

# HOW TO USE THE LAST ATTEMPT KIT?

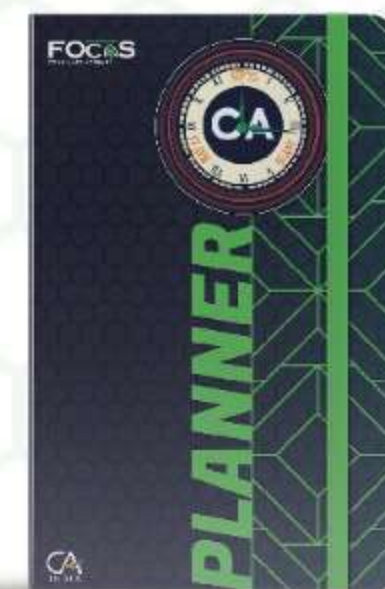


## STEP 01

The Last Attempt Kit Manual contains every key concept and formula. First read it to grasp these basics, then mark the areas you want to focus on according to your strengths and weaknesses..

Use the study planner that covers every topic in the subject. It's built for accountability-fill in the daily to-do list to plan your tasks and log each revision. Aim for three full revisions.

## STEP 02



## STEP 03

Now refer to the ICAI Study Material and run through the concepts and sums.

Kit "Question Bank" Next, pick up the Last Attempt Kit Question Bank and start solving. Every question shows its source for easy reference, covering ICAI Study Material, RTPs, MTPs, and past exam papers.

## STEP 04



## STEP 05

Now attempt the Last Attempt Kit Test Series and assess your performance and areas of Improvement with our personalized video review on your evaluated answer sheet from our team of professionals.

Note down the sums and areas where you made the mistake and Ensure that you practice them before appearing for your exams

By following the above steps the next attempt is

**"YOUR LAST ATTEMPT"**

**SUCCESSFUL**



# AUDIT EVIDENCE

**QUESTION 1****(MTP 2 MARKS MARCH '19)**

Examine with reasons (in short) whether the following statements are correct or incorrect: When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence.

**ANSWER**

Correct. — When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

**QUESTION 2****(MTP 5 MARKS APRIL '21)**

Discuss the following: Name the assertions for the following audit procedures:

- (i) Yearend inventory verification.
- (ii) Depreciation has been properly charged on all assets.
- (iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.
- (iv) All liabilities are properly recorded in the financial statements.
- (v) Related party transactions are shown properly.

**ANSWER**

- (i) Yearend inventory verification: Existence Assertion.
- (ii) Depreciation has been properly charged on all assets: Valuation Assertion.
- (iii) Title deeds of the lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.
- (iv) All liabilities are properly recorded in the financial statements: Completeness. (v) Related party transactions are shown properly: Presentation & Disclosure.

**QUESTION 3****(MTP 2 MARKS NOV '21)**

Examine with reasons (in short) whether the following statements are correct or incorrect: Inquiry alone ordinarily does not provide sufficient audit evidence.

**ANSWER**

Correct: Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may

even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

**QUESTION 4****(RTP NOV'19)**

State with reason (in short) whether the following statements are true or false Inquiry alone provides sufficient audit evidence of the absence of a material misstatement at the assertion level and of the operating effectiveness of controls:

**ANSWER**

Incorrect: Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

**QUESTION 5****(MTP 3 MARKS NOV '21)**

In the course of audit of SMP Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ` 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing.

**ANSWER**

Certificate from a Management's Expert: In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service. The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

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

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

**QUESTION 6****(MTP 3 MARKS MARCH 22)**

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence.

**ANSWER**

Reliability of Audit Evidence: As per SA 500 on “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, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

- (i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- (ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- (iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- (iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- (v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

**QUESTION 7****(MTP 2 MARKS OCT'22)**

Examine with reasons (in short) whether the following statements are correct or incorrect Audit evidence obtained through observation of the application of a control is less reliable than audit evidence obtained by inquiry about the application of a control.

**ANSWER**

Incorrect: Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

**QUESTION 8****(MTP 3 MARKS OCT'22)**

CA Amar is the statutory auditor of XYZ Ltd. for the FY 2021-22. During the course of audit, CA Amar found that a litigation is going against the company for which the company has hired an external legal team (management expert). CA Amar wanted to use the information as audit evidence which is prepared using the work of the management expert. What should CA Amar consider before using the work of such management expert?

**ANSWER**

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.
4. CA Amar should consider the above before using the work of the management's expert.

**QUESTION 9****(MTP 3 MARKS APRIL '23)**

What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.

OR

The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. Analyse and Explain stating clearly the factors affecting the auditor's judgement as to sufficiency of audit evidence.

(RTP May '18 & May '19)

OR

There was a Partnership Firm of Chartered Accountants WT and Associates. Mr. W, one of the partners of WT and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. H, one of the members of audit team of WT and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

(Old & New SM)

**ANSWER**

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:

(i) Materiality: It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if

assertions are more material to the users of the financial statements, more evidence would be required.

(ii) Risk of material misstatement: It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level: — Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. — Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) Size of a population: It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

**QUESTION 10****(MTP 2 MARKS SEP '23)**

Examine with reasons (in short) whether the following statements are correct or incorrect: While auditing the books of accounts of XYZ Ltd., the auditor of the company was involved in examining records and documents in paper form, electronic form etc. and was also conducting physical examination of assets. In the present case, audit procedure used by the auditor is known as "Observation".

**ANSWER**

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "Inspection". Whereas Observation consists of looking at a process or procedure being performed by others.

**QUESTION 11****(MTP 2 MARKS OCT '23)**

Examine with reasons (in short) whether the following statements are correct or incorrect: Negative assertions, encountered in the financial statements, may be expressed or implied.

**ANSWER**

Correct: Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability, it would be an expressed negative assertion. On the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

**QUESTION 12****(MTP 3 MARKS OCT'23)**

Discuss the following: An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute Assurance.

OR

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with the help of examples. (MTP 3 Marks Oct 20)

**ANSWER**

The Nature of Audit Procedures: The auditor carries out his work by obtaining audit evidence through performance of audit procedures. There are practical and legal limitations on the auditor's ability to obtain audit evidence.

For example:

1. There is possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

**QUESTION 13:****(MTP 4 MARKS OCT'23)**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the meaning of audit evidence in detail.

**ANSWER**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige. He needs evidence to obtain information for arriving at his judgment. Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

- (1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers;

invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

**QUESTION 14****(RTP NOV '19)**

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain.

**ANSWER**

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.



**QUESTION 15****(RTP MAY '20)**

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and Analyse and explain with the help of example of evidence in respect of Sales.

**ANSWER**

Evidence is the very basis for formulation of opinion and an audit program me is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit program me. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction. Example Sales are evidenced by:

- (i) invoices raised by the client;
- (ii) price list;
- (iii) forwarding notes to client;
- (iv) inventory-issue records;
- (v) sales managers' advice to the inventory section;
- (vi) acknowledgements of the receipt of goods by the customers; and collection of money against sales by the client. explain with the help of evidence in respect of Sales.

**QUESTION 16****(RTP NOV'20)**

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. An auditor picks up evidence from a variety of fields. Analyse and explain with the help of examples.

**ANSWER**

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion. An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (a) Documentary examination,
- (b) Physical examination,
- (c) Statements and explanation of management, officials and employees,
- (d) Statements and explanations of third parties,
- (e) Arithmetical calculations by the auditor,
- (f) State of internal controls and internal checks,
- (g) Inter-relationship of the various accounting data,
- (h) Subsidiary and memorandum records,
- (i) Minutes,
- (j) Subsequent action by the client and by others.

Examples:

1. For cash in hand, the best evidence is 'count'
2. For investment pledged with a bank, the banker's certificate.
3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

**QUESTION 17****(RTP MAY '21)**

When information to be used as audit evidence has been prepared using the work of a management's expert and having regard to the significance of expert's work for the auditor's purposes, explain the considerations auditor would consider for the purposes of his audit.

**ANSWER**

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

- (i) Evaluate the competence, capabilities and objectivity of that expert;
- (ii) Obtain an understanding of the work of that expert; and
- (iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

**QUESTION 18****(RTP MAY '18)**

Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. Discuss

**ANSWER**

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes: -

- (1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.



(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

**QUESTION 19****(RTP MAY '22)**

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

OR

Evaluating responses to inquiries is an integral part of the inquiry process. Explain.

**(RTP May '18)****ANSWER**

Inquiry: As per SA 500 Audit Evidence: -

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

**QUESTION 20****(RTP NOV'22)**

An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. Explain.

**ANSWER**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige. He needs evidence to obtain information for arriving at his judgement.

SA 500 – “Audit Evidence”, explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor’s responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor’s opinion.

**QUESTION 21****(RTP NOV'22)**

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

**ANSWER**

If:

- (a) audit evidence obtained from one source is inconsistent with that obtained from another; or
- (b) the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

**QUESTION 22****(RTP NOV'20)**

If an entity has a known number of employees at fixed rates of pay throughout the period, there would be more need to perform tests of details on the payroll.

**ANSWER**

Incorrect: If 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.



**QUESTION 23****(RTP NOV'19)**

State with reason (in short) whether the following statements are true or false Subjective examination connotes critical examination and scrutiny of the accounting statements.

**ANSWER**

Incorrect: Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs.

**QUESTION 24****(RTP MAY '19)**

State with reason (in short) whether the following statements are true or false:

The matter of difficulty, time, or cost involved is in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

**ANSWER**

Incorrect: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

**QUESTION 25****(RTP MAY '23)**

State with reason (in short) whether the following statements are true or false: While auditing the books of accounts of XYZ Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as "Inspection".

**ANSWER**

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "observation". Whereas inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

**QUESTION 26****(RTP NOV '23)**

T Ltd has used the services of an expert for the purpose of physical verification of its inventory which is appearing in the financial statements of the company at 75 Crores. Discuss the broad parameters auditor would take into consideration while deciding about using the work performed by the Management's Expert in physical verification of company's inventory.

**ANSWER**

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

- Evaluate the competence, capabilities and objectivity of that expert;
- Obtain an understanding of the work of that expert; and

- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

**QUESTION 27**

SA 500 – “Audit Evidence”, explains what constitutes audit evidence in an audit of financial statements. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements. Explain and discuss the meaning of Audit Evidence in detail. (RTP Nov '23)

OR

The auditor of Fresh and Well Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor. (Old & New SM)

**ANSWER**

SA 500 – “Audit Evidence”, explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:

(1) Information contained in the accounting records: Accounting records include

- the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers;
- invoices;
- contracts;
- the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
- records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example:

- minutes of the meetings,
- written confirmations from trade receivables and trade payables,
- manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

**QUESTION 28**

(PYP 2 MARKS, NOV'19)

Examine with reasons whether the following statements are correct or incorrect. The auditor's substantive procedure at the assertion level means substantive analytical procedures only.



**ANSWER**

Incorrect: The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedure, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

**QUESTION 29****(PYP 3 MARKS, DEC'21)**

CA K audited the books of accounts of E Ltd. for the financial year 2020 -2021. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor and its reliability.

**ANSWER**

Audit Procedure:

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example of inspection used as a test of controls is inspection of records for evidence of authorisation. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting. In view of above, it can be concluded that CA K used Inspection as an audit procedure.

**QUESTION 30****(PYP 3 MARKS MAY'22)**

SPR Ltd has been into the media business since 1990. During the F.Y 2021-2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances?

**ANSWER**

Circumstances when becoming necessary to meet with external legal counsel: In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel. In certain

circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, for example, where:

- (i) The auditor determines that the matter is a significant risk.
- (ii) The matter is complex.
- (iii) There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

**QUESTION 31****(PYP 2 MARKS MAY '2018)**

Examine with reasons (in short) whether the following statements are correct or incorrect: During the audit process, the Auditor can easily identify all mistakes or manipulations that may exist in the accounts through routine checking processes.

**ANSWER**

Incorrect: Routine checking cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts. Certain other procedures also have to be applied like trend and ratio analysis including review of internal control.

**QUESTION 32:****(PYP 4 MARKS NOV 22)**

The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence?

**ANSWER**

Audit Procedures to Obtain Audit Evidence: Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

- (I) Risk assessment procedures; and
- (II) Further audit procedures, which comprise:
  - i. Test of controls, when required by the SAs or when the auditor has chosen to do so; and
  - ii. Substantive procedures, including tests of details and substantive analytical procedures.

Audit procedures to obtain audit evidence can include

- (a) Inspection
- (b) Observation
- (c) External Confirmation
- (d) Recalculation
- (e) Repperformance
- (f) Analytical Procedures
- (g) Inquiry

**QUESTION 33****(PYP 2 MARKS MAY '23)**

Appropriateness is the measure of the quantity of audit evidence.



**ANSWER**

Incorrect: Appropriateness is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

**QUESTION 34****(PYP 2 MARKS JAN '21)**

Sufficiency is the measure of the quantity of audit evidence.

**ANSWER**

Correct: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence is affected by the auditor's assessment of the risks of misstatement. (Higher the assessed risks the more audit evidence is likely to be required.)

**QUESTION 35****(PYP 3 MARKS MAY '23)**

Management is often in the best position to perpetrate fraud. As an auditor you are suspecting existence or suspicion of fraud from management. Give any three examples of "others within the entity" to whom direct inquiries can be made.

**ANSWER**

Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

1. Operating personnel not directly involved in the financial reporting process.
2. Employees with different levels of authority.
3. Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
4. In-house legal counsel.
5. Chief ethics officer or equivalent person.
6. The person or persons charged with dealing with allegations of fraud.

SA 610- Using the Work of Internal Auditors.

**QUESTION 36****(RTP MAY '19)**

Explain the meaning, objectives and scope of internal audit functions as per SA 610. Also discuss who can be appointed as Internal Auditor?

**ANSWER**

Who can be appointed as Internal Auditor? As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

The objectives and scope of internal audit functions: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

1. Activities Relating to Governance: The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

2. Activities Relating to Risk Management: The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.

3. Activities Relating to Internal Control

(i) Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(ii) Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

(iv) Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

#### QUESTION 37

(PYP 2 MARKS JAN '21)

Explain whether the following statements are correct or incorrect, with reasons/ explanations/ examples The objectives and scope of internal audit functions are restricted to activities relating to evaluation of internal control only.

#### ANSWER

Incorrect: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control.

From the above, it can be concluded that the objective and scope of internal audit function are not restricted to activities relating to evaluation of control only.

**QUESTION 38****(MTP 2 MARKS MARCH '18)**

Examine with reasons (in short) whether the following statement is correct or incorrect: According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to 100% of items within a population of audit relevance.

**ANSWER**

Incorrect: According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

**QUESTION 39****(MTP 2 MARKS OCT 18)**

Examine with reasons (in short) whether the following statement is correct or incorrect: Stratified Sampling involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

**ANSWER**

Correct: Stratified Sampling involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

**QUESTION 40****(MTP 5 MARKS OCT 18)**

Discuss the following: The sample size can be determined by the application of a statistically -based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls.

OR

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls.

**ANSWER**

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.



Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- ◆ When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

- ◆ If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.

- ◆ When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

- ◆ An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

- ◆ In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

**QUESTION 41****(MTP 2 MARKS APRIL 19)**

Examine with reasons (in short) whether the following statement is correct or incorrect: Sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

**ANSWER**

Correct: The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and nonstatistical approaches. Whatever maybe the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

**QUESTION 42****(MTP 3 MARKS APRIL 19)**

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

OR

While designing an audit sample, the auditor shall determine a sample size sufficient to reduce the sampling risk to an acceptably low level. In this context, explain sampling risk and non-sampling risk.  
(PYP 4 Marks May '23)

OR

"Sampling risk can lead to erroneous conclusions". Justify. (MTP 4Marks April '21)

OR

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk leads to erroneous conclusions. Explain in detail distinguishing it from non-sampling risk with examples.  
(RTP Nov'20)

OR

In the context of SA 530 'Audit Sampling', explain the terms 'Sampling Risk' and 'Non-Sampling risk' with examples.  
(RTP Nov'20)

OR

In the context of SA 530 'Audit Sampling', explain the terms 'Sampling Risk' and 'Non-Sampling risk'.  
(PYP 4 Marks, Jan'21)

### ANSWER

Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling".

**Sampling Risk:**

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (i) 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.
- (ii) 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.

**Non-Sampling Risk:** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

**Example:**

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sources of non-sampling risk are;

- (i) Human Mistakes.
- (ii) Applying audit procedures not appropriate to the objectives of audit.
- (iii) Relying on erroneous information e.g. erroneous confirmation.
- (iv) Misinterpreting the sample results.
- (v) Non sampling risk can never be mathematically measured.

**QUESTION 43****(MTP 2 MARKS OCT 19)**

Examine with reasons (in short) whether the following statement is correct or incorrect: The method which involves dividing the population into groups of items is known as block sampling.

**ANSWER**

Incorrect: The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

**QUESTION 44****(MTP 4 MARKS OCT 19)**

XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analysing the whole accounts receivables, auditor wanted to use sampling technique. In considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques. Advise the auditor in accordance with SA 530.

OR

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. Guide the auditor on the use of stratification and value-weighted sampling techniques.

(RTP Nov '21)

**ANSWER**

**Stratification and Value-Weighted Selection:** In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value weighted sampling techniques.

**Stratification:** 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.

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

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

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.

**Value-Weighted Selection:** When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

**QUESTION 45****(MTP 4 MARKS OCT 20)**

Audit testing done through Statistical sampling is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Explain and also state advantages of Statistical sampling.

OR

What are the advantages of statistical sampling techniques in Auditing?

(RTP May'22, Old & New SM)

**ANSWER**

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective and thereby more defensible.
- (3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
- (6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

**QUESTION 46****(MTP 4 MARKS OCT '21)**

State the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

**ANSWER**

**Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below –

**Sample design -** When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

**Sample Size-** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. **Selection of Items for Testing-** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

**QUESTION 47****(MTP 3 MARKS NOV '21)**

CA X is not sure about the kind of Sampling method to be used for audit of a company. Advise him about the choice of methods (name of methods only) of Sampling to be used in various circumstances. Also explain briefly the advantages of the Sampling to be used by him in auditing.

**ANSWER 47**

**Sample Selection:** CA. X should obtain the knowledge before using the sampling methods. The principal methods are as follows:

- (1) Random selection.
- (2) Systematic selection.
- (3) Monetary Unit sampling.
- (4) Haphazard selection.
- (5) Block selection.

**Advantages of Statistical Sampling in Auditing:**

- (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (ii) The sample selection is more objective and thereby more defensible.
- (iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

**QUESTION 48****(MTP 3 MARKS MARCH 22)**

ABC Ltd is a Large Company with huge purchase and sales transactions. Which sampling approach is recommended in such a company? Explain giving features of such sampling approach along with example.

**ANSWER**

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged. **Features/Characteristics of Statistical Sampling:**

(1) Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. (2) Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(3) There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be

highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

**QUESTION 49****(MTP 2 MARKS APRIL 22)**

The level of sampling risk that the auditor is willing to accept will not affect the sample size.

**ANSWER**

Incorrect: As per SA 530, "Audit Sampling" the level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

**QUESTION 50****(MTP 2 MARKS SEP'22)**

Examine with reasons (in short) whether the following statements are correct or incorrect: In case of stratified sampling, the conclusions are drawn on the stratum.

**ANSWER**

Correct: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

**QUESTION 51****(MTP 2 MARKS OCT'22)**

Examine with reasons (in short) whether the following statements are correct or incorrect Systematic sampling means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population.

**ANSWER**

Incorrect: Stratification means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. Systematic sampling is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

**QUESTION 52****(MTP 4 MARKS APRIL 22)**

There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain.

**ANSWER**

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-

consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

**QUESTION 53****(MTP 2 MARKS OCT'22)**

Examine with reasons (in short) whether the following statements are correct or incorrect. The higher the auditor's assessment of the risk of material misstatement, the smaller the sample size needs to be.

**ANSWER**

Incorrect: The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

**QUESTION 54****(MTP 2 MARKS MARCH23 )**

Examine with reasons (in short) whether the following statements are correct or incorrect. Low acceptable sampling risk requires larger sample size.

**ANSWER**

Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

**QUESTION 55****(MTP 2 MARKS APRIL '23)**

Examine with reasons (in short) whether the following statements are correct or incorrect: Statistical sampling being more scientific and without personal bias will always be appropriate to use under all circumstances.

**ANSWER**

Incorrect: Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way. Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

**QUESTION 56****(MTP 3 MARKS OCT'23)**

It is imperative for the auditor to project misstatements for the population while performing audit procedures through sampling. Comment.

**ANSWER**

(i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

(ii) When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.



(iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

**QUESTION 57****(RTP NOV '19)**

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. It is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed Explain.

**ANSWER**

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognized basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.

**QUESTION 58****(RTP MAY '20)**

State with reason (in short) whether the following statements are true or false: Statistical sampling has narrower application where a population to be tested consists of a large number of similar items.

**ANSWER**

Incorrect: Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

**QUESTION 59****(RTP MAY '20)**

Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example.

**ANSWER**

**Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example:

Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

**QUESTION 60****(RTP NOV'20)**

Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan.

**ANSWER**

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

- (i) Size of the organization under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.
- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

**QUESTION 61****(RTP MAY '21)**

Explain the following terms with reference to Audit Sampling:

- (i) Stratification
- (ii) Tolerable misstatement
- (iii) Tolerable rate of deviation

**ANSWER**

- (i) Stratification – 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).
- (ii) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
- (iii) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

**QUESTION 62:****(RTP MAY '21)**

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Explain in detail.

**ANSWER**

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realized that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organization because they provide the reliability of the records. Sampling is used as a part of Test of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for test of details (i.e. checking of transactions and balances).

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result. Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results.

It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

**QUESTION 63****(RTP NOV '21)**

When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. Explain in detail.

**ANSWER**

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of relevant portion (paragraph 8) of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a disposing between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected

rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

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.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

**QUESTION 64****(RTP MAY '18)**

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. Discuss explaining Statistical and Non-Statistical sampling approaches.

**ANSWER**

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered non-statistical sampling.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample must be representative. Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

**QUESTION 65****( MTP 5 MARKS AUG'18)**

The auditor shall evaluate the results of the sample and whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. Explain.

**ANSWER**

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.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus



anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also, if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained. In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or 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.

**QUESTION 66****(RTP NOV'22)**

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

**ANSWER**

Simple Random Sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cell phones like the random number generator.

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

**QUESTION 67****(RTP NOV '23)**

Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2022- 2023. Chintan & Mani seem to have different opinion 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 whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530.

**ANSWER**

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

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

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

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

**QUESTION 68****(PYP 2 MARKS)**

Examine with reasons (in short) whether the following statements are correct or incorrect: When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.

**ANSWER**

Incorrect: Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

**QUESTION 69****(PYP 2 MARKS, NOV'19)**

Examine with reasons whether the following statements are correct or incorrect. The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific.

**ANSWER**

Correct: The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques.

**QUESTION 70****(PYP 3 MARKS DEC '21)**

With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider when determining the sample size for the Test of Details –

- (i) The desired level of assurance
- (ii) Stratification of the population.

**ANSWER**

Examples of factors influencing Sample Size for Test of Details:

- (i) Desired Level of Assurance: An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
- (ii) Stratification of population: When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size

that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

**QUESTION 71****(PYP 4 MARKS)**

CA B is appointed as an auditor of M/s. Divine Pharmacy, a wholesale medicine supplier. While auditing for the financial year 2020-21, CA B wants to use test checking technique. Advise CA B, what kind of precautions should be taken by him in this regard.

OR

What precautions should be taken by the auditor while applying test check techniques?

(Old &amp; New SM)

**ANSWER**

While auditing the accounts of Divine Pharmacy, CA B wanted to use Test Checking technique. The following Precautions should to be taken by CA B while applying test check techniques:

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

**QUESTION 72:****(PYP 3 MARKS MAY'22)**

The approach to audit and extent of checking are undergoing a progressive change in favour of more attention towards the questions of principle and controls with a curtailment of non-consequential routine checking. Discuss the given statement.

**ANSWER**

Sampling: An Audit Procedure: No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors. Thus, the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking, we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and

become bound by that. To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e., sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

**QUESTION 73:****(PYP 3 MARK)**

What are the matters that the auditor shall consider while designing an audit sample?

**ANSWER**

Matters to be considered while designing an Audit Sample: As per SA 530, "Audit Sampling",

(i) When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.

(ii) When designing an audit sample, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

(iii) When designing an audit sample, the auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

(iv) When designing an audit sample, the auditor shall determine that sample selected must be representative of the population.

(v) When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.

(vi) When designing an audit sample, Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

(vii) In fulfilling the requirement of SA 500 "Audit Evidence", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

SA 501- Audit Evidence-Specific Considerations for Selected Items

**QUESTION 74****(MTP 5 MARKS AUG '18 )**

Krishna Cycles Ltd is engaged in manufacturing of different type of Bicycles. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor.

OR

(MTP-March'18,5 Marks)

ABC Ltd is engaged in manufacturing of different type of yarns. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor.



**ANSWER**

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

(a) Attendance at physical inventory counting, unless impracticable, to:

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

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

**QUESTION 75:****(MTP 2 MARKS MAY 20)**

Depending on how the business operates, the management may value inventory using weighted average basis.

**ANSWER**

Incorrect: Depending on how the business operates, the management may value inventory using First in first-out (FIFO) or weighted average basis.

**QUESTION 76:****(MTP 4 MARKS OCT '21)**

While conducting audit of Vee Ltd, CA Aman, auditor of the company, found that some goods are lying with third party for a long period. Advise Aman how will he verify them.

**ANSWER**

Goods Lying with Third Party: The auditor should check that the materiality of the amount of goods lying with them.

- (i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.
- (ii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.
- (iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.
- (iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transactions for ensuring existence and working of internal control system for them.
- (v) The excise gate pass, entry in such records, information in returns, be also cross-verified.
- (vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.
- (vii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.
- (viii) Evaluate condition of goods and see whether adequate provision has been made.
- (ix) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.
- (x) Ensure that the goods have been included in the closing inventory though lying with third party.

**QUESTION 77:****(MTP 4 MARKS MARCH '21)**

TRM Ltd. is a company engaged in manufacture of beauty products. It has hair care segment, skin care segment and kids' beauty products. The auditor wants to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework. Suggest the audit procedures in the given case.

**ANSWER**

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

- (1) Obtaining an understanding of the methods used by management in determining segment information. Further,
  - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
  - (ii) Where appropriate, testing the application of such methods; and
- (2) Performing analytical procedures or other audit procedures appropriate in the circumstances.

**QUESTION 78:****(MTP 2 MARKS SEP '23)**

Examine with reasons (in short) whether the following statements are correct or incorrect: When inventory under the custody and control of a third party is material to the financial statements, the auditor cannot obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management.

**ANSWER**

Correct: 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.

**QUESTION 79:****(RTP MAY '20)**

Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

**ANSWER**

Matters relevant in planning attendance at physical inventory counting include, for example:

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

**QUESTION 80:****(RTP MAY '22)**

GPS & Co, Chartered Accountants, conducting the audit of Pratibha Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GPS & Co wanted to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GPS & Co with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.

**ANSWER**

The auditors, GPS & Co wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- (i) Sales, transfers and charges between segments, and elimination of inter - segment amounts.
- (ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
- (iii) The allocation of assets and costs among segments.
- (iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

**QUESTION 81:****(RTP MAY '22, OLD & NEW SM)**

Pachanga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose.

**ANSWER**

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. Further if:

- (a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding; and

(b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.  
SA 505- External Confirmations.

**QUESTION 82:****(MTP 2 MARKS OCT '21)**

Audit evidence obtained from external confirmation is always reliable.

**ANSWER**

Incorrect: 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, including the controls over its preparation and maintenance where relevant. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

**QUESTION 83:****(MTP 2 MARKS APRIL 22)**

R Ltd. has asked for email responses for the purpose of external confirmation. The auditor, however, feels that external confirmation received electronically involves the risk of its reliability.

**ANSWER**

Correct: SA 505, "External Confirmations", responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. Hence R Ltd. Should avoid using email responses as evidence for external confirmation.

**QUESTION 84:****(MTP 3 MARKS APRIL 22)**

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. Apart from confirmations for bank balances and accounts receivables, what are the other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement?

**ANSWER**

Other examples of situations where external confirmations may be used include the following:

- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms
- Long outstanding share application money.

**QUESTION 85:****(RTP MAY '20)**

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.



**ANSWER**

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested;
- (b) Selecting the appropriate confirming party;
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

**QUESTION 86:****(RTP MAY '20)**

Define the following:

- (i) Positive confirmation request
- (ii) Negative confirmation request
- (iii) Non-response
- (iv) Exception

**ANSWER**

(i) 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.

(ii) 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.

(iii) Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered. (iv) Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

**QUESTION 87:****(RTP NOV '18)**

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. Analyze and explain.

**ANSWER**

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. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

**QUESTION 88:****(PYP 2 MARKS, MAY'19)**

Examine with reasons whether the following statements are correct or incorrect. Positive Confirmation request is a request where the confirming party respond only if it disagrees with the information provided in the request.

**ANSWER**

Incorrect –In Positive confirmation request 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 whereas Negative confirmation request 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.

**QUESTION 89:****(PYP 2 MARKS, NOV'20)**

Examine with reasons whether the following statements are correct or incorrect. External confirmation procedures are restricted to the items of addressing assertions associated with account balances & their elements only.

**ANSWER**

Incorrect: External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmation need not be restricted to account balances only.

**QUESTION 90:****(PYP 4 MARKS, JULY'21)**

CA Rohit is appointed as an auditor of Grace Ltd.; he wants to design a suitable confirmation request letter for a few debtors of Grace Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level.

**ANSWER**

Negative confirmations are 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 information provides less persuasive audit evidence than positive confirmations. Accordingly, CA Rohit, Auditor of Grace Ltd, shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions; (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

**QUESTION 91:****(PYP 4 MARKS MAY '23)**

CA P is the auditor of MN Ltd. While scrutinising the accounts of MN Ltd., he observed that the company had large volume of Trade payable outstanding in the Balance sheet as on 31st March, 2023 for which external confirmations are not available, CA P wants to send external confirmation request to selected Trade payables but management of MN Ltd. refused for the same. Discuss how CA P should deal in this regard as per relevant Standard on Auditing.

**ANSWER**

If management refuses to allow the auditor to send a confirmation request, CA P should deal in this regard in the manner prescribed in SA 505 explained hereunder: (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 those charged with governance in accordance with SA 260. The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with SA 705.

**QUESTION 92:****(MTP 4 MARKS OCT 19)**

Auditors of M/s Tender India (P) Ltd. were changed for the accounting year 2016-17. The closing inventory of the company as on 31.3.2016 amounting to Rs. 100 lacs continued as it is and became closing inventory as on 31.3.2017. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.

**ANSWER**

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

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

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

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date. The contention of the management that the inventory has not undergone any change cannot be accepted, it forms part of normal duties of auditor

to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude the audit of closing inventory from his audit programme.

**QUESTION 93:****(RTP MAY '23, OLD & NEW SM)**

What is the objective of the auditor with respect to the opening balances when conducting an initial audit engagement as per the relevant SA?

OR

M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2020- 21-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510? (Old & New SM)

**ANSWER**

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether: (a) Opening balances contain misstatements that materially affect the current period's financial statements; and (b) 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.

**QUESTION 94:****(PYP 2 MARKS, NOV'2018)**

Examine with reasons (in short) whether the following statements are correct or incorrect: An auditor is not concerned with consistency of accounting policies relating to opening balances.

**ANSWER**

Incorrect: In conducting an initial audit engagement, one of the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether 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.

**QUESTION 95:****(PYP 5 MARKS)**

M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach

OR

The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?

(PYP 3 Marks May'22)

**ANSWER**

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.



From the above, it is quite clear that CA Pankaj is not correct in his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

**Audit Procedures regarding Opening Balances:** The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (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 policies; and
- (c) Performing one or more of the following:
  - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
  - (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.

**QUESTION 96:****(RTP NOV'20, MAY'19)**

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements. Explain in detail stating clearly the auditor's responsibility in the above context.

**ANSWER**

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions: (a) Achieve a true and fair presentation; or

(b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties. Owing to the inherent limitations of an audit, there is an

Unavoidable risk that some material misstatement of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships.

- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
- Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions.

The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

**QUESTION 97:****(RTP NOV '21)**

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances. During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples.

**ANSWER**

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following 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 those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
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 e.g., prospectuses)

**QUESTION 98:****(RTP MAY'20)**

The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

**ANSWER**

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example;

- ◆ Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- ◆ Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- ◆ Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

**QUESTION 99:****(PYP 2 MARKS, JULY'21)**

State with reasons whether the following statements are correct or incorrect. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater.

**ANSWER**

Correct: In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

**QUESTION 100:****(PYP 4 MARKS MAY'22)**

P Ltd. is a company from a business group "ABCD" and is engaged in trading of garments. The promoters and directors of some other group companies also. You have been appointed as an auditor of P Ltd. P Ltd has entered into various intercompany transactions (within group during the year which are outside its normal course of business. What will be your duties as an auditor in relation to those transactions?

**ANSWER**

Duties of Auditor in identifying Significant Related Party Transactions: For identified significant related party transactions outside the P Ltd.'s normal course of business, the auditor shall:

1. 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; and
2. Obtain audit evidence that the transactions have been appropriately authorised and approved.

**QUESTION 101:****(MTP 2 MARKS MARCH '18)**

Examine with reasons (in short) whether the following statement is correct or incorrect: A modelling tool constructs a statistical model from financial data only of prior accounting periods to predict current account balances.

**ANSWER**

Incorrect: A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

**QUESTION 102:****(MTP 5 MARKS MARCH '18)**

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

**ANSWER**

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

- (i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;
- (iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity.

For example, controls over the preparation, review and maintenance of budgets. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

**QUESTION 103:****(MTP 2 MARKS AUG '18)**

Examine with reasons (in short) whether the following statement is correct or incorrect: Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.

**ANSWER**

Incorrect: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

**QUESTION 104:****(MTP 2 MARKS OCT 18)**

Examine with reasons (in short) whether the following statement is correct or incorrect: Ratio analysis is a commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

**ANSWER**

Incorrect: Trend analysis is a commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

**QUESTION 105:****(MTP 4 MARKS APRIL 19)**

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain.

**ANSWER**

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, 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. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

**QUESTION 106:****(MTP 3 MARKS APRIL '21)**

CA Amar wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2020-21. The rent amounts to Rs.50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

**ANSWER**

If CA Amar checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid Rs. 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Amar may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location. If CA Amar applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Amar does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.



**QUESTION 107:****(MTP 4 MARKS OCT '21)**

Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances.

OR

Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances.

(RTP May '21)

**ANSWER**

Analytical Review Procedures: The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

- (i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;
- (ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;
- (iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;
- (iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;
- (v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;
- (vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

**QUESTION 108:****(MTP 3 MARKS NOV '21)**

Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

OR

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain. (RTP Nov'20)

**ANSWER**

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

Analytical Procedures in Planning the Audit In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

**QUESTION 109:****(MTP 4 MARKS MARCH 22)**

While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

OR

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Explain clearly stating the techniques available as substantive analytical procedures. (MTP 5 Marks Aug '18)

**ANSWER**

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence.

**Trend analysis** – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

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

**Reasonableness tests** – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Examples include:

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

(Examples included in May 21) **Structural modelling** – A modelling tool constructs a statistical model from financial and/or nonfinancial data of prior accounting periods to predict current account balances (e.g., linear regression). The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

**QUESTION 110:****(MTP 3 MARKS OCT'23)**

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, how would the auditor investigate such differences.

**ANSWER**

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- (ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

**QUESTION 111:****(RTP NOV '19)**

Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis. Analyze and Explain stating clearly the meaning of analytical procedures.

**ANSWER**

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit.

Meaning of Analytical Procedures. As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**QUESTION 112:****(RTP NOV '19)**

Give examples of Analytical Procedures having consideration of comparisons of the entity's financial information

**ANSWER**

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information with are:

- Comparable information for prior periods. ⊗ Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

**QUESTION 113:****(RTP MAY '20)**

Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

**ANSWER**

Trend analysis – A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

**QUESTION 114:****(RTP MAY '20)**

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall 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. Explain the other relevant points in this context.

**ANSWER**

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

- (i) 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;
- (ii) 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;
- (iii) 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
- (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

**QUESTION 115:****(RTP NOV'20)**

The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain.

**ANSWER**

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

**QUESTION 116:****(RTP NOV '21)**

For the purposes of the SAs, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Explain giving examples of both.

**ANSWER**

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods. Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entity is of comparable size in the same industry. Analytical procedures also include consideration of relationships,
  - for example: Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
  - Between financial information and relevant non-financial information, such as payroll costs to number of employees.

**QUESTION 117:****(RTP NOV '21)**

Analysis by computation of ratios includes the study of relationships between financial statement amounts. State Commonly used ratios

**ANSWER**

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- ◆ Elements of income or loss as a percentage of sales
- ◆ Gross profit turnover
- ◆ Accounts receivable turnover
- ◆ Inventory turnover
- ◆ Profitability, leverage, and liquidity.

**QUESTION 118:****(RTP NOV '18)**

The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities. Analyze and explain.

**ANSWER**

The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometre of road construction or the number of vehicles acquired compared with vehicles retired.



**QUESTION 119:****(RTP MAY '22)**

Discuss the matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated.

**ANSWER**

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

- (i) The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- (ii) The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
- (iii) The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

**QUESTION 120:****(RTP NOV'22)**

Explain the aspects to be considered by an auditor when designing and performing substantive analytical procedures, either alone or in combination with test of details, as substantive procedures in accordance with SA 330.

**ANSWER**

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

- (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and test of details, if any, for these assertions.
  - (ii) 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.
  - (iii) 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.
- Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation

**QUESTION 121:****(RTP NOV'22)**

Discuss with examples the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures.

**ANSWER**

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

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

For example, controls over the preparation, review and maintenance of budgets. The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

**QUESTION 122****(RTP NOV '23)**

Flower Limited presented its financial statements for the F.Y. 2022-2023 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons?

**ANSWER**

**Purpose of Applying Analytical Procedure:** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. The auditor of Flower Ltd. would achieve the following by carrying out the comparison stated in the question:

- (i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- (ii) By setting up certain expenses' ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is

possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.

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

(iv) It would be possible to identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.

**QUESTION 123:****(RTP NOV '23)**

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

**ANSWER**

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

- ◆ The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

- ◆ However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

- ◆ In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments 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. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion.

For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

**QUESTION 124:****(RTP MAY '20)**

State with reason (in short) whether the following statements are true or false: In the planning stage, analytical procedures would not in any way assist the auditor.

**ANSWER**

Incorrect: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

**QUESTION 125:****(PYP 3 MARKS, NOV'19)**

Discuss the audit procedure to be considered by an auditor while performing analytical procedure to obtain audit evidence as to overall reasonableness of purchase quantity and price.

**ANSWER**

Auditor needs to perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

- (i) Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from management if any significant variations found.
- (ii) Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with compare the same with previous years and ask for the reasons from management if any significant variations found.
- (iii) Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.
- (iv) Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

**QUESTION 126:****(PYP 3 MARKS, JULY'21)**

The statutory auditor of ABC Ltd., CA Raj identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of ABC Ltd. With reference to SA 520 on "Analytical Procedures", how CA Raj shall investigate such differences?

**ANSWER**

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those

responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Conclusion: In the present case CA Raj identifies certain inconsistencies while applying analytical procedure to financial or nonfinancial data of ABC Ltd. CA Raj should inquire the management of ABC Ltd, and obtain sufficient and appropriate audit evidences relevant to the management response. Further CA Raj should also perform other audit procedures, if required in the circumstances of the case to obtain further sufficient and appropriate evidence.

(iii) with the audit evidence obtained relevant to management's response, is not considered adequate.

Conclusion: In the present case CA Raj identifies certain inconsistencies while applying analytical procedure to financial or nonfinancial data of ABC Ltd. CA Raj should inquire the management of ABC Ltd, and obtain sufficient and appropriate audit evidences relevant to the management response. Further CA Raj should also perform other audit procedures, if required in the circumstances of the case to obtain further sufficient and appropriate evidence.

**QUESTION 127:****(PYP 2 MARKS MAY'22)**

State with reasons whether the following statements are correct or incorrect SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit, that assist the auditor in preparation of the financial statements.

**ANSWER 127:**

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

**QUESTION 128:**

State with reasons whether the following statements are correct or incorrect: The term "Analytical Procedures" means evaluation of financial information through analysis of plausible relationships among financial data and non-financial data.

**ANSWER 128 :**

Correct: As per Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.



**QUESTION 129:****(PYP 3 MARKS NOV 22)**

As per the Standard on Auditing (SA) 520 "Analytical Procedures", what are the examples of analytical procedures having consideration of relationships?

**ANSWER**

Examples of Analytical Procedure having consideration of relationship:

As per the Standard on Auditing (SA) 520 "Analytical Procedures", examples of Analytical Procedures having consideration of relationships are:

- i. Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- ii. Between financial information and relevant non-financial information, such as payroll costs to number of employees.

**QUESTION 130:****(PYP 2 MARKS MAY '23)**

Analytical procedures are used in all stages of audit by experienced auditors.

**ANSWER**

Correct: Experienced auditors use analytical procedures in all stages of the audit. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.

Alternative solution:

Incorrect: Every auditor shall use analytical procedures in all stages of the audit. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.

**QUESTION NO 131**

In an initial audit engagement, in the case of inventories, 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, in such a case, additional audit procedures become necessary so that auditor may obtain sufficient appropriate audit evidence. Discuss those additional audit procedures.

**ANSWER**

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

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

**QUESTION 132**

Sanjeev, an articled clerk in an audit firm, is part of an engagement team conducting audit of a company for year 2023-24. It is a small company having a turnover of about

₹25 crores. During the course of audit, he notices that senior team member has taken following approach for selecting items for testing reflected in financial statements to obtain audit evidence: -

- He has selected to test items debited under the head “Machinery repair & maintenance” as expenditure relating to it during year 23-24 has increased considerably as compared to last year.
- Out of purchases, he has selected to test purchases from related parties amounting to ₹5 crores.
- He has also selected to test all individual items of expenditure exceeding ₹5 lakhs.
- Besides, he has also selected amount of ₹0.50 lakhs debited under head “legal expenses” to know purpose of payment made to external legal counsel.

Sanjeev understands that senior team member is using “audit sampling” for selecting items for testing. Do you agree with him? Which risk is involved in above approach? Discuss with reasons.

#### ANSWER

Audit Sampling refers to the application of audit procedures to less than 100% of items within a population relevant under the audit such that all sampling units (i.e. all the items in the population) have an equal chance of selection. In the given situation, senior team member is not selecting items for testing by means of audit sampling. He is only selecting specific items from a population. In accordance with SA 500, one of the means available to auditor for selecting items for testing is “by selecting specific items.” Specific items selected may include: -

- High value or key items: The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount: The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information: The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions. Therefore, Sanjeev’s understanding is not proper.

The above approach for selecting items for testing is subject to nonsampling risk.

Non-sampling risk is the risk that auditor may reach an erroneous conclusion for any reason not related to sampling risk. Like, erroneous conclusion may be reached due to some inappropriate audit procedure.

#### QUESTION 133

CA M, auditor of a company, has planned to use substantive analytical procedures during course of audit. In this regard, he has decided to use such procedures in following areas: -

- (i) For testing relationship between sales and cost of sales
- (ii) For testing rights over certain assets forming part of account balances

Comment upon his approach along with reasons.

**ANSWER**

(i) Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable. A predictable relationship is one that may reasonably be expected to exist and continue over time. In the given case CA M, auditor of a company, has planned to use substantive analytical procedures for testing relationship between sales and cost of sales. Hence, auditor's approach is appropriate in this case.

(ii) Using substantive analytical procedures is also affected by nature of assertion. Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). In the given case, CA M has planned to use substantive analytical procedures for testing rights over certain assets forming part of account balances. Such procedures are likely to be less effective in this case.

**QUESTION 134**

During the audit of a company, CA Z is using a software to select samples pertaining to sales records of the company. While performing this process, a window opens in software prompting the user to enter certain information. CA Z is in the process of entering information in this regard as given under: -

Selection Interval	?
Number of records to select	100
Starting record number to select	1
Ending record number to select	1000
File name	Sales

Going through the above fields, which method of sampling is likely being used in the software? Discuss. Which foremost consideration should be kept in mind by auditor for selecting samples in such a manner?

Additionally, partner of CA Z suggested him to select the first 200 sales invoices from the sales book of the last month. Which method of sampling is being suggested by partner of CA Z?

**ANSWER**

In the given case, method of sampling being used in software is known as interval sampling or systematic sampling. It is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval. Sampling interval = Sampling units in population / Sample size i.e.  $1000/100$  Sampling interval = 10 Records selected = 100 Software would pick every 10th record from 1 to 1000 records. When using this method, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population. Further, partner of CA Z suggested him to select the first 200 sales invoices from the sales book for the last month. He is suggesting him block sampling for sales, this method involves selection of a block(s) of contiguous items from within the population.

**QUESTION 135**

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence.

(MTP Mar 22, RTP May 18)

OR

The reliability of audit evidence depends on its source, nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance. Although exceptions may exist, few generalisations can be made about reliability of audit evidence. Considering above discuss such generalisations that can be made about the reliability of audit evidence.

(MTP Nov 24)

**ANSWER**

Reliability of Audit Evidence: As per SA 500 on "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, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.

While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

- (i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- (ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- (iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- (iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- (v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

**QUESTION 136**

(MTP MAR 24)

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. Give one example each for such practical and legal limitations.

**ANSWER**

Example of practical limitation on ability of auditor to obtain audit evidence

An auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Example of legal limitation on ability of auditor to obtain audit evidence

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

**QUESTION 137**

CA Kanika audited books of accounts of Engineering Ltd. for the financial year 2022-2023. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor. Comment on reliability of audit evidence obtained by performing such an audit procedure in some situations. (RTP May 24, PYP Dec 21)

**ANSWER**

Audit Procedure: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. In view of above, it can be concluded that CA Kanika used Inspection as an audit procedure.

Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example of inspection used as a test of controls is inspection of records for evidence of authorisation. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

**QUESTION 138**

SPR Ltd has been into the media business since 2001. During the F.Y 2022-2023, many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in certain circumstances only. Can you list down such circumstances?

RTP May 24, PYP May 22)



**ANSWER**

Circumstances when it becomes necessary to meet with company's external legal counsel: In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- (i) The auditor determines that the matter is a significant risk.
- (ii) The matter is complex.
- (iii) There is disagreement between management and the entity's external legal counsel. Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

**QUESTION 139**

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

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

Discuss whether each of above constitutes audit evidence. State reasoning for your answer.

**ANSWER**

Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. Purchase bill of ₹ 5.00 lacs pertaining to TIM Industries has been entered in books of TIM Private Limited. Therefore, it is contradicting management's assertion relating to occurrence of such purchases. Hence, it constitutes audit evidence.

Further, the absence of information (for example, management's refusal to provide a requested representation) is used by auditor, and therefore, also constitutes audit evidence. In the given case, management has refused to provide a written representation relating to physical verification of inventories during the year. Therefore, absence of information is used by auditor and it also constitutes audit evidence.

**QUESTION 140**

Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor? (MTP July 24)

OR

Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor? (MTP Oct 22)

OR

When information to be used as audit evidence has been prepared using the work of a management's expert and having regard to the significance of expert's work for the auditor's purposes, explain the considerations auditor would consider for the purposes of his audit. (RTP May 21)

OR

T Ltd has used the services of an expert for the purpose of physical verification of its inventory which is appearing in the financial statements of the company at ` 75 Crores. Discuss the broad parameters auditor would take into consideration while deciding about using the work performed by the Management's Expert in physical verification of company's inventory. (RTP Nov 23)

**ANSWER**

As per SA 500, "Audit Evidence", if the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: -

- (a) Evaluate the competence, capabilities and objectivity of that expert
- (b) Obtain an understanding of the work of that expert and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. Before using the work of PQR Associates, management's expert, auditor should ensure that the criteria mentioned above are fulfilled.

**QUESTION 141****(MTP AUG 24)**

Truthful Products Private Limited is engaged in trading stationery items. During the year 2023-24, there was a huge fire in one storage location of the company resulting in loss of inventories of ₹ 5 crores. As a result, the operations of the company were badly affected for about two months. Unfortunately, the insurance claim of the company was rejected due to certain defects in the policy issued and loss was booked by company in the year 2023-24 itself. There was no change in nature of business of company in relation to the last year. The draft financial statements of the company reflect following information:

Particulars	FY 2022-23	FY 2023-24
Revenue from Operations	80	100
Net profit before tax	6	10

CA D who has been the statutory auditor for past three years, has decided to rely upon the same tests of details as performed in previous years. In the given situation what is lacking on part of the auditor?

Discuss.

**ANSWER**

Maintaining professional skepticism throughout audit is necessary if auditor is to reduce risks of overlooking unusual circumstances and using inappropriate assumptions in determining the nature, time and extent of audit procedures and evaluating results thereof.

In the given situation, revenue from operations of the company have increased from ₹ 80 crores to ₹100 crores despite its operations being affected by fire for about two months. Further, despite loss of inventories to the tune of ₹ 5 crores, financial statements reflect increase in net profit before tax from 7.5% in year 2022-23 to 10% in year 2023-24. Thus, approach of CA D lacks professional skepticism.

In spite of these unusual circumstances, the auditor has decided to rely upon same tests of details as performed in the previous years. The nature and extent of audit procedures need to be suitably altered considering changed circumstances. He may include substantive analytical procedures to analyse variations and seek necessary explanations from management. In case of doubt about the reliability of information or indications of possible fraud, Standards on Auditing require auditor to determine what modifications or additions to audit procedures are necessary to resolve the matter. CA D, the auditor of a listed company, shall document the overall audit strategy, the audit plan and any significant changes made

during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

**QUESTION 142****(PYP SEP 24)**

CA B, was the auditor of Star Limited. He wanted to ensure that the company had correctly reconciled its bank accounts and also wanted to understand whether and how far the internal control system was operating in the company. What kind of test of control was CA B performing? What are the other procedures that can be applied while undertaking test of controls?

**ANSWER**

Inquiries of Management and Others Within the Entity: After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. Test of controls are performed to obtain audit evidence about the effectiveness of the: -

- (i) Design of the accounting and internal control system
- (ii) Operation of the internal control throughout the period In the given case, CA B was performing Re-performance. It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity. Other procedures that can be applied while undertaking test of controls are:
  - Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
  - Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
  - Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

**QUESTION 143****(MTP DEC 24)**

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls.

**ANSWER**

Matters the auditor may consider in determining the extent of test of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.

- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

**QUESTION 144****(MTP DEC 24)**

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

**ANSWER**

As per SA 610, "Using the Work of Internal Auditors", coordination between the external auditor and the internal audit function is effective when, for example;

- (i) Discussions take place at appropriate intervals throughout the period.
- (ii) The external auditor informs the internal audit function of significant matters that may affect the function.
- (iii) The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

**QUESTION 145****(MTP MAR 24)**

CA Z is appointed as statutory auditor of BETA Private Limited for the year 2023-24. There exists an internal audit function in the company headed by its Chief Internal Auditor, CA K. Valuation of trade receivables of company is assessed as area of higher risk by statutory auditor. He wants to take direct assistance of Chief Internal Auditor in respect of above matter. Discuss along with reasons whether it would be proper for statutory auditor to: - (i) assign checking of accuracy of aging of trade receivables to Chief Internal Auditor? (ii) assign evaluation of adequacy of provision based on aging of trade receivables to Chief Internal Auditor?

**ANSWER**

In accordance with SA 610, the external auditor shall not use internal auditors to provide direct assistance to perform procedures that relate to higher assessed risks of material misstatement where the judgment



required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

In the given situation, valuation of trade receivables is assigned as an area of higher risk by statutory auditor. Judgment required in checking of accuracy of aging of trade receivables is limited. Therefore, external auditor can assign the checking of the accuracy of the aging to Chief Internal Auditor providing direct assistance as it involves limited judgment.

However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to Chief Internal Auditor providing direct assistance.

**QUESTION 146****(RTP JAN 25)**

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

**ANSWER**

As per SA 610, "Using the work of Internal Auditor", direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor. Prior to using internal auditors to provide direct assistance for purposes of the audit, CA Mukul, the external auditor shall: -

- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and
- (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Examples of procedures in which CA Mukul shall not use internal auditor to provide direct assistance to him are: -

- (a) Procedures which involve making significant judgments in the audit;
- (b) Procedures relating to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

(c) Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

**QUESTION 147****(RTP JAN 25)**

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

**ANSWER**

As per SA 610, "Using the work of Internal Auditor", direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Prior to using internal auditors to provide direct assistance for purposes of the audit, CA Mukul, the external auditor shall: -

- (a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and
- (b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Examples of procedures in which CA Mukul shall not use internal auditor to provide direct assistance to him are: -

- (a) Procedures which involve making significant judgments in the audit;
- (b) Procedures relating to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.
- (c) Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

**QUESTION 148****(PYP SEP 24))**

You are the statutory auditor of NP Ltd. Looking at the huge size of similar transactions, you directed your team members to use statistical sampling. One of the team members, Mr. Q, wants to select samples based upon his personal experience & knowledge as he is not aware of statistical sampling. You are required to explain to Mr. Q why the use of statistical sampling method is more scientific and appropriate.

**ANSWER**

Statistical sampling: Statistical sampling is an approach to sampling that has the random selection of the sample units and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. Statistical Sampling is more scientific and appropriate as:

- Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.
- Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of samples can be evaluated and projected on the whole population in a more reliable manner.

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged.

**QUESTION 149****(PYP MAY 24))**

M/s KLM & Co. Chartered Accountants, a partnership firm, while designing tests of controls and tests of details in MN Ltd. has to determine the items for testing that can be effective in meeting the purpose of the audit procedure. For this, they decided to select specific items from a population. State the factors that can be considered by the audit firm for selecting specific items from a population and also state the specific items that can be included for such testing.

**ANSWER**

The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include:

- (i) the auditor's understanding of the entity,
- (ii) the assessed risks of material misstatement, and

(iii) the characteristics of the population being tested.

Specific items selected may include:

- ☐ High value or key items: The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.
- ☐ All items over a certain amount: The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- ☐ Items to obtain information: The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

#### QUESTION 150

(MTP AUG 24)

During the audit of a company, CA Z is using a software to select samples pertaining to sales records of the company. While performing this process, a window opens in software prompting the user to enter certain information. CA Z is in the process of entering information in this regard as given under: -

Selection Interval	?
Number of records to select	100
Starting record number to select	1
Ending record number to select	1000
File name	Sales

Going through the above fields, which method of sampling is likely being used in the software? Discuss. Which foremost consideration should be kept in mind by auditor for selecting samples in such a manner?

#### ANSWER

In the given case, method of sampling being used in software is known as interval sampling or systematic sampling. It is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval.

Sampling interval = Sampling units in population / Sample size i.e  $1000/100$

Sampling interval = 10

Records selected = 100

Software would pick every 10th record from 1 to 1000 records.

When using this method, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Further, partner of CA Z suggested him to select the first 200 sales invoices from the sales book for the last month. He is suggesting him block sampling for sales, this method involves selection of a block(s) of contiguous items from within the population.

**QUESTION 151****(MTP APR 24)**

Sanjeev, an articled clerk in an audit firm, is part of an engagement team conducting audit of a company for year 2023-24. It is a small company having a turnover of about `25 crores. During the course of audit, he notices that senior team member has taken following approach for selecting items for testing reflected in financial statements to obtain audit evidence: -

- He has selected to test items debited under the head “Machinery repair & maintenance” as expenditure relating to it during year 23-24 has increased considerably as compared to last year.
- Out of purchases, he has selected to test purchases from related parties amounting to ` 5 crores.
- He has also selected to test all individual items of expenditure exceeding `5 lakhs.
- Besides, he has also selected amount of `0.50 lakhs debited under head “legal expenses” to know purpose of payment made to external legal counsel.

Sanjeev understands that senior team member is using “audit sampling” for selecting items for testing. Do you agree with him? Which risk is involved in above approach? Discuss with reasons.

**ANSWER**

Audit Sampling refers to the application of audit procedures to less than 100% of items within a population relevant under the audit such that all sampling units (i.e. all the items in the population) have an equal chance of selection.

In the given situation, senior team member is not selecting items for testing by means of audit sampling. He is only selecting specific items from a population. In accordance with SA 500, one of the means available to auditor for selecting items for testing is “by selecting specific items.”

Specific items selected may include: -

- High value or key items: The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- All items over a certain amount: The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information: The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Therefore, Sanjeev’s understanding is not proper.

The above approach for selecting items for testing is subject to nonsampling risk. Non-sampling risk is the risk that auditor may reach an erroneous conclusion for any reason not related to sampling risk. Like, erroneous conclusion may be reached due to some inappropriate audit procedure.

**QUESTION 152****(PYP SEP 24)**

Auditors cannot normally examine all the information available to them as it would be impracticable to do so and using audit sampling will produce valid conclusions. Samples should be selected in such a manner that it is representative of the population from which the sample is being selected. Which sample selection method is used in the following two cases? Identify and explain them briefly.



- (i) Auditor divided the trade receivables in three groups: balances above ` 20 lakhs, balances between ` 10 lakhs to ` 20 lakhs and balances below ` 10 lakhs. He selected different percentages of items from each group.
- (ii) Auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year.

**ANSWER**

Sample Selections Methods:

(i) Stratified Sampling method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. In the given case, Auditor divided the trade receivables in three groups i.e. balances above ` 20 lakhs, balances between ` 10 lakhs to 20 lakhs and balances below ` 10 lakhs and he selected different percentages of items from each group will be considered as Stratified Sampling.

(ii) Block Sampling:

This method involves selection of a block(s) of contiguous items from within the population. Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once. In the given case, the auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year is Block Selection Method.

**QUESTION 153****(MTP NOV 24)**

CA Shubham, the auditor of Sigma Limited, is performing tests of controls and tests of details using audit sampling. During these procedures, he observed deviations in compliance with management's prescribed procedures for sales transactions of small values of a product at one location during tests of controls. Additionally, misstatements were identified in the sample related to these small-value sales transactions during tests of details. How should he proceed to analyse the nature and cause of the deviations and misstatements observed in the sample results?

**ANSWER**

In the given case, while performing tests of details on a sample in respect of sales, misstatements have been found by CA Shubham in selected sample pertaining to the sales transactions of small values. This indicates observance of deviations and misstatements while performing tests of controls and tests of details respectively in selected samples.

As per SA 530, "Audit Sampling", in analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.

In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

**QUESTION 154****(MTP APR 24)**

In an initial audit engagement, in the case of inventories, 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, in such a case, additional audit procedures become necessary so that auditor may obtain sufficient appropriate audit evidence. Discuss those additional audit procedures.

**ANSWER**

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

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

**QUESTION 155****(MTP MAR 24)**

While performing statutory audit of Contra Industries Private Limited, a company engaged in manufacturing and assembling of LED lights, CA Varun has decided to attend physical inventory count process of the company on 30th and 31st March, 2024. The inventories are lying at three different locations - two such locations A and B are in one city and third location C is in another city. Further, company also sends inventories to some service providers for quality control and testing as such facilities are not available with the company.

CA Varun is well-versed with this type of industry and has prepared a list of following matters which could be relevant to him in planning attendance at physical inventory count process for discharging his responsibilities in accordance with SAs: -

- Nature of inventories i.e. LED light components, parts, circuits, panels, body, WIP and finished packed LED lights
  - Materiality of inventories at different locations A, B and C
  - Stage of completion of work-in-progress
  - Maintenance of perpetual inventory system by company
  - Materiality of inventories lying with service providers
  - Timing of physical inventory counting i.e. year end
- There are two important matters which do not find place in above list. Without considering these crucial matters, it would be difficult for the auditor

to properly plan his attendance at inventory count process in accordance with relevant SA. Discuss such matters.

**ANSWER**

The list given in the question does not contain following important matters: -

- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting. The auditor has to evaluate management's instructions for recording and controlling physical inventory counting. It is important for the auditor to know beforehand how the inventory count will be conducted so as to assess its effectiveness.
- The nature of internal control related to inventories at different locations. It is possible that inventories at one location have unsatisfactory control leading to higher risk of material misstatement related to inventories at that particular location.

**QUESTION 156****(RTP SEP 24)**

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

**ANSWER**

In accordance with requirements of 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:

- (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.

Other audit procedure may include –

- Inspecting documentation regarding inventory held by third parties.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- 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.

**QUESTION 157****(MTP JULY 24)**

Zed Limited is engaged in the manufacturing and export of shoes. The statutory auditor of the company wants to reasonably ensure that only the inventories recorded in the financial statements are exclusively owned by the company and do not include any inventories that belong to third parties but includes inventories owned by the company but lying with third party. Advise the auditor on the audit procedures to be performed to achieve this assurance.

**ANSWER**

Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under: -

- Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
  - Compute inventory turnover ratio (COGS/ average inventory)
  - Perform vertical analysis (inventory/ total assets)
  - Compare budgetary expectations vis-à-vis actuals
- Examine non-financial information related to inventory, such as weights and other measurements.
- Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- Verify the clerical and arithmetical accuracy of inventory listings.
- Reconcile physical inventory amounts with perpetual records.
- Reconcile physical counts with ledger control totals.
- Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
- Goods received on a consignment basis have been properly segregated from other items of inventory.

**QUESTION 158****(PYP MAY 24)**

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

**ANSWER**

A letter of specific inquiry includes:

- (i) A list of litigation and claims;
- (ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (iii) 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 by the entity's external legal counsel to be incomplete or incorrect.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. Further, if management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding, and the auditor is unable to obtain sufficient appropriate evidence by performing alternate audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

Alternatively, if the auditor is able to perform alternate audit procedures and can obtain sufficient and appropriate audit evidence to resolve the issue, then he can give an unmodified opinion.

**QUESTION 159****(MTP DEC 24)**

Kavita, auditor of Healthify Ltd., while assessing potential risks of material misstatement related to CA litigations at Healthify Ltd., identified a possible legal claim that could affect the financial statements. She sent a general inquiry letter to the company's external legal counsel, Mohit & Co., seeking clarification. However, Mohit & Co. informed her that their professional rules prohibited them from responding to these general inquiries. Guide CA Kavita that what other option is available to obtain the necessary information for the audit?

**ANSWER**

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

- (i) A list of litigation and claims;
- (ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (iii) 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 by the entity's external legal counsel to be incomplete or incorrect.

**QUESTION 160****(MTP JULY 24)**

CA X is contemplating the use of negative confirmation requests as the sole substantive audit procedure to verify certain accounts payable balances reflected in financial statements of a company. Which conditions need to be met to use negative confirmation requests as stated above? Additionally,



CA X is of the view that negative confirmations provide same level of persuasive audit evidence as in case of positive confirmations. Do you agree with his viewpoint? Provide reasons for your answer.

**ANSWER**

In accordance with SA 505, "External Confirmations", the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- (i) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.
- (ii) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions.
- (iii) A very low exception rate is expected and
- (iv) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

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

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

Therefore, view of CA X is not correct.

**QUESTION 161****(RTP MAY 24, MAY 20)**

CA J is conducting statutory audit of Gemini Ltd engaged in manufacturing of pharma products. The company is fairly large one and has a well-functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, CA J has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is the approach of CA J proper?

**ANSWER**

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- (a) Determining the information to be confirmed or requested;
- (b) Selecting the appropriate confirming party;
- (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- (d) Sending the requests, including follow-up requests when applicable, to the confirming party. In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

**QUESTION 162****(PYP MAY 23,PYP NOV 20,MTP DEC 24)**

CA P is the auditor of MN Ltd. While scrutinising the accounts of MN Ltd., he observed that the company had large volume of Trade payable outstanding in the Balance sheet as on 31st March, 2023 for which external confirmations are not available, CA P wants to send external confirmation request to selected Trade payables but management of MN Ltd . refused for the same. Discuss how CA P should deal in this regard as per relevant Standard on Auditing.

**ANSWER**

If management refuses to allow the auditor to send a confirmation request, CA P should deal in this regard in the manner prescribed in SA 505 explained hereunder:

- (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 those charged with governance in accordance with SA 260.

The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with SA 705.

**QUESTION 163****(PYP SEP 24)**

During the audit of accounts for the year ended 31.03.2024, the auditor of FD Limited wanted confirmation from a Trade Receivable, which was outstanding for more than six months, amounting to ₹ 4,25,000/-. The auditor sent a Confirmation letter to the party requesting them to respond directly to him, whether or not they agree with the amount outstanding from them.

That trade receivable confirmed to the auditor of FD Limited, that they were required to pay an amount of ₹ 4,20,000 to FD Limited as per their books of accounts.

State and explain the type of Confirmation Request sent by the auditor and the course of action that he should take on the confirmation received from the trade receivable.

**ANSWER**

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.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party. The exception needs to be assessed to the entire population after analyzing the reason for difference.

In the given situation, the auditor has sent the positive confirmation request for the amount of 4,25,000 to a trade receivable which was outstanding for more than 6 months, however, due to difference between information requested to be confirmed, or contained in the entity's records (i.e.

4,25,000), and information provided by the confirming party (i.e. 4,20,000) is forming situation of exception confirmation.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330 in case a response is indicating an exception.

The company should be asked to investigate and reconcile the discrepancy indicated by the confirming party.

**QUESTION 164****(PYP MAY 22, MTP APR 23, RTP MAY 24)**

M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach?

**ANSWER**

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.

From the above, it is quite clear that CA Pankaj is not correct in his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

**Audit Procedures regarding Opening Balances;** The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (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 policies; and
- (c) Performing one or more of the following:
  - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
  - (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.

**QUESTION 165**

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related

party relationships, transactions or balances. During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples.(RTP NOV 21,MTP OCT 23)

While performing audit of financial statements of a listed company, statutory auditor needs to maintain an attitude of professional skepticism for related party information. State examples of the records or the documents that may provide information about related party relationships and transactions.(MTP JULY 24)

#### ANSWER

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. Examples of the records or the documents that may provide information about related party relationships and transactions are:

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 those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
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 auditor's reports.
12. Documents associated with the entity's filings with a securities regulator (e.g. prospectuses).

#### QUESTION 166

(PYP MAY 24)

XY and Associates are auditors of PQR Ltd., which provides electrical components on project basis. The purchases are huge and the auditor wants to make sure that all the purchases made during the period are recorded and there is no understatement or overstatement. For this purpose the audit team have performed procedures like cut-off tests, correct treatment of goods in transit, obtaining written representations and performing analytical procedures. What are the analytical procedures required to be performed to obtain audit evidence as to overall reasonableness of purchase quantity and price?

#### ANSWER

The auditor should perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

- (i) Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management, if any significant variations are found.
- (ii) Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.

- (iii) Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.
- (iv) Quantitative Reconciliation: Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

**QUESTION 167****(MTP AUG 24)**

CA M, auditor of a company, has planned to use substantive analytical procedures during course of audit. In this regard, he has decided to use such procedures in following areas: -

- (i) For testing relationship between sales and cost of sales
  - (ii) For testing rights over certain assets forming part of account balances
- Comment upon his approach along with reasons.

**ANSWER**

- (i) Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable. A predictable relationship is one that may reasonably be expected to exist and continue over time. In the given case CA M, auditor of a company, has planned to use substantive analytical procedures for testing relationship between sales and cost of sales. Hence, auditor's approach is appropriate in this case.
- (ii) Using substantive analytical procedures is also affected by nature of assertion. Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). In the given case, CA M has planned to use substantive analytical procedures for testing rights over certain assets forming part of account balances. Such procedures are likely to be less effective in this case.

**QUESTION 168****(MTP NOV 24)**

CA Srishti, while auditing KSM Private Limited for the first time, utilised software to analyse financial data, comparing amounts recorded in the financial statements for the current audit year with the preceding two years. Her objective was to evaluate the risk of material misstatement.

Identify the type of audit procedure performed by CA Srishti in the given case, discuss its relevance, and explain whether an auditor's opinion can solely rely on such procedures.

**ANSWER**

In the given case, CA Srishti is performing analytical procedures as risk assessment procedures. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

Analytical procedures performed as risk assessment procedures may include both financial and non-financial information. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.



Risk assessment procedures are a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Thus, it can be concluded that auditor's opinion cannot be solely based upon such procedures.