SA 500 "Audit Evidence"

1 **Comment on the following: Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides Rs. 80 lakhs as gratuity in the financial statements.** **[May 09 (4 Marks)]**

or

What are the procedures to be followed by a statutory auditor for verifying the provision for accrued liability for retirement benefits which is based on a certificate of an reputed actuary? **[May 10 (8 marks)]**

or

Y Ltd. Engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd. You would like to use the report of actuary as an audit evidence. How do you evaluate the work of actuary. **[May 11 (8 Marks)]**

Answer: 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.

2 **As a Statutory Auditor, how would you deal with the following case: M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures.**

Answer: 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.
- This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to Important figures. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are reasonable based on the auditor's knowledge of the client's business and result of his audit procedures.
- In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc.

Conclusion: in view of provisions of SA 500 as discussed above, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

3	**The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. Comment.** **Or** **For determining the liability for Gratuity, Actuary's Report is produced to the auditor. On examination auditor notices a serious wrong assumption in the report. Auditor challenges the Actuary's report – Comment.**
	Answer: 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.
4	**Write short note on: Inquiry. [Nov. 10 (4 marks)]**
	Answer: Inquiry: • As per SA 500 "Audit Evidence" , inquiry is one of the methods to obtain audit evidences. Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. • Inquiry is used extensively throughout the audit in addition to other audit procedures. • Inquiries may range from formal written inquiries to informal oral inquiries. However in case oral inquiries, the auditor may consider it necessary to obtain written representations from management and, where appropriate, TCWG to confirm responses to such inquiries. • Evaluating responses to inquiries is an integral part of the inquiry process. • Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

5	**Write short note on: Assessing the reliability of Audit Evidence. [May 09 (4 Marks)]**

Answer: Assessing the reliability of audit evidence:

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

(a) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

(b) The reliability of audit evidence that is generated internally is increased when the related controls, imposed by the entity are effective.

(c) Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly.

(d) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally.

(e) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

SA 501 "Audit Evidence – Specific Considerations for Selected items"

6	**You are the auditor of Easy Communications Ltd. for the year 2015–16. The inventory as at the end of the year i.e. 31.3.16 was Rs. 2.25 crores. Due to unavoideable 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? [Nov. 08 (5 Marks)]**

Answer: Auditor's duties in case of non-attendance of inventory count:

- SA 501 "Audit Evidence – Additional 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 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.

SA 505 "External Confirmation"

7 **Write short note on: External Confirmations in audit.** **[Nov. 09 (4 Marks)]**

Answer: External Confirmations:

- As per SA 505 external confirmation may be defined as Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
- External confirmations are of two types:
  (a) **Positive confirmation request** – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
  (b) **Negative confirmation request** – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties.

8 **Write short notes on Situations where external confirmations can be used.**

Answer: Situations where external confirmations can be used:

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties.

Other situations where external confirmation procedures may provide relevant audit evidence include:

(i) Bank balances and other information relevant to banking relationships.

(ii) Accounts receivable balances and terms.

(iii) Inventories held by third parties at bonded warehouses for processing or on consignment.

(iv) Property title deeds held by lawyers or financiers for safe custody or as security.

(v) Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.

(vi) Amounts due to lenders, including relevant terms of repayment.

(vii) Accounts payable balances and terms.

9 **The management of S Ltd. Request you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response?** **[May 11 (6 Marks)]**

or

The auditor of H Ltd. wanted to obtain confirmation from its creditors. But the management made a request to the auditor not to seek confirmation from certain creditors citing disputes. Can the auditor of H Ltd. Accede to this request? **[May 13 (4 Marks)]**

	Answer: 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 a 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.
10	**Moon Limited replaced its statutory auditor for the Financial year 2015-16. During the course of audit, the new auditor found a credit item of Rs. 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor he is traceable. Under the circumstances, no confirmation of the credit balance is available. [Nov. 09 (5 Marks)]**
	Answer: Auditor's duties in case of non availability of External Confirmation: • SA 505 "External Confirmations" provides that if the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, and alternative audit procedures will not provide the audit evidence the auditor requires, he should determine the implications for the audit and the auditor's opinion in accordance with SA 705. • In the present case the identities of trade payables are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation. It might be a case that an income of Rs. 5 lakhs had been hidden in previous year/s. • The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.
11	**As an auditor how would you deal with the following: When the audit team visited the client to perform substantive audit of debtor, the client produced ledger account of customers and confirmations for the top 10 customers. One of the debtors was more than 5 years old, but it had confirmed his balance. [May 10 (5 Marks)]**

Answer: Auditor's duties in case of doubt over reliability of external confirmations:

- SA 505 "External Confirmations" deals with the auditor's use of external confirmation procedures to obtain audit evidence. External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by the management in the financial statements.
- As per SA 505, the auditor is required to maintain a control over the process of selecting those to whom a request will be sent out, the preparation and sending of confirmation requests and responses to those requests. This is because there have been several cases of clients presenting forged confirmation to auditors when such control was absent.
- In the present case, one of the debtors of more than 5 years old had confirmed his balance. The auditor should enquire into the debtor whose dues are outstanding for 5 years or more about his financial abilities and why he has not paid, reasons behind the same, and if found adverse, the client should be advised to provide for "Provision for bad debts' and also to confirm that it is not a forged confirmation.

12 During the course of audit of Star Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables of small balances except one, old outstanding of Rs. 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing.

Answer: **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 favor, and less likely to respond otherwise.
- In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of rupees 15 lacs 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.

SA 510 "Initial Audit Engagements – Opening Balances"

13 What are Initial Audit Engagement

Answer: Initial Audit Engagements:

As per SA 510 "Initial Audit Engagements - Opening Balances", initial audit engagement is an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

14 Comment on the following: You have been appointed as the auditor of Good Health Ltd. for 2015-16 which was audited by CA Trustworthy in 2014-15. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2014-15 have been brought to account in 2015-16 as Opening Balances and the Opening Balances do not contain misstatements. [Nov. 08 (5 Marks)]

Or

What are the procedures to be followed by a Statutory Auditor in the audit of opening balances if the financial statements for the preceding year were audited by another auditor?

Answer: **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 changes 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.

15 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 instatements, 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? [May 15 (5 Marks)]

Answer: **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 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.

SA 520 "Analytical Procedures"

16 **What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client.** **[May 09 (6 Marks)]**

Answer: Auditor's considerations while performing analytical procedures:

SA 520 "Analytical Procedures" deals with the auditor's use of analytical procedures as substantive procedures and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Accordingly, when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:

1. Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
2. Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
3. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
4. Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

17	**In the audit of Hotel Great Hay Limited its auditor wants to use the analytical procedure as substantive procedure in respect of room rental income as well as pay roll costs, guide him as to how it can be done. [Nov. 13 (4 Marks)]**
	Answer: Applying analytical procedures as substantive procedures: • SA 520 "Analytical Procedures" deals with the auditor's use of analytical procedures as substantive procedures and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. • Accordingly, in some cases, predictive model may be effective as an analytical procedure. • In case of Payroll cost - Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. • In case of Room Rental Income of Hotel, different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.

SA 530 "Audit Sampling"

18	**Write short note on: Sampling Risk.** **or** **While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind? [May 10 (4 marks)]**
	Answer: **Risk Factors while Sampling technique**: • SA 530 deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample. • While using sampling technique, auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. This is known as sampling risk. • Sampling risk can lead to two types of erroneous conclusions: 1. In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. **2.** In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

SA 540 "Auditing Accounting Estimates, including Fair Value Accounting Estimates and Related Disclosures	
19	**While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements? [May 11 (6 Marks)]**
	Answer: **Evaluation of financial statement assertions based on management estimates:** As per SA 540 "Auditing Accounting Estimates, including Fair Value Accounting Estimates" auditor shall obtain an understanding of the following in order to identify and assess the risks of material misstatement for accounting estimates: (a) The **requirements of the applicable FRF** relevant to accounting estimates. (b) **How management identifies** those transactions, events and conditions that may give rise to the need for accounting estimates. In obtaining this understanding, the auditor shall make **inquiries of management** about changes in circumstances that may give rise to new, or the need to revise existing accounting estimates. (c) The **estimation making process** adopted by the management including: (a) The method, including where applicable the model used in making the accounting estimates. (b) Relevant controls (c) Whether management has used an expert. (d) Assumptions underlying the accounting estimates. (e) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so why. (f) Whether and if so, how the management has assessed the effect of estimation uncertainty. **(d)** The auditor shall **review the outcome of accounting estimates** included in the prior period financial statements.

SA 550 "Related Parties"	
20	**Elaborate how the statutory auditor can verify the existence of related parties for the purpose of reporting under AS 18.** **or** **As a statutory auditor how do you verify the existence of related parties and disclosures of related party transactions. [Nov. 09(8 Marks)]** **or** **In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information. [May 12 (8 Marks)]** **Or** **As an Auditor, how will you verify the existence of related parties. [Nov. 12 (8 Marks)]**

Answer: <u>Possible sources of related Party Information</u>:

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 (for example, prospectuses)

21 A statutory auditor is required to follow the procedures so as to identify the risk of material misstatement associated with related parties. What are the auditor's duties when he identifies related parties or related party transactions that management not previously disclosed to him.

Answer: Verification of existence of related parties:

SA 550 "Related Parties" requires the auditor to perform procedures so as to identify the risk of material misstatement associated with related parties. Accordingly auditor should perform the following:

(a) Inquire the management regarding
- Identity of entity's Related Party, changes from prior period.
- Nature of relationships between entity and Related Party.
- Type & purpose of transactions with Related Party during the period.

(b) The auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

(c) If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:
   (i) Promptly communicate the relevant information to the other members of the engagement team;
   (ii) Where the applicable FRF establishes related party requirements:

- Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
- 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;

(iii) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;

(iv) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and

(v) 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.

22 In the course of your audit you have come across a related party transaction which prima facie appears to be biased. How would you deal with this? [Nov. 14 (4 marks)]

Answer: Related Parties:

As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties and for this purpose, he may inspect records or documents that may provide information about related party relationships and transactions.

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

(i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets,

(ii) The terms of the transactions are consistent with management's explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

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

Conclusion: If the auditor concludes that the related party transaction is biased, he should report that the related party relationships and transactions prevent the financial statements from achieving true and fair presentation.

SA 560 "Subsequent Events"

23 Briefly Explain: Audit procedures on subsequent events. **[Nov. 09 (4 Marks)]**

Or

Briefly describe auditor's responsibility regarding subsequent events.

Answer: Audit Procedures on subsequent Events:

- SA 560 "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.
- As per SA 560 the term, Subsequent Events may be defined as the events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor's report.
- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- The auditor's procedures on subsequent events shall include the following:
  - (a) Obtaining an understanding of the procedures through which management has identified subsequent events.
  - (b) Inquiring of management and, TCWG as to occurrence of subsequent events which might affect the financial statements.
  - (c) Reading minutes of management & TCWG meetings that have been held after the date of the financial statements.
  - (d) Reading the entity's latest subsequent interim financial statements, if any.
- When, as a result of the procedures performed as required the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

24 Comment on the following: A Co. Ltd. has not included in the Balance Sheet as on 31-03-2015 a sum of Rs. 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2015. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2015. The auditor came to know the result of the negotiations on 15-05-2015.

[Nov. 10 (5 Marks)]

Answer: Treatment of subsequent Events:

- SA 560 "Subsequent Events" requires that in respect of events occurring between the date of F.S. and date of the Audit Report, the auditor shall perform audit procedures to obtain sufficient & appropriate audit evidence to ensure that events which require adjustments or disclosure in the F.S. have been identified.
- If auditor identifies events that require adjustment or disclosure in the F.S., the auditor should determined whether each such event is appropriately reflected in the F.S.
- The auditor shall request the management to provide a "Written Representation" that all events occurring subsequent to the date of the F.S. and requires adjustment or disclosure have been adjusted or disclosed.

	• In the instant case, the amount of Rs. 1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. As per the provisions of AS-4 and AS-29, the obligation requires provision for outstanding expenses. **Conclusion**: The facts of the case indicates the event as of adjusting nature as per AS–4 "Contingencies and Events Occurring after the Balance Sheet date" and requires adjustment in assets and liabilities, which has not been made by the management. Auditor should request management to adjust the sum of Rs. 1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the Audit Report.
25	**As a statutory auditor of a company, comment on the following: A fire broke out on 15th May, 2015, in which material worth Rs. 50 lakhs which was lying in inventory since 1st March, 2015 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2015-16, no provision for the loss needs to be made in the financial statements for 2014-15. [Nov. 12 (5 Marks)]**
	Answer: Event Occurring after the Balance Sheet Date: • As per AS- 4 on 'Contingencies and Events Occurring After the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern is not appropriate. • AS – 4 also requires disclosure of the non-adjusting event, in the report of approving authority. • Further as per SA 560 "Subsequent Events" the auditor should ensure that all events occurring subsequent to the date of financial statements and for which applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed. • In the instant case, fire took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. **Conclusion**: The event will have no impact on items appearing at the Balance Sheet date and hence not required any adjustment, subject to satisfaction in respect of non-violation of going concern concept. Hence management is correct by not providing provision. However, auditor is required to ensure the proper disclosure in report of approving authority.

SA 570 "Going Concern"	
26	**ABC Company files a law suit against Unlucky Company for Rs. 5 crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the notes accompanying its financial statements. As an auditor of Unlucky Company, how will you deal with the situation?**
	Answer: Evaluating appropriateness of going concern assumption: • AS 29 "Provisions, Contingent liabilities and Contingent Assets", requires that if any future event may cause a possible obligation, a provision should be made in the accounts to recognize the obligation where there is sufficient evidence that the event will occur.

- SA 570 "Going Concern" requires that the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.
- When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions.
- In the instant case, ABC Company has filed a law suit against Unlucky Company for Rs. 5 crores. The attorney of Unlucky Company feels that the suit is without merit, so the company merely discloses the existence of law suit in the notes accompanying its financial statements.

Conclusion: Auditor should evaluate the source data on which basis the opinion is formed and evaluate the appropriateness of use of going concern assumption. If the auditor finds the uncertainty, he may request the management to adjust the sum of Rs. 5 crore by making provision for expenses as per AS 29. If the management does not accept the request the auditor should qualify the audit report.

27 **A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders. [May 09 (4 Marks)]**

Answer: Appropriateness of Going Concern Assumption :

- SA 570 "Going Concern" requires that the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Eroded net worth and nonpayment to creditors are one of the examples of such event.
- As per SA 570, when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors.
- In the present case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 "Going Concern".

Conclusion: Based on the results of evaluation of appropriateness of going concern assumption, auditor is required to modify the opinion.

28 **R & Co. is the statutory auditor of S Ltd. for the financial year ended on 31st March 2015, S Ltd had disclosed in the notes (Note No. X) "The state pollution control board had ordered the closure of the company's only manufacturing plant on the ground that it is environmentally damaging, which the company had challenged in a law suit. Pending the outcome of the law suit the financial statements are prepared on a going concern basis". Further the financial statements prepared by the management of S Ltd include financial statements of certain branches which are audited by other auditors. What are the reporting responsibilities of R & Co? [May 12 (10 Marks)]**

	Answer: Reporting responsibilities of Auditor: **(A) Evaluation of appropriateness of Going concern Assumption**: • As per SA 570 "Going Concern" auditor is required to obtain sufficient appropriate audit evidence about the appropriateness of management use of going concern assumption in the preparation and presentation of financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. • When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements: (a) Adequately describe the principal events that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and (b) Disclose clearly that there is a material uncertainty related to going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business. • If adequate disclosure is made in the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report. **Conclusion**: In the present case, as disclosure is given in financial statements, R & Co. should include an Emphasis of Matter paragraph in the Auditor's Report. **(B) Reporting of Branches audited by other auditors**: • As per SA 600 "Using the work of Another Auditor", when the principal auditor has to base his opinion on the financial information of an entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity. **Conclusion**: R & Co. should include an "Other Matter" paragraph in the audit report on this matter.
29	**While examining the going concern assumption of an entity, what important indications should be evaluated and examined?** **or** **What are the Financial indications to be considered by an auditor for evolution of the going Concern assumption? [Nov. 08 (4 Marks)]**
	Answer: Indications to be considered while evaluating Going Concern Assumption: SA 570 "Going Concern", requires that auditor should obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements. Accordingly, when performing risk assessment procedures as required by SA 315, the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Examples of such events or conditions are:

Financial Indications

1. Net liability or net current liability position.
2. Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
3. Indications of withdrawal of financial support by trade payables.
4. Negative operating cash flows indicated by historical or prospective financial statements.
5. Adverse key financial ratios.
6. Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
7. Arrears or discontinuance of dividends.
8. Inability to pay trade payables on due dates.
9. Inability to comply with the terms of loan agreements.
10. Change from credit to cash-on-delivery transactions with suppliers.
11. Inability to obtain financing for essential new product development or other essential investments.

Operating Indications

1. Management intentions to liquidate the entity or to cease operations.
2. Loss of key management without replacement.
3. Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
4. Labour difficulties.
5. Shortages of important supplies.
6. Emergence of a highly successful competitor.

Other Indications

1. Non-compliance with capital or other statutory requirements.
2. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
3. Changes in law or regulation or government policy expected to adversely affect the entity.
4. Uninsured or underinsured catastrophes when they occur.

SA 580 “Written Representations”

30 **Explain what is meant by “Written Representations” and indicate to what extent an auditor can place reliance on such representations.**

Answer: Meaning of Written Representation:

- As per SA 580 “Written Representations” it is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.
- Written representations are necessary information that the auditor requires in connection with the audit, hence they are recognized as audit evidence as a response to inquiries.
- Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

	• The written representations shall be in the form of a representation letter addressed to the auditor. **Extent of Reliance**: • If the auditor has concerns about the competence, integrity, ethical values or diligence of management, the auditor shall determine their effect on the reliability of representations (oral or written) and audit evidence in general. • In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. • If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion • If he claims that there is sufficient doubt about integrity of management, he shall issue a disclaimer of opinion.
31	**State briefly the basic elements of Management Representation Letter.**
	Answer: Basic Elements of a Management Representation Letter: As per SA 580 "Written Representations", some of the basic elements of a Management Representation letter are- (1) It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. (2) It does not include financial statements, the assertions therein, or supporting books and records. (3) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. (4) The written representations shall be for all financial statements and period(s) referred to in the auditor's report. (5) The written representations shall be in the form of a representation letter addressed to the auditor.
32	**In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty? [May 10 (4 Marks)]**
	Answer: Duty of an Auditor if management refuses to provide written representations: As per SA 580 "Written Representations", if the management does not provide one or more of the requested written representations, the auditor shall: (i) Discuss the matter with management, (ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general, and (iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report. (iv) Disclaim an opinion on the financial statements in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

33 **An auditor of Mohan Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?**

Or

The Auditor of PQR Pvt. Ltd. having turnover of Rs. 12 crore, was not able to get the confirmation about the existence and value of certain stock. However, a certificate from the management has been obtained regarding the existence and value of the stock at the year end. The auditor relied on the same and without any further procedure, signed the Audit Report. Is he right in his approach?

[Nov. 14 (5 Marks)]

Answer: Validity of Management Representation:

- The physical verification of fixed assets (Inventory) is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets (inventory).
- In the case of Mohan Ltd., the auditor has not been able to verify the existence and value of some machinery (inventory) despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry.
- As per SA 580 "Written Representation" the representations received from management are recognised as audit evidence, but they do not constitutes Sufficient and appropriateness.
- Auditor is required to seek corroborative audit evidence from other sources inside or outside the entity, to evaluate whether such representations are reasonable and consistent with other evidences. Representation received from Management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available.
- If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter, which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.

Conclusion: The approach adopted by the auditor is not right.

34 **In the course of audit of K Ltd., its auditor Mr. 'N' observed that there was a special audit conducted at the instance of the management on a possible suspicion of a fraud and requested for a copy of the report to enable him to report on the fraud aspects. Despite many reminders it was not provided. In absence of the special audit report, Mr. 'N' insisted that he be provided with at least a written representation in respect of fraud on/by the company. For this request also, the management remained silent. Please guide Mr. 'N'.**

Answer: Auditors Responsibilities Relating to Fraud:

- As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In addition an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

	• As per SA 580, "Written Representations", if management does not provide the requested written representations, the auditor shall discuss the matter with management; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report. • The auditor shall disclaim an opinion on the financial statements if the auditor concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable; or management does not provide the written representations. • In the instant case, in the course of audit of K Ltd., its auditor Mr. N observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report, which was not provided by the management despite of many reminders. Mr. N also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent. **Conclusion**: Auditor is required to state the facts in his report and he should also disclaim an opinion on the financial statements.
