

# 5. “Audit Evidence”

## PART- I DESCRIPTIVE QUESTIONS

### 5.1 – SA 500 “Audit Evidence”

**Q.1.** During the course of the audit of TK Home Pvt. Ltd., 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 2023-24. 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 recognized 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 2024 having a value of ₹ 75 lacs have not been recognized in export revenue on the ground that bills of lading for these invoices were issued in the month of April 2024.

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 2023-24?

**Ans: Sources for obtaining Audit Evidences:**

- In the given case, audit evidences can be obtained by going through GST returns filed on GST portal and correlating same with e-way bills. Audit evidences can be obtained as to how company has reflected its export sales in 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.

**Q.2.** The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. Comment.

**Ans: Using the work of Management Expert as an audit evidence:**

- SA 500 (Revised), “Audit Evidence” states that the auditor has to evaluate the work of management expert, say, actuary, before adopting the same.
- The work of management expert is required to be evaluated in terms of following:

- (i) **Relevance and reasonableness of that expert findings and conclusion:**
- (ii) **Relevance and reasonableness of assumptions and methods used;** and
- (iii) **Relevance, completeness and accuracy of source data.**

- There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures.
- In the instant case, a qualified actuary has issued a certificate for gratuity liability valuation, for which retirement age adopted is 65 years against the existing retirement age of 60 years; however, the company is considering a proposal to increase the retirement age.

**Conclusion:** In view of provisions of SA 500 as discussed above, the assumption made by actuary has no relevance and reasonableness as presently retiring age is of 60 years. Hence the auditor is required to bring out the facts to the notice of management and advice the modification accordingly. In case of failure of compliance of the same the auditor may qualify the report.

**Q.3.** 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

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

**Ans: Evaluating the work of Management 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 perform the following:

- (i) **Evaluate the competence, capabilities and objectivity of that expert:** For this purpose, auditor may consider his qualification, membership of a professional body or industrial association license to practice etc.
- (ii) **Obtain an understanding of the work of that expert:** It may include areas of specialty, applicable professional standards and other legal requirements
- (iii) **Evaluate the appropriateness of that expert's work:** With respect to following:
  - (a) **Relevance and reasonableness of that expert findings and conclusion;**
  - (b) **Relevance and reasonableness of assumptions and methods used;** and
  - (c) **Relevance, completeness and accuracy of source data.**

## 5.2 SA 501 "Audit Evidence – Specific Considerations for Selected Items"

**Q.4.** 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 31<sup>st</sup> March 2024. He has already informed the management of his intention to reach the plant site by evening of 29<sup>th</sup> March 2024. He plans to inspect inventories, observe the counting process and perform test counts among other matters. The management has made necessary arrangements to facilitate the above exercise. However,

an agitation in Himalayan hills has started on 28<sup>th</sup> March 2024 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?

**Ans: Auditor's procedures in case of inability to attend inventory count:**

- Situation as given in questions does not highlight the impracticability of attendance at inventory counting it only shows that 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.

**Conclusion:** Auditor should attend to the physical inventory count after the blockade is lifted and perform audit procedures on intervening transactions.

**Q.5.** On reviewing legal expenses account of Zed Ltd. CA. Sunitha, auditor of company, finds those legal fees amounting to ₹ 10 lacs was paid to B. George, a reputed lawyer, during the year 2023-24. 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 , 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?

**Ans: Obtaining audit Evidences directly from company Lawyer:**

- SA 501 states that when audit procedures performed indicate that material litigation or claims may exist, auditor shall seek direct communication with the entity's external legal counsel.
- 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.

**Q.6.** On going through financial statements and records of “TS Ltd” during the of statutory 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, planned about seeking confirmation from “Super Industries” regarding existence and condition such mast lighting poles belonging to TS Ltd. lying with them as on 31.03.2024. However, the premises of “Super Industries were raided by DGGI officials (Director General of Intelligence) in connection with the busting of a fake billing scam. The proprietor of the firm was arrested on November 22 and came out on bail in the month of March 2024. The details proprietor and his firm were flashed prominently in local newspapers of the city where company located. CA. Tanmaya also belongs to the same place. Discuss how he should proceed in the above matter as auditor of TS Ltd. –

**Ans:** **Obtaining Evidences as to Existence & Condition of Inventory lying with third parties:**

- 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 third party as to the quantities and condition of inventory held on behalf of the entity.
  - (b) Perform inspection or other audit procedures appropriate in the circumstances
- It further states that where information is obtained that raises doubt about the integrity and objectivity of the third party, 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:
  - (a) Attending or arranging for another auditor to attend the third party’s physical counting of Inventory, if practicable
  - (b) Obtaining another auditor’s report, or a service auditor’s report, on the adequacy of the third party’s internal control for ensuring that inventory is properly counted and adequately safeguarded
  - (c) Inspecting documentation regarding inventory held by third parties.
- In the given case, integrity of the third party appears to be doubtful in view of DGGI raids and his possible involvement in a fake billing scam.

**Conclusion:** 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.

**Q.7.** LMN Ltd. supplies navy uniforms across the country. The company has 4 warehouses at different one throughout the India and 5 warehouses at the borders. The major stocks are generally Supplied from the borders. LMN Ltd. appointed M/s OPQ & Co. to conduct its audit for the financial year 2023-24. Mr. C. partner of M/s OPQ & 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 OFQ & Co:

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

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

OR

Crush Ltd. is a dealer in fast moving consumer goods. The Company has warehouses throughout the country where the stocks are stored. The Auditor of the Company normally conducts physical verification of stocks along with the Management at the end of the financial year. However, the Auditor could not be physically present during stock-taking at two places on account of certain disturbances in the region.

in light of the above facts

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

**Ans:** (i) **Auditor's duties to obtain evidences regarding existence and condition of inventory:** SA-501 "Audit Evidence-Specific Considerations for Specific Items", requires from the auditor that when inventory is material to the financial statements, he shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

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

**Auditor's procedures in case of impractical situations**

- In some cases, attendance at physical Inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor.
- Where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide SAAE about the existence and condition of inventory.
- In some cases, though, it may not be possible to obtain SAAE regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires auditor to modify the opinion in the auditor's report as a result of the scope limitation.

**Q.8.** Your firm has been appointed as the statutory auditors of GBM Private Limited for the Financial year 2023-24. While verification of company's inventories as on 31st March 2024, you found that the significant amount of inventories belonging to the company are held by other parties. However, the company has kept all the records of the inventories maintained by other parties. What is your duty, as an auditor in order to ensure that third parties are not such with whom the stock should not be held and the stock as disclosed in company's records actually belongs to them?

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

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

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

**Q.9.** You are the auditor of Easy Communications Ltd. for the year 2023-24. The inventory as at the end of the year i.e. 31.03.24 was ₹ 2.25 Crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?

**Ans: Auditor’s procedures w.r.t. inventory count procedures:**

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

of information provided regarding the inventory, and (b) assurance with regard to adherence to laid down procedures for physical inventory count.

**Q.10.** 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 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.

**Ans:** **Audit Procedures to be carried out if physical inventory counting is conducting at a date other than the date of financial statements:**

SA 501 “Audit Evidence - Specific Considerations for Specific Items”, requires from the auditor that when inventory is material to the financial statements, he shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting, unless impracticable, to:

- (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting;
- (ii) Observe the performance of management’s count procedures;
- (iii) Inspect the inventory; and
- (iv) Perform test counts.

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures as specified above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

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

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

**Q.11.** GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended on 31.03.2024 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 SA.

**Ans:** **Examples of Matters relevant in obtaining an understanding of the methods used by management for determining segment information:**

As per SA 501, “Audit Evidence - Specific Consideration for Selected Items”, the auditor determining obtain SAAE regarding the presentation and disclosure of segment information

in accordance applicable FRF by obtaining an understanding of methods used by management in segment information, and evaluating whether such methods are likely to result in disclosure in accordance with the applicable FRF.

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:

1. Sales, transfers & charges between segments, & elimination of intersegment amounts.
2. Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
3. The allocation of assets and costs among segments.
4. Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

**Q.12.** The Engagement Partner of the audit team of High Inventory Limited assessed that the inventory is material with respect to the audit of the financial statement for the current period. Upon inquiring with the management, the Engagement Partner identified that the management will be performing an annual physical inventory count at all the warehouses where the entity stores and maintains its inventory. Moreover, management confirmed in its written representation that they will be performing a 100% physical count of inventory for the current period.

As a result, the engagement Partner decided not to perform any physical count of inventory as it will be a duplication of the work. Moreover, he decided that the written representation from management stating “the inventory exists and is in appropriate physical condition” will be sufficient and appropriate with respect to audit evidence to conclude that the inventory balance in the financial statement is free from any material misstatement.

In the light of SA 501, evaluate whether the decision taken by the Engagement Partner is appropriate or not.

**Ans:** Auditor’s duties to obtain evidences regarding existence & condition of inventory:

SA 501 “Audit Evidence - Specific Considerations for Specific Items”, requires from the auditor that when inventory is material to the financial statements, he shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attendance at physical inventory counting, unless impracticable, to:

- (i) Evaluate management’s instructions and procedures for recording and controlling the results of the entity’s physical inventory counting;
- (ii) Observe the performance of management’s count procedures;
- (iii) Inspect the inventory; and
- (iv) Perform test counts.

Attendance at physical inventory counting involves:

- (1) Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- (2) Observing compliance with management’s instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- (3) Obtaining audit evidence as to the reliability of management’s count procedures.

Hence in the given case, the approach of Engagement Partner is not appropriate as when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate

audit evidence regarding the existence and condition of inventory. This should be done by performing various audit procedures which also includes attending physical count, observing the count, inspecting the inventory and reperforming physical counts.

## 5.2 SA 505 “External Confirmation”

**Q.13.** As auditor of Groom Limited, you have sent positive confirmation requests to 30 creditors of the company in March 2024. 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 2023-24 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?

**Ans: Responses to Confirmation Requests:**

- SA 505 states that if auditor determines that a response to a confirmation request is not reliable, auditor shall evaluate implications on the assessment of the relevant RMM, including risk of fraud, and on the related NTE of other audit procedures.
- In the instant case, GST registrations of 25 concerns have been cancelled in the year 2023-24. It indicates that businesses on those addresses were closed. Further, there are no fresh registrations pertaining to PANs of these parties. However, auditor sent external confirmation requests in March 2024, 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:
  - (a) was received by the auditor indirectly or
  - (b) appeared not to come from the originally intended confirming party.

**Conclusion:** Keeping in view circumstances as described, 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.

**Q.14.** Never Permit Limited refused 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?

**Ans: Management refusal to allow auditor to send confirmation request:**

- SA 505, “External Confirmations”, establishes standards on the auditor’s use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management.
- The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of some reasons, for example, due to a dispute with the particular creditor or debtor.

- If the management refuses to allow the auditor to send a confirmation request, the auditor shall:
  - (a) Inquire as to Management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
  - (b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and
  - (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.
- If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with TCWG and also determine its implication for the audit and his opinion.

**Q.15.** M/s ABC & Co., LLP are appointed auditors of Sharp Company Ltd. for the year ended on 31<sup>st</sup> March, 2023. 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?

**Ans: Use of Negative confirmations:**

- As per SA 505, “External Confirmation”, Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall use negative confirmation requests as the sole substantive audit procedure only when all of the following conditions are present:
  - (a) Low Risk of material misstatement and auditor has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls.
  - (b) The population comprises a large number of small, homogeneous, account balances or transactions.
  - (c) A very low exception rate is expected.
  - (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

**Factors to be considered while designing confirmation requests:**

As per SA 505 “External Confirmations” factors to consider when designing confirmation requests include:

- (i) Assertion being addressed.
- (ii) Specific identified RMM.
- (iii) Layout & Presentation of request.
- (iv) Prior experience on the audit of similar engagements.
- (v) Method of communication.
- (vi) Management authorisation/encouragement to Confirming Party to respond to auditor.
- (vii) Ability of Confirming Party to provide/confirm requested information.

**Q.16.** Your firm has been appointed as the statutory auditors of AGM Private Ltd. for the financial year 2023-24. While verification of company’s trade receivables as on 31st March 2024,

accountant of AGM Ltd. has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal In this situation?

**Ans: Management refusal to allow auditor to send confirmation request:**

- SA 505, “External Confirmations”, establishes standards **on** the auditor’s use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management.
- The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of some reasons, for example, due to a dispute with the particular creditor or debtor.
- If the management refuses to allow the auditor to send a confirmation request, the auditor shall:
  - (a) Inquire as to Management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
  - (b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
  - (c) Perform alternative audit procedures designed to obtain relevant & reliable audit evidence.
- If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with TCWG and also determine its implication for the audit and his opinion.

**Q.17.** 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 ₹ 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.

**Ans: Response to Negative Confirmation Request:**

- As per SA 505, “External Confirmation”, Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- Negative confirmations provide less persuasive audit evidence than positive confirmations. In case of negative confirmation request, confirming parties 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.
- Failure of confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.
- In the instant case, the auditor sent the negative confirmation re-requesting the trade payable having outstanding balances in the ‘balance sheet while doing audit of Star Ltd. One of the mid outstanding of ₹ 20 lakhs has not sent the confirmation on the credit balance.
- Non-response for negative confirmation request does not means that there is some

misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided In the request

- In the present case, considering the materiality of the account balance, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

#### 5.4 - SA 510 Initial Audit Engagements — Opening Balance?

**Q.18.** CA M. ‘Hussain is appointed auditor of a firm for year 2023.24 on 31st July, 2023. The accounts of firm were unaudited in year 2022-23. The firm had material inventories reflected in Its financial statements even as on close of 31st March, 2023.

He is performing audit procedures, including attending physical Inventory count as on 31st March, 2024. 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?

**Ans:** Auditor’s responsibilities regarding unaudited Opening Balances:

- 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 SAAE about whether opening balances contain misstatements that materially affect the current period’s F.S. Auditor has to evaluate whether audit procedures performed in the current period provide evidence relevant to the opening balances or specific audit procedures are required to be performed to obtain evidence regarding the opening balances.
- In the case of Inventories, however, the current period’s audit procedures **on** the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide MAE:
  - (a) Observing a current physical inventory count and reconciling it to the opening inventory quantities.
  - (b) Performing audit procedures on the valuation of the opening inventory items
  - (c) Performing audit procedures on gross profit and cut-off

**Q.19.** In an Initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of ‘Opening balances’ to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow, when financial statements are audited for the first time.

If, after performing the procedure, you are not satisfied about the correctness of ‘Opening Balances’, what approach you will adopt In drafting your audit report?

**Ans:** Audit procedures for verification of opening balances in case of initial audit engagement:

As per SA 510 “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 evidences<sup>o</sup> that the:

- (i) opening balances of the preceding period have been correctly brought forward to the 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.

When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies.

Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc, and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

**Considerations while drafting Report:**

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion In accordance with SA 705.

**Q.20.** CA Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P.) Ltd, for the financial year 2023-21, 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 ₹ 100 lakhs, continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA Jack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment

**Ans:** **Audit procedures for verification of opening balances in case of initial audit engagement:**

As per SA 510 '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 the preceding period have been correctly brought forward to the 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 charges thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited

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

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

Conclusion: CA Jack was required to obtain from the management a written representation (as covered by SA 500) for their views and expressions; and to perform appropriate procedures on closing balances of Accounts Receivable to ensure its appropriateness. In the present case, CA Jack will be held guilty for professional misconduct for not exercising due diligence in the conduct of his professional duties as per the Code of Ethics.

**Q.21.** You have been appointed as statutory auditor of M/s Moon Ltd, for the financial year 2023-24. As the auditor of the company, you want to ensure that closing balances of previous year have been correctly brought forward as opening balances in the current year. State the audit procedures for the same to ensure that there is no misstatement.

OR

Mr. X has been appointed as an auditor of Mis 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 Mis 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'?

**Ans: Audit procedures for verification of opening balances in case of initial audit engagement:**

SA 510 "Initial Audit Engagements - Opening Balances", deals with the auditor's responsibilities relating to verification of opening balances in case of initial audit engagements. Accordingly, auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's F.S. by;

- (a) 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
- (b) Determining whether the opening balances reflect the application of appropriate accounting
- (c) Performing one or more of the following:
  - (i) Where the prior years F.S. were audited, perusing the copies of the audited F.S. including the other relevant documents relating to the prior period FS.;
  - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
  - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

### **Approach to be followed while drafting Report:**

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion in accordance with SA 705.

**Q.22.** In an Initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements, Lay down the audit procedure, you will follow In cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time. If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balance'; what approach you will adopt in drafting your audit report in two situations mentioned in (i) above?

**Ans:** **Audit Procedure for verification of opening balances in case of initial audit engagements:**

SA 510 'Initial Audit Engagements - Opening Balances' deals with the auditor's responsibilities relating to the opening balances in case of initial audit engagements,

#### **(I) Audit procedure if F,5, Audited by another Auditor:**

- If the prior period's F.S. were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period F.S such as supporting schedules to the audited financial statements.
- Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

#### **(II) Audit procedures if F.S. are audited for the First Time:**

- When the audit of F.S. is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence.
- Opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies.
- Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

### **Considerations while Drafting Audit Report:**

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of

the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.

### 5.5 - SA 530 "Audit Sampling"

**Q.23.** 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

**Ans: Sampling Risk:**

- Risk described in the question 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

**Q.24.** Chintamani Ltd. appoints Chintan & Mani as statutory auditors for the financial year 2022-23. 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.

**Ans: Evaluating Results of Audit Sampling:**

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

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

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

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

**Q.25.** 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 2023-24 into groups on the basis of personal judgment as follows:

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

**Ans: Concept of Stratification:**

- As per SA 530 "Audit Sampling", the objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected. Accordingly, in considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.
- SA 530 "Audit Sampling" defines the term stratification as "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)". Every such group so divided is called strata. Each stratum is treated as if it were a separate population and proportionate items are selected from each of the stratum.

**Various uses of stratification in accordance with SA 530 are:**

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

## 5.6 - SA 550 "Related Parties"

**Q.26.** "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"?

**Ans:** **Related Party Transactions outside the Normal Course of Business:**

- In respect of significantly related party transactions outside the normal course of business of an entity, it is the responsibility of the auditor, in accordance with SA 550, to evaluate the business rationale or lack thereof of transactions that may have been entered to indulge in fraudulent financial reporting or conceal misappropriation of assets.
- The auditor has to seek to understand the business rationale of such a transaction from a related party's perspective. It would help him understand the economic reality of such a transaction and why it was carried out.
- In the given situation, there is no primary rationale for such a transaction. Living Well Private Limited does not manufacture blankets, and the purchase of part of old machinery pertaining to blanket manufacturing has no rationale for it primarily.

**Conclusion:** A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

**Q.27.** 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.

**Ans:** **Possible sources of related Party Information:**

- As per SA 550 "Related Parties" the auditor shall remain alert, when inspecting records or documents with respect to arrangements or information indicating the existence of related party relationships or transactions, not previously identified or disclosed to the auditor.
- During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:
  1. Entity income tax returns.
  2. Information supplied by the entity to regulatory authorities.
  3. Shareholder registers to identify the entity's principal shareholders.
  4. Statements of conflicts of interest from management and TCWG.
  5. Records of the entity's investments and those of its pension plans.
  6. Contracts and agreements with key management or TCWG.

7. Significant contracts and agreements not in the entity's ordinary course of business.
  8. Specific invoices and correspondence from the entity's professional advisors.
  9. Life insurance policies acquired by the entity.
  10. Significant contracts re-negotiated by the entity during the period.
  11. Internal auditors' reports.
  12. Documents associated with the entity's filings with a securities regulator.
- Auditor should also obtain further information on significant transactions outside entity's normal course of business. It enables him to evaluate whether fraud risk factors, if any, are present.
  - In addition, auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. For example: Complex equity transactions such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises etc.
  - Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties.

**Q.28.** 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.

**Ans:** **Examples of transactions outside the entity's normal course of business:**

- SA 550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements.
- Accordingly, if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures, the auditor shall inquire of management about:
  1. The nature of these transactions; and
  2. Whether related parties could be involved.
- 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 the applicable FRF establishes related party requirements, to identify the RMM.
- Examples of transactions outside the entity's normal course of business, include the following:
  1. Complex equity transactions, such as corporate restructurings or acquisitions.
  2. Transactions with offshore entities in jurisdictions with weak corporate laws.
  3. The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
  4. Sales transactions with unusually large discounts or returns.
  5. Transactions with circular arrangements, for example, sales with a commitment to repurchase.
  6. Transactions under contracts whose terms are changed before expiry.

**Q.29.** JKL Limited is engaged in the business of Construction and real estate having various projects across states. Mis YT & Co. Chartered Accountants have been appointed as Statutory Auditors. Audit Team from M/s yr & 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.

**Ans: Matters to be addressed in the Engagement Team Discussion:**

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 and extent of the entity's relationships and transactions with related parties.
- (2) Emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- (3) 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.
- (4) Records or documents that may indicate the existence of related party relationships or transactions.
- (5) Importance that management and TCWG attach to the identification, appropriate accounting for and disclosure of related party relationships and transactions 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:

- (1) How special-purpose entities controlled by management might be used to facilitate earnings management.
- (2) 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.

## PART- II COMPREHENSIVE CASE STUDY

### Comprehensive Case Study - 1

Honest Specialty 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 & Paint industry, etc. The company has built up a good reputation, & 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:

- (1) The company needs to Import the key raw materials and Is exposed to high risk of price fluctuations and currency risks.
- (2) The company carries high inventory due to the long import cycle and seasonal sales pattern.
- (3) The working capital is almost 60% blocked in inventory and rest in receivables.
- (4) The company has huge investments in plant and machinery financed through term loans from financial institutions.
- (5) Since the company has large imports, It buys import licenses from the open market.
- (6) The company has received customs notices about using fake licenses for importing materials without paying duty. The company has filed an appeal against the 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.
- (7) The company has liquid chemicals stored in huge tanks.
- (8) The powdered form of chemicals is stored in standard-sized drums.
- (9) Few items of stocks like coal, sulphur are lying in the open area.
- (10) The company has huge domestic sales on a consignment basis, and vast quantities of finished inventories are lying with the consignees across India.
- (11) 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.
- (12) 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.
- (13) 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.
- (14) The company has prepared its inventory details by involving a management expert.
- (15) During the year, the previous auditor resigned, and a new auditor got appointed.

#### **Theoretical Questions:**

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 knowing:

- Q.1.** Which audit procedures are required for verifying existence and condition of company's Inventories with specific reference to its nature of operations?
- Q.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.
- Q.3.** What additional procedures does the auditor need to carry out In respect of stocks lying with consignees all over the country?
- Q.4.** What procedures should the auditor need to undertake for litigation matters?

#### **Multiple Choice Questions**

- Q.1.** The objectivity of the management's expert Is likely to be lesser
  - (a) The expert is competent.
  - (b) The expert is capable.
  - (c) The expert has relevant experience.
  - (d) The expert is employed by the entity

- Q.2.** Which of the following matters is Irrelevant for auditor In planning attendance at physical inventory counts?
- (a) Nature of inventory
  - (b) The timing of physical inventory counting
  - (c) The nature of the Internal control related to inventory
  - (d) Whether 100% of Inventory is covered in the count
- Q.3.** External confirmations for receivables are not reliable in which of the following situations:
- (a) The response directly received by the auditor
  - (b) The confirmation has come From the address of the confirming party
  - (c) The confirmation is signed by the plant manager
  - (d) The confirmation is positive confirmation
- Q.4.** The new auditor planned certain procedures with respect to opening balances. Which of the following procedures is not in accordance with SA 510?
- (a) Reading the most recent financial statements and audit report
  - (b) Where the prior period report is modified, the impact on the current period
  - (c) Correctly bringing forward of prior period closing balances
  - (d) Ascertaining whether predecessor auditor had attended physical inventory count

### **Answer - Comprehensive Case Study 1**

#### **Part A - Theoretical Questions**

- 1.** Audit procedures required for verifying existence and condition of inventories:  
Auditor needs to obtain sufficient appropriate audit evidence regarding existence and condition of inventory. For this purpose, auditor it required to:
- (A) Attend physical inventory count to;
- (i) 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.
    - The accurate identification of the 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.
    - The 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 the cutoff date.
  - (ii) 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.
  - (iii) Inspect the inventory to assist in identifying obsolete, damaged or ageing of inventory.
  - (iv) Perform the test counts to obtain the sufficient appropriate audit evidence by (i) tracing items selected from the physical inventory to management’s count records, (ii) obtaining topics of Management’s completed physical inventory count records
- (B) Cross matching the final inventory records with the actual Inventory count results.

- 2. Auditor's Responsibilities w.r.t. Information prepared using Management Expert;**
- 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 management's expert, the auditor shall, 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.
- 3. Additional Procedures to verify the inventory lying with third party:**
- (a) 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;
  - (b) Attending, or arranging for another auditor to attend, the third party's physical counting of inventory,
  - (c) Obtaining another auditor's report or a service auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
  - (d) Inspecting documentation regarding inventory held by third parties
- 4. Procedures for Verification of Litigation Matters:**
- Auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity by:
    - (a) Inquiry of management and, where applicable, others within the entity including inhome legal counsel.
    - (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.
    - (c) Reviewing legal expense account
  - 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) A list of litigation and claims
    - (b) Where applicable, management's assessment of the outcome of each of the identified litigation and claims and its estimate oldie financial implications, including cost involved and
    - (c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered incomplete or incorrect-
    - (d) The auditor may seek meeting with the external legal counsel lithe matter is having significant risk, it is complex or there is disagreement between management assertion and legal counsel's views.

- (e) Obtaining written representation from the management and where appropriate TCWG that all the known actual or possible litigation and claims whose effects should be considered when preparing the financial statement have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable FRF.

### **Part B - Multiple Choice Questions**

1. (d) The expert is employed by the entity
2. (d) Whether 100% of inventory is covered in the count
3. (c) The confirmation is signed by the plant manager
4. (d) Ascertaining whether predecessor auditor had attended physical inventory count

### **Comprehensive Case Study - 2**

‘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 Lai 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 Lai, who was from a middleclass 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. Morose Lal used to dictate the decisions. Even though as part of the Joint Venture, there were 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.

### Theoretical Questions:

- Q.1.** Please guide the engagement team on the further course of action as per SA 550.
- Q.2.** What are fraud risk factors in given case?
- Q.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?
- Q.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?

### Multiple Choice Questions

- Q.1.** Which of the following best describes the method that Mr. Bharose Lal can indulge to commit fraud?
- (a) Concealing and not disclosing facts that could affect the amounts recorded in financial statements.
  - (b) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
  - (c) Causing an entity to pay for goods or services not received.
  - (d) Using undisclosed business partners to misappropriate funds in the garb of making a business transaction and thus siphoning off the funds.
- Q.2.** In the given case scenario, the main Factor giving rise to risk of material misstatement is:
- (a) The expensive lifestyle of owners
  - (b) Appointment of an auditor having experience in unearthing of frauds
  - (c) The deteriorating financial condition of the owner's business.
  - (d) The vulnerability and dependence of the foreign partner on the local partner
- Q.3.** In the given case scenario, which is the most important red flag for auditor:
- (a) Expensive lifestyle
  - (b) Undisclosed related party relationships to siphon off the funds.
  - (c) Financial crunch
  - (d) The dominant influence of the owners
- Q.4.** Which of the following is not a fraud risk factor?
- (a) Dominant influence of the owners
  - (b) Expensive lifestyle
  - (c) Fraud risk due to the nature of the industry
  - (d) Floating of a new SPV itself

## Answer - Comprehensive Case Study 2

### Part A - Theoretical Questions

#### 1. Course of Action as per SA 550:

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.

- (a) 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.
- (b) 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.
- (c) 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).
- (d) The records or documents that may indicate the existence of related party relationships or transactions.
- (e) 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.
- (f) In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:
  - (i) How special-purpose entities controlled by management might be used to facilitate earnings management.
  - (ii) 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.

#### 2. Fraud Risk Factors:

- 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.

(A) An incentive or pressure to commit fraud:

- Financial difficulty with huge outstanding dues towards vendors and Financial Institutions.
- Expensive lifestyle.
- Requirement to fund ₹ 5 crore as equity contribution in the SPV.

(B) A perceived opportunity to commit fraud:

- Dependency of the foreign partner and no knowledge of the foreign partner of local

laws and the SRA business model in India.

- The risk is due to the way the real estate industry functions and particularly risk due to the SRA business model.
- 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. Additional Audit Procedures in case of any doubt as to existence of Related Party Relationships or transactions:**

- 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:
  - (a) 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.
  - (b) Where the applicable FRF 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;
  - (c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.
  - (d) 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
  - (e) 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.
- 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.
- 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.
- 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. Auditor Duties in case of likelihood of misappropriation of funds:**

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:
  - (i) Discuss with the appropriate level of management and TCWG the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
  - (ii) 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.

### **Part B - Multiple Choice Questions**

1. (d) Using undisclosed business partners to misappropriate funds in the garb of making a business transaction and thus siphoning off the funds.
2. (d) The vulnerability and dependence of the foreign partner on the local partner.
3. (b) Undisclosed related party relationships to siphon off the funds.
4. (d) Floating of a new SPV itself

## **PART- III MULTIPLE CHOICE QUESTIONS**

1. BDJ Private Ltd, was established in 2001 and since then the company's operations have grown significantly. The company is based in Kanpur and has branch offices outside Kanpur. The company is engaged in tours and travels business and because of the nature of the business, it has voluminous transactions. The annual turnover of the company is INR 700 crore.

During the audit of the financial statements of the company for the year ended 31 March 2024, the auditors observed wide variation in various details of sales and various expenses as compared to last year. Various balances of trade receivables, loans and advances, statutory liabilities showed significant increase and many balances were found to be non-moving which were aged for more than 3 years.

On the basis of the materiality and planned procedures, the audit team requested the client for testing of various samples for sales, expenses etc. The client observed that the number of samples that the team has requested increased as compared to last year and asked the team to cut down on the number of samples so that it is the same number of samples which were tested in the previous years.

The audit team did not agree with this and explained various factors which the team had considered for sample selection and the reasons for changes in the samples and also explained the requirements of SA 530 to the client but the client still did not agree.

Now there is a situation of deadlock and you are requested to provide your guidance to resolve this matter.

- (a) The argument of the client is not valid. Sample selection is based on certain principles as per SA 530 and that is on the assessment of the audit team. It may change year on year and hence the client should provide the required information to the audit team.
- (b) The explanation of the audit team is not valid. Referring SA 530 was not correct in this case. The audit team should have explained their entire approach around risk assessment to the client before starting the fieldwork and should have formally shared that with the client in writing.
- (c) In the given situation, the audit team instead of getting into any arguments should cut down the number of samples and should increase their procedures around analytical work. That would resolve the problem.
- (d) The audit team should make a formal request in writing for these details from the client and if the client still refuses then they should report this matter to the audit partner. In that case, the auditing standards require audit partner to check some of the documents which may not be provided by the client to the audit team.

2. MNO Ltd. is a company engaged in the manufacture of Kids toys. The company sells its goods on credit basis. M/s. Ajay Vijay & Associates have been appointed as statutory auditors of MNO Ltd. for the FY 2023-24. During the Course of audit CA Ajay, the engagement partner asks the management about the email addresses of trade receivables of the company for the purpose of obtaining balance confirmation from the trade receivables. The management of the company asked its sales supervisor to send confirmation request to the trade receivables and collect all the responses and provide all such responses to the auditor. The management of MNO Ltd. also informed CA Ajay that confirmation with respect to two of its trade receivables namely Sports Star Ltd. and Kids Zone Ltd, won't be available as a dispute between MNO La and both the trade receivables is going on With respect to other trade receivables, the sales supervisor provided CA Ajay with all the balance confirmation. With respect to the balance confirmation request, which of the following is warranted as per the requirement of the relevant SA?

- (a) CA Ajay should not have relied on the explanation provided by the management with respect to the trade receivables namely Sports Star Ltd. and Kids Zone Ltd. and he should perform alternative procedures with respect to such trade receivables.
- (b) CA Ajay should have obtained direct response from all other trade receivables instead of sales supervisor receiving direct responses from trade receivables and providing them to the auditor.
- (c) Both (a) and (b).
- (d) CA Ajay should give a qualified opinion as balance confirmation with respect to two trade receivables is not available.

3. Auditors do not normally examine all the information available to them as it would be impractical to do so and using audit sampling will produce valid conclusions. Random selection ensures that all items in the population have an equal chance of selection, e.g. by use of random number tables or random number generators. Block sampling method includes selection of a block or blocks of continuous items from within the organisation. Which of the following selection can be considered as block sampling method?

- (a) Auditor Mr. A divided the trade receivables into 2 groups as: balances above 20 lakh and balances between 10 lakh to t 20 lakh and selected different percentage of items from each group.

- (b) Auditor Mr. A determined the starting point as 10 for the list of receivables and selected every 10th balance for receivables thereafter as samples to perform the tests.
- (c) Auditor Mr. A selected sample size as all the high-value balances from the list of trade receivables to ensure that these balances shown are correctly recorded.
- (d) Auditor Mr. A uses a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year.

4. SKJ Private Ltd. is engaged in the business of construction. The company has also got some real estate projects few years back on which it started the work in the last 2 years. The annual turnover of the company is INR 600 crores and profits of INR 40 crores.

The statutory auditors of the company got rotated by another audit firm due to mandatory audit rotation requirements as per the Companies Act, 2013.

The new statutory auditors of the company started audit of the financial statements for the year ended 31<sup>st</sup> March 2023 in May 2023. The audit team also requested the client to provide certain information on the opening balances to perform their audit procedures. Initially the management did not provide any information to the auditors on the opening balances thinking that this is not within the scope of their work, however, after going through the auditing standards, the management agreed and provided the required information.

Later on, the audit team also started requesting information for the period from 1<sup>st</sup> April 2023 to 31<sup>st</sup> May 2023. With this requirement, CFO of the company got very upset and angry and set up a meeting with the senior members of the audit team. CFO raised a concern that the audit team has not been doing the work properly and has been asking for unnecessary information like information on opening balances and then the information for the period after 31<sup>st</sup> March 2023. The audit partner explained to the CFO that everything requested by the audit team has been as per the auditing standards, however, CFO said that in the earlier years, the previous auditors never asked for such information.

You are requested to give your view in respect of this matter.

- (a) The requirement of the auditors for opening balances was valid but for the period after 31<sup>st</sup> March 2023 is completely wrong as that is out of their scope for the current year's audit. They can ask for those
- (b) The concern of the CFO was valid. He has seen the previous auditors not performing such audit procedures and hence the new audit team should also follow the same approach which was followed by previous auditors as that would lead to efficient in audit.
- (c) The requirement of the auditors for opening balances as well as for the period after 31<sup>st</sup> March 2023 is valid. After the requirements of SA 510 and SA 560, audit team is required to perform these procedures.
- (d) The audit team should set up a meeting with previous auditors wherein it should be assessed why different approach was followed by the previous auditors. On the basis of that discussion with the previous auditors, next course of action should be decided.

5. M/s Ram Raj & Associates have been appointed as statutory auditors of Venus Ltd. for the FY 2022-23. During the year, the company has entered into some related party transactions. CA Ram, the engagement partner has taken a management representation letter regarding the proper accounting, presentation and disclosure of such related party transactions. Is there any further responsibility of CA Ram with respect to the other procedures to be performed for related party transactions?

- (a) No, there is no further responsibility of CA Ram as the best audit evidence for the related party transaction is the management representation letter.
- (b) No, there is no further responsibility of CA Ram as the audit firm is responsible for verifying the balances and disclosure of related party transactions. The identification of related party transactions is the responsibility of the management of Venus Ltd.
- (c) Yes, the audit firm has the responsibility to perform the audit procedures to identify, assess and respond to the risk of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions and balances, and obtaining merely management representation letter can be considered to be sufficient appropriate audit evidence.
- (d) Yes, the auditor has the responsibility to detect fraud and error with respect to the related party transactions.

6. While auditing Veer Ltd., CA. Vardhman divided the whole population of trade receivables balances to be tested in a few separate groups called 'strata' and started taking a sample from each of them. He treated each stratum as if it was a separate population. He divided the trade receivables balances of Veer Ltd. for the Financial Year 2023-24 into groups on the basis of personal judgment as follows:

S. No.	Particulars
1	Balances in excess of ₹ 10,00,000;
2	Balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
3	Balances in the range of ₹ 5,50,001 to ₹ 7,75,000;
4	Balances in the range of ₹ 2,25,001 to ₹ 5,50,000;
5	Balances ₹ 2,25,000 and below

From the abovementioned groups, CA. Vardhman picked up different percentage of items for examination from each of the groups, for example, from the top group i.e. balances in excess of ₹ 10,00,000, he selected all the items to be examined; from the second group, he opted for 25 % of the items to be examined; from the lowest group, he selected 2% of the items for examination; and so on from rest of the groups. Which one of the following methods of sample selection is he following?

- (a) Systematic sampling.
- (b) Stratified sampling.
- (c) Section sampling.
- (d) Selection sampling.

7. As per SA 550 on Related Parties, existence of which relationship indicate the presence of control or significant influence?

- (a) Friend of a family member of a person who has the authority and responsibility for planning.
- (b) Holding debentures in the entity.
- (c) The entity's holding of debentures in other entities.
- (d) The entity's holding of equity in other entities

8. XYZ & Associate Chartered Accountants were appointed auditors for Weknow LLP. The engagement manager of the audit team, while designing the auditor response to assessed risk, concluded that there are no requirements of the applicable financial reporting framework for

disclosing the related party transaction in the Firm's Financial Statement and hence the audit team is not required to perform any audit procedures with respect to identification and disclosure of related party relationship and transaction in financial statement. You as an engagement partner guide the engagement manager by selecting the appropriate response from below:

- (a) Even if the applicable FRF establishes minimal or no related party requirements, auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions and should sufficiently be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions achieve a true and fair presentation and are not misleading.
- (b) If the applicable FRF establishes minimal or no related party requirements, then the auditor is not required to obtain an understanding of the entity's related party relationships and transactions.
- (c) Even if the applicable FRF establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions and should sufficiently be able to conclude whether the financial statements, as a whole, are free from all the material related party transactions.
- (d) Because related parties are not independent of each other, hence auditor can obtain the written representation from the Related Party's auditor regarding the accuracy and completeness of the related party transactions disclosed in Firm's Financial Statement. This should only be carried where the applicable financial reporting framework establishes minimal or no related party requirements.

9. .... approach to sampling has the following characteristics:

- I. Random selection of the sample items; and
  - II. The use of probability theory to evaluate sample results, including measurement of sampling risk
- (a) Statistical sampling
  - (b) Non-statistical sampling
  - (c) Stratified sampling
  - (d) Haphazard sampling

### Answer Key

- 1. (a) The argument of the client is not valid. Sample selection is based on certain principles as per SA 530 and that is on the assessment of the audit team. It may change year on year and hence the client should provide the required information to the audit team.
- 2. (c) Both (a) and (b).
- 3. (d) Auditor Mr. A uses a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year.
- 4. (c) The requirement of the auditors for opening balances as well as for the period after 31<sup>st</sup> March 2023 is valid. After the requirements of SA 510 and SA 560, audit team is required to perform these procedures.

5. (c) Yes, the audit firm has the responsibility to perform the audit procedures to identify, assess and respond to the risk of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions and balances, and obtaining merely management representation letter can be considered to be sufficient appropriate audit evidence.
6. (b) Stratified sampling
7. (d) The entity's holding of equity in other entities
8. (a) Even if the applicable FRF establishes minimal or no related party requirements, auditor nevertheless needs to obtain understanding of entity's related party relationships & transactions and should sufficiently be able to conclude whether the F.S., insofar as they are affected by those relationships and transactions achieve a true and fair presentation and are not misleading
9. (a) Statistical sampling.

## PART- IV INTEGRATED CASE SCENARIO

Black & White Ltd. is into the business of manufacturing readymade garments in Amritsar. It procures all the raw material required for its production from Punjab, Himachal Pradesh & J&K. Its sales market, however, covers almost all the northern parts of the country. CA Anu is the engagement partner of Maheshwari & Co appointed as the statutory auditor of the company. She calls for a meeting of the engagement team to delegate work and responsibilities. During the audit. the engagement team comes across the following facts:

- Woolen Private Limited is one of the vendors of the company from which the company has been purchasing wool for many years on a current account basis, but no single purchase has been made in the last nine months, and the outstanding balance stands as it is in the books of accounts. CA Ann wants to confirm the balance and requests the CFO of the company for sending a balance confirmation request to Woolen Private Ltd., to which he refuses and is not willing.
- The Fashion Jingo Ltd. is one of the customers of the company and hasn't replied to CA Anu's positive balance confirmation request sent.
- Mr. X, one of the fashion designers, had sold his designs to the company but owing to a dispute, the contract got cancelled, and now both the parties are under litigation in the local court of law. The engagement team is guided as to the procedures to be designed and performed to identify this matter.
- CA Anu simultaneously seeks direct communication with the company's external legal counsel sensing the risk of material misstatement. However, it ends up in vain as the external legal counsel, Mr. Chadha, refuses to comment She is unable to obtain sufficient appropriate audit evidence in this regard through alternative audit procedures either.

The team documents all the relevant information w.r.t. the above facts, and CA Ann issues the audit report accordingly.

- Q.1.** Fashion Jingo Ltd. has not responded to CA Ann's request What should be proper course of action for her in such a situation?
- (a) Perform alternative audit procedures
  - (b) Consider it as a negative confirmation

- (c) Give a Qualified opinion
  - (d) Should visit the customer company premises herself and confirm the balance on the spot.
- Q.2.** With respect to advocate Chadha's cold shoulder to CA Anu's request, what she should do?
- (a) Modify her audit opinion
  - (b) Give an unqualified opinion
  - (c) Give a disclaimer of opinion
  - (d) Withdraw from this engagement
- Q.3.** What should be CA Anu's first and foremost response in the case of request made relating to balance confirmation from Woolen Pvt. Ltd.?
- (a) Perform alternate audit procedures.
  - (b) Withdraw from the engagement.
  - (c) Communicate with those charged with Governance telling the effects on his audit opinion.
  - (d) Inquire as to the reasons behind the management's response and seek audit evidence as to its validity and reasonableness.
- Q.4.** Which of the following procedures will not be performed by the engagement team as audit procedures while dealing with the case of Mr. X?
- (a) Inquiry of Management.
  - (b) Inquiry of Mr. X
  - (c) Reviewing Minutes of Meetings
  - (d) Reviewing Legal expenses account

#### **Answer Key - Integrated Case Scenario**

- 1. (a) Perform alternative audit procedures
- 2. (a) Modify her audit opinion
- 3. (d) Inquire as to the reasons behind the management's response and seek audit evidence as to its validity and reasonableness.
- 4. (b) Inquiry of Mr. X