collateral.
4) The auditor shall design and perform audit procedures **in order to identify litigation and claims** involving the entity by:
   a) **Inquiry of Mgt.** &, where applicable, others within entity, including inhouse legal counsel;
   b) **Reviewing minutes** of meetings of TCWG & **Correspondence** b/w entity & its external legal counsel; &
   c) **Reviewing legal expense accounts**.

   The legal claims involving customs and fine of NGT are material. In such circumstances if auditor assesses risk of material misstatements regarding litigation, **he can seek letter of specific inquiry from the external legal counsel including:**
   - A **list** of litigation and claims
   - Where available, **Mgt. assessment** of the outcome of each of the identified litigation and claims and **its estimate of the financial implications**, including costs
   - A **request** that the entity's external legal counsel **confirm the reasonableness of Mgt. assessments** and **provide auditor with further info**. if the **list** is considered by the entity's external legal counsel to be **incorrect.**
   - Auditor may **seek meeting** with the external legal counsel if the matter is:
     a) Auditor determines that the **matter is a significant risk**
     b) Matter is **complex**.
     c) **Disagreement** between Mngt & external legal counsel.

Ordinarily, such meetings require Mgt. permission & are held with representative of Mgt. in attendance.

**Written Representations**

Auditor shall request Mgt. & TCWG to provide WR that all litigation and claims whose effects should be considered when preparing FS have been

- **disclosed** to the auditor and
- **appropriately accounted for & disclosed** as per applicable FRF.

## SA 505 –"External Confirmations"

**Q14**. 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? **(SM-TYU)**

**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.

---

**Q15**. During the audit of Star Ltd. A company engaged in the production of paper, the auditor received **certain confirmation for 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 small balances **except one which is an old outstanding of Rs. 20 lakhs for which no confirmation was received.** Comment with respect to Standards of Auditing relating to the confirmation process and how to deal the non-receipt of confirmation. **(PYQ-N22/SM-TYK)**

**Answer**

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

Negative confirmations **provide less persuasive audit evidence than positive confirmations.**

**Failure to receive a response to negative confirmation request does not explicitly indicate receipt by intended confirming party of the confirmation request or verification of accuracy of information contained in 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.

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. 20 lakh has not sent the confirmation on the credit balance. 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. **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.** But if **auditor identifies factors that give rise to doubt about the reliability of response** to confirmation request, he shall **obtain further audit evidence to resolve these doubts.**

---

**Q16**. **Neverpermit Limited refuses to allow you to get direct confirmation** of the outstanding balances of trade receivables. You want to ensure on grounds of materiality that at least outstanding above a threshold limit needs to be confirmed and reconciliation is to be carried out before finalising the audit. If the Company does not relent, how will you respond? **(PYQ-M18)**

**OR**

The accountant of C 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**

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

Auditor shall:

a) **Inquire** as to Mgt.'s reasons for the refusal, and **seek AE** as to their validity and reasonableness;
b) **Evaluate implications of Mgt.'s refusal** on the auditor's assessment of the relevant risks of MM, including the risk of fraud, and on the NTE of other audit procedures; and
c) Perform **alternative audit procedures** designed to obtain relevant and reliable AE.

If **Mgt. refusal** is **unreasonable**, or he is **unable to obtain relevant & reliable AE** from alternative audit procedures, he shall:

- communicate with TCWG as per **SA 260** &
- determine implications for audit & auditor's opinion as per **SA 705**

A refusal by management to allow auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore. required to inquire as to the reasons for limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reasonableness of the reasons because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

---

**Q17**. Mr. Agarwal, in the course of audit of PQ Limited, wants to perform external confirmation procedures to obtain audit evidence.

Guide Mr. Agarwal, listing out the **factors that may assist him in determining whether external confirmation procedures are to be performed as substantive audit procedures. (PYQ-D21)**

**Answer**

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

1) **Confirming party's knowledge of subject matter** – responses may be more reliable if provided by person at confirming party who has requisite knowledge about info. being confirmed.
2) **Ability or willingness of intended confirming party to respond** – for ex: confirming party:
   a) May not accept responsibility for responding to confirmation request;
   b) May consider responding too costly or time consuming;
   c) May have concerns about potential legal liability resulting from responding;
   d) May account for transactions in different currencies; or
   e) May operate in environment where responding to confirmation requests is not significant aspect of day-to-day operations.
3) **Objectivity of intended confirming party** – if confirming party is **related party** of entity, responses to confirmation requests may be less reliable.

---

**Q18**. M/s ABC & Co, LLP are appointed auditors of Sharp Company Ltd. As part of the audit process, they want to use confirmation procedures as audit evidence during the course of audit. In view of the fact that positive confirmations are not responded favourably, the **firm also intends to use negative confirmation requests. What are the factors to be considered for the same? (PYQ-M19)**

**Answer**

**Factors to be considered for Negative Confirmation requests**: A request that the confirming party respond directly to the auditor only if confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

Accordingly, auditor **shall not use NCR** as the **sole substantive audit procedure** to address assessed ROMM at assertion level unless **all** of following are present:

a) Auditor has **assessed ROMM as low** & has **obtained SAAE** regarding operating effectiveness of controls relevant to assertion;
b) **Population** of items comprises a large no. of small, homogeneous, account balances, transactions or conditions;
c) **Very low exception rate** is expected; and
d) Auditor **is not aware of circumstances or conditions** that would cause recipients of NCR to disregard such requests.

Failure to receive a response to negative confirmation request does not explicitly indicate receipt by intended confirming party of the confirmation request or verification of accuracy of information contained in 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.

---

**Q19**. Mr. Z who is appointed as auditor of Elite Co. Ltd. wants to use confirmation request as audit evidence during the course of audit. What are the **factors to be considered by Mr. Z when designing a confirmation request?** Also state the **effects of using positive external confirmation request by Mr. Z. (PYQ)**

**Answer**

As per SA 505, "External Confirmation", **factors to be considered when designing confirmation requests:**
1) '**Assertions being addressed.**
2) Specific identified **ROMM**, including fraud risks.
3) **Layout & presentation** of confirmation request.
4) **Prior experience** on audit or similar engagements.
5) **Method of communication** (ex: in paper form/by electronic or other medium)
6) **Mgt. authorisation** or encouragement to confirming parties to respond to auditor. Confirming parties may only be willing to respond to a confirmation request containing Mgt. authorisation.
7) **Ability of intended confirming party** to confirm or provide requested info. (ex: individual invoice amount v/s total balance).

- Positive confirmation request asks confirming party to **reply in all cases**, either by indicating agreement with given info, or providing info.
- Response to PCR is expected to provide **reliable Audit evidence**.
- Risk - party may **reply without verifying** that info. is correct.
- Auditor may **reduce this risk** by using PCR that **do not state amt (or other info)** on confirmation request, and ask confirming party to fill amount or furnish other info.
- Use of this type of **"blank" confirmation request may result in lower response rates** because additional effort is required by confirming parties

---

## SA 510 –" Initial audit engagements -opening balances "

**Q20**. 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? (SM-TYU)**

**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 case of **inventories,** current period's audit procedures on closing inventory balance provide little AE regarding inventory on hand at beginning of period.

Therefore, additional audit procedures may be necessary:

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

---

**Q21**. CA. Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P) Ltd. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, **CA. Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting 150 lakhs,** continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year.
CA. Jack, therefore, **excluded from the audit programme, audit of accounts receivable** on the understanding **that it pertains to the preceding year which was already audited by predecessor auditor**. Comment. **(MTP)**

**Answer**

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-

(i) Opening balances **contain misstatements** that materially affect the current period's financial Statements; and

(ii) **Appropriate. accounting policies reflected in the opening balances** have been **consistently applied** in the current period's financial statements, or **changes** thereto are properly accounted for and **adequately presented and disclosed** in accordance with the applicable financial reporting framework.

**When the financial statements for the preceding period were audited by another auditor**

- Current auditor may be able to obtain SAAE regarding opening balances **by perusing copies of audited FS.**
- Ordinarily, **current auditor can place reliance on closing balances contained in FS for preceding period, except** when during performance of audit procedures for current period possibility of misstatements in opening balances is indicated.

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

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

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

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.

---

**Q22**. Mr. X has been appointed as an auditor of M/s ABC Ltd., Mr. X **wants to be satisfied about the sufficiency and appropriateness of 'Opening Balances'** to ensure that they are free from misstatements. **Lay down the audit procedure**, Mr. X should follow, in the initial audit engagement of M/s ABC Ltd. Also suggest the **approach to be followed regarding mention in the audit report if Mr. X is not satisfied about the correctness of 'Opening Balances'? (PYQ-N19)**

**OR**

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

**Answer**

As per **SA 510 "Initial Audit Engagements-Opening Balances"**, the auditor shall **obtain sufficient appropriate audit evidence** about whether the opening balances contain misstatements that materially **affect the current period's financial statements by** -

1) 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;
2) Determining whether the opening balances **reflect the application of appropriate accounting policies**; and
3) By **evaluating whether audit procedures performed in the current period** provide evidence relevant to the opening balances; or **performing specific audit procedures** to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances **contain misstatements** that could materially affect the current period's financial statements, the auditor shall **perform such additional audit procedures as are appropriate** in circumstances **to determine effect on current period's financial statements.**

If the auditor **concludes** that such misstatements exist in current period's financial statements, auditor shall **communicate misstatements** with the appropriate level of management and those charged with governance.

**Approach for drafting Audit Report:** If the auditor **concludes** that the opening balances **contain** a **misstatement** that materially affects 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, as appropriate, in accordance with SA 705.**

In case where 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, in accordance with **SA 705.**

---

**Q23**. CA. Ashutosh has been appointed as an auditor of Awesome Health Ltd. for the financial year 2023-24 which was audited by CA. Amrawati in 2022-23. As the Auditor of Awesome Health Ltd., **state the steps** that CA. Ashutosh would take **to ensure that the Closing Balances** of the financial year 2022-23 have been brought to account in 2023-24 as Opening Balances and the **Opening Balances don't contain any misstatements**.

**Answer**

According to **SA 510 on "Initial Audit Engagements- Opening Balances"**, the **objective** of the Auditor while conducting an initial audit engagement with respect to opening balances is to **obtain sufficient appropriate audit evidence so that the-**

(i) opening balances of preceding period have been **correctly brought forward** to current period;
(ii) opening balances **do not contain any misstatement** that materially affect the current period's financial statements; and
(iii) **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.

Being a new assignment, audit evidence regarding opening balances can be obtained by perusing the copies of audited financial statements.

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

In respect of **other assets and liabilities such as property plant and equipment, investments, long term debts,** the auditor will **examine 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).

## SA 530 " AUDIT SAMPLING"

**Q24**. 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.**

---

**Q25.** Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2022- 2023. 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:
Auditor shall evaluate

a) **Results of the sampl**e &
b) Whether use of audit sampling provided **reasonable basis for conclusions** about population that has been tested.

If audit sampling has **not provided a reasonable basis** for conclusions about population auditor may:

- **Request Mgt.** to investigate misstatements & to make necessary adjustments; or
- **Tailor NTE of FAP** to best achieve 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.

---

**Q26.** Write a short note on **Sampling Risk**.

**OR**

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

**Answer**

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**:

(i) In case of Test of Controls, that **controls are more effective** than they actually are, or
In case of a Test of Details, that a **MM does not exist** when in fact it does.
Auditor is primarily concerned with this type of erroneous conclusion because it **affects audit effectiveness** & is more likely to lead to inappropriate audit opinion.

(ii) In case of TOC, that **controls are less effective** than they actually are, or
In case of TOD, that **MM 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.

---

**Q27.** 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:

| S.N. | Particulars |
|---|---|
| 1 | (a) Balances in excess of Rs 50,00,000; |
| 2 | (b) Balances in the range of Rs. 40,00,001 to Rs.50,00,000; |
| 3 | (c) Balances in the range of Rs. 30,00,001 to Rs. 40,00,000; |
| 4 | (d) Balances in the range of Rs. 20,00,001 to Rs. 30,00,000; |
| 5 | (e) Balances in the range of Rs. 10,00,001 to Rs. 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 sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).**

**Uses of Stratification**

A. **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.**

B. **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 valuation of accounts receivable, balances may be stratified by age.

C. **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).

D. If a class of transactions or account balance has. been divided into strata, **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.

---

**Q28.** In course of your audit assignment of Indraprastha Ltd., you want to guide your audit assistants in selecting sample items in such a way that sample can be expected to be representative of the population and all items have an opportunity of being selected. **Guide your assistants with principal methods of collecting samples.**

**Answer**

According to **SA 530 "Audit Sampling"**, the principal methods of selecting samples are the use of random selection, systematic selection, monetary unit sampling selection, haphazard selection and block selection. Each of these methods is discussed below: -

1) **Random selection:** This method is applied **through random number generators, for example, random number tables.**

2) **Systematic selection:**
   - No. of sampling units in population is divided by sample size to give a **sampling interval**,
   - Ex: 50, and having determined a starting point within the first 50, **50th sampling unit thereafter is selected.**

   Although **starting point** may be <u>determined haphazardly</u>, sample is more likely to be truly random if it is determined by use of computerised random number generator or random number tables.

3) **Monetary Unit sampling:**
   Type of **value-weighted selection** in which <u>sample size, selection & evaluation results</u> in a conclusion in **monetary amounts.**

4) **Haphazard selection:**
   - Samples are selected **without following structured technique.**
   - Although no structured technique is used, auditor would nonetheless **avoid any conscious bias** or **predictability** (for ex: avoiding difficult to locate items, or always choosing or avoiding first or last entries on a page) & thus attempt to ensure that all items in population have a chance of selection.
   - **Not appropriate** when using statistical sampling.

5) **Block selection:**
   - It involves **selection of a block(s) of contiguous items** from within the population.
   - Block selection **can't ordinarily be used in audit sampling** because most populations are structured such that items in a sequence can be expected to have similar characteristics .

In **some circumstances** it may be an appropriate audit procedure to examine block of items, it would **rarely be appropriate** sample selection technique when auditor intends to draw valid inferences about entire population based on sample.

---

**Q29.** Write short notes on **Statistical and Non-Statistical Sampling.**

**Answer**

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

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

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

2) **Non-statistical sampling:** Under this method, the sample size and its composition are determined on the basis of personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September 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 to maintain an element of surprise as to what auditor is going to check. It is a common practice to check large number of items towards close of the year so that adequacy of cut-off procedures can also be determined.

## SA 550– "RELATED PARTIES"

**Q30**. "**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"? **(SM-TYU)**

**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.**

Auditor has to **seek to understand business rationale of such 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.**

---

**Q31**.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:-

1. The long term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.
2. Certain computers were received from the parent company free of cost, the value of which is Rs. 0.23 lac and no accounting or disclosure of the same has been made in the notes to accounts.
3. An amount of Rs. 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 Rs.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. Rs. 47 lac) but the CFO refused to provide the same since the same is perceived to be confidential and cannot be shared with the Auditors.
You are required to **advise about items to be reported to those charged with governance,** where applicable, based on your audit findings in the given situation. **(MTP)**

**Answer**

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 authorized 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.

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:

a) One of related party transaction amounting 3.25 lac per month i.e. in lieu of marketing services has been noticed of which amount Rs. 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.
b) 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 Rs. 47 lac is imposing limitation of scope of auditor in view of SA 705.
c) Receipt of free of cost Computers and long-term borrowing (on no agreed terms and repayment of interest and principal) from the Parent Company need separate disclosure in financial statements as per Ind AS 24 / AS 18 Related Party Disclosures.

Further, in case of all the above cases, the auditor would also need to assess his reporting requirements under the clauses (xiii) of Paragraph 3 of CARO 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.

---

**Q32.** 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. **(PYQ-N20)**

**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:**

- **Complex equity transactions**, such as corporate restructurings or acquisitions.
- **Transactions** with **offshore entities** in jurisdictions with weak corporate laws.
- **Sales transactions** with unusually large discounts or returns.
- Transactions with **circular arrangements**, for example, sales with a commitment to repurchase.
- **Transactions** under **contracts whose terms are changed** before expiry.
- **Leasing of premises or rendering of Mgt. services** by entity to another party if no consideration is exchanged.

---

**Q33.** 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. (PYQ-M22)**

**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) **Nature & extent** of entity's relationships & transactions with RP.
2) **An Emphasis on importance** of maintaining professional skepticism throughout audit regarding potential for MM associated with RP relationships & transactions.
3) **Circumstances or conditions** of entity that indicate existence of RP relationships or transactions that Mgt. has not identified or disclosed to auditor
4) **Records or documents** that indicate existence of RP relationships or transactions.
5) **Importance** that Mgt. and TCWG **attach to the identification, appropriate accounting for, and disclosure** of related party relationships and transactions (if the applicable FRF establishes related party requirements), and the related risk of Mgt. 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.

---

**Q34.** 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.**

**OR**

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

**OR**

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

**Answer**

AS per SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. **Example**:

- Entity **ITR**.
- **Info. supplied** by entity **to regulatory authorities**.
- **Shareholder registers** to identify entity's principal shareholders.
- Statements of **conflicts of interest** from Mgt. & TCWG.
- **Records** of **entity's investments** & those of its pension plans.
- **Contracts & agreements** with key Mgt. or TCWG.
- **Significant contracts & agreements** not in entity's ordinary course of business.
- **Life insurance policies** acquired by entity.
- **Internal auditors' reports.**
- Documents associated with entity's filings with a securities regulator (e.g., prospectuses).
- Specific invoices & correspondence from entity's professional advisors.
- Significant contracts re-negotiated by entity during period.

In particular, **Auditor shall inspect following for indications of existence of RP relationships or transactions that Mgt. has <u>not previously identified or disclosed to auditor:</u>**

a) **Bank**, **legal** & **3rd party confirmations** obtained as part of auditor's procedures;
b) **Minutes** of meetings of shareholders & of TCWG; and
c) **Such other records** or documents as auditor considers necessary in the circumstances of the entity.

---

**Q35.** In the course of your audit you have come across **a related party transaction which prima facie appears to be biased. How would you deal with this? (Old-PM)**

**Answer**

The duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties.

Since it is the management, which is primarily responsible for identification of related parties, SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions.

In this case, the auditor is finding a related party transaction which prima facie appears to be biased. So the auditor is required to confirm the same.
For identified significant related party transactions outside the entity's normal course of business, the auditor shall inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) **Business rationale** (or lack thereof) of transactions suggests that they may have been entered into to **engage in fraudulent financial reporting** or **to conceal misappropriation of assets;**
(ii) **Terms of transactions** are **consistent** with Mgt. explanations; and
(iii) **Transactions** have been **appropriately accounted for & disclosed** as per FRF;

The auditor should also **obtain audit evidence** that the **transactions have been appropriately authorised and approved.**

After obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where applicable financial reporting framework establishes related party requirements, to identify risks of material misstatement.

In addition, the auditor needs to be **alert for transactions** which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Where the applicable financial reporting framework establishes related party requirements, auditor shall obtain **written representations** from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Finally, the auditor should report on the basis of this fact that the related party relationships and transactions prevent financial statements from achieving true and fair presentation (for fair presentation frameworks); or they are not cause for financial statements to be misleading (for compliance frameworks).

---

**Q36.** You are the Auditor of Power Supply Corporation Limited, a Government Company for the year ended on 31st March 20XX. The turnover of the Company for the period was 7 12,000 crores from sale of power. During your audit, you found that the Company had procured Spares for Transmitters for 850 crores from abroad through a Corporation by name Procurement and Supply India Limited which is also **owned and controlled by Government of India.** The Financial Statements of the Power Supply Corporation Limited, prepared in compliance with Ind AS for the year ended on 31.3.20XX did not contain any additional disclosure regarding the procurement of spares as referred to above. To your query as to **whether any disclosure regarding Related Party Transaction would be required**, the Management of the Corporation replied that no such disclosure would be necessary for transactions between State Controlled Enterprises.

Analyse this issue in finalizing the Audit Report. **(PYQ-N18)**

**Answer**

Related Party Disclosures: As per Ind AS 24, "Related Party Disclosures", **reporting entity** is exempt from disclosure requirements in relation to RPT & o/s balances, including commitments, with:

(i) **Government** that has control or joint control of, or significant influence over reporting entity; and
(ii) **Another entity that is RP** because same government has control or joint control of, or significant influence over, both reporting entity & other entity.

**If reporting entity applies above exemption**, **shall disclose** following about transactions & related o/s balances referred to:

(i) Name of government & nature of its relationship with reporting entity (i.e. control, joint control or significant influence);
(ii) **Following info. in sufficient detail** to enable users of entity's F.S. to understand effect of RPT on its F.S.:
   - **Nature & amount** of each individually **significant transaction**: and
   - for **other transactions** that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

Further, as per SA 550 Related Parties, in forming an opinion on the financial statements in accordance with SA 700, the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with applicable financial reporting framework.

In the instant case, Power Supply Corporation Limited, a Government Company has procured spares for transmitters for rupees 850 crore from abroad through a corporation namely Procurement and Supply India Limited which is also owned and controlled by Government of India.

**Even after applying the exemption of Ind AS 24, Power Supply Corporation Limited has to disclose the matters specified above** (i.e.name of Government, natures of its relationship with reporting entity, the nature and amount of transaction etc.).

**Contention of Management of Corporation regarding no requirement of disclosure for transactions between State Controlled Enterprise is not tenable.**

---

**Q36.** "Trustworthy Real Estate Private Limited" with Mr. Bharose Lal as MD along with his wife, Maya, owned the company.

The company had floated one SPV "Real Trust Developers Private Limited" in which a foreign entity became a Joint Venture partner with a 50% stake.

The venture was formed with its Head Office in Mumbai to invest in SRA projects (Slum rehabilitation authority) and develop them into commercial units for sale.

Mr. Bharose Lal was going through a rough patch in his life. He was in financial difficulty and had mounting dues and huge outstanding exposure to banks and suppliers in his companies. Mrs. Maya was from a very wealthy family and had fallen in love with Mr. Bharose Lal, who was from a middle-class family. Mrs. Maya had an expensive lifestyle and was always short of funds to maintain her lifestyle. Mr. Bharose Lal sensed a golden opportunity in the new venture because the foreign partner had no knowledge of Indian regulations and how the SRA projects worked and was solely dependent on the local partner to get all the permissions, scouting for the projects, getting consents from the slum dwellers for the project, giving contracts for the construction of projects and such matters.

M/S ABC and Company, Chartered Accountants were appointed as the auditor of the joint venture, and the engagement team was headed by CA Sceptic, who had, in his stint with the firm, was instrumental in unearthing two major frauds and had the ability to sniff out any such scenarios.

Mr. Bharose Lal has a dominant personality and a powerful influence on functioning, and everybody looks to him for guidance. The governance structure was very poor in the organization, and Mr. Bharose Lal used to dictate the decisions. Even though as part of the Joint Venture, there was a detailed governance structure and policies and procedures in place for the decision-making process at the joint venture. However, the representative on the board of the Joint Venture of the foreign partner who had shifted to India to supervise the SRA project had grown friendly with Mr. Bharose Lal, and Mr. Bharose Lal had even gone out of the way to help him get good accommodation and second- hand Mercedes. Often, they both go to a club in the evening for a drink.

The dealings in the SRA project are not very transparent and above board but are very opaque. Given the above situation, CA Sceptic wants to discuss with the audit team areas and situations where risk of material misstatement is possible and there are chances of having an undisclosed related party relationship to misappropriate the funds. **(Case Study-SM)**

**1. Please guide the engagement team on the further course of action as per SA 550.**

**Answer**

The engagement team 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.

- The nature and extent of the entity's relationships and transactions with related parties as identified independently by the Auditor by verification of MBP-1 data and data available on MCA website relating to directors and companies, etc.
- An emphasis on the importance of maintaining Professional Skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special purpose entities off-balance sheet transactions, or an inadequate information system).
- The records or documents that may indicate the existence of related party relationships or transactions.
- The importance of management and those charged with governance attached to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirement), and the related risk of Management override of relevant controls.
- 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 transaction between the entity and known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behaviour or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind through out the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

**2. What are fraud risk factors in given case?**

**Answer**

The fraud risk factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The fraud risk factors are classified based on the three conditions that are generally present when fraud exists:

(i) An incentive or pressure to commit fraud

(ii) A perceived opportunity to commit fraud

(iii) An ability to rationalize the fraudulent action.

In the given case scenario following fraud risk factors can be segregated in the 2 conditions of incentive or pressure to commit fraud in a perceived opportunity to commit fraud.

1) An incentive or pressure to commit fraud:
   a) Financial difficulty with huge outstanding dues towards vendors and Financial Institutions.
   b) Expensive lifestyle.
   c) Requirement to fund ` 5 crore as equity contribution in the SPV.

2) A perceived opportunity to commit fraud:
   a) Dependency of the foreign partner and no knowledge of the foreign partner of local laws and the SRA business model in India
   b) The risk is due to the way the real estate industry functions and particularly risk due to the SRA business model.
   c) Dominant personality of MD, which can lead to management override of controls for undisclosed business relationships with M/s. Useless and Sons (P) Ltd.

**3. Given the situation that each partner in the joint venture has to bring into the entity a contribution of 5 crores each and given the situation that Mr Bharose Lal had appointed one agency, the name Useless & Sons Private Limited, to get consent from the slum dwellers, for which the agency was paid 20 crores as Kitty to get the job done.**

**CA Sceptic inclines that there is some connection between the 20 crores paid and, simultaneously, within a short span, the infusion of INR 5 crores as equity contribution by Mr. Bharose Lal.**

**Please guide CA Sceptic in establishing this link based on the guidance available in SA 550 and SA 240.**

**What additional audit procedures does his team need to undertake for the conclusion?**

**Answer**

If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditors, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

In such situations, the auditor shall:

- Promptly communicate the relevant information to the other members of the engagement team in order to assist them in determining whether this information affects the results of and conclusions drawn from risk assessment procedures already performed, including whether the risk of material misstatement needs to be reassessed.
- Where the applicable financial reporting framework establishes related party requirements:
  (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and

  (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
    - Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.
    - Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclose to the auditor, and perform additional audit procedures as necessary; and
    - If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. In such cases, the requirements and guidance in SA-240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may

also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

- The Auditor needs to carry out verification and inspection of the ownership structure and the review of the financial statements of the M/s. Useless and Sons (P) Ltd through the MCA website and establish the nexus between the two.
- The Auditor needs to carry out an inspection of the data filed by Mr. Bharose Lal for his group companies to establish any past transactions/relationships between the two entities.
- The Auditor needs to ask for all the documents for the utilization of INR 20 crore and can investigate by visiting the parties involved and asking for confirmation directly.

**4. If, based on additional audit procedures undertaken by CA Sceptic, it is established that there is a likelihood of misappropriation of funds and the financial statements as a whole may be materially misstated, how CA Sceptic needs to plan the future course of action?**

**Answer**

The Auditor needs to reassess the reliability of evidence previously obtained as there are doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation.

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is the requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

- Discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and
- Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s withdrawal from the engagement and the reasons for the withdrawal.