

1.

*M/s K & Co., Chartered Accountants were appointed as statutory auditors of PC limited for the financial year 2023-24. During the course of audit, one of the partners CA K observed that there is misappropriation of assets in the form of theft of entity's inventory and is perpetrated by employees in relatively small and immaterial amounts. CA K is concerned with the existence of certain circumstances for increasing the susceptibility of assets to misappropriation. Guide CA K with respect to Risk factors related to misstatements arising from misappropriation of assets with reference to relevant Standards.*

**Guidance to CA K with respect to risk factors that relate to misstatements arising from misappropriation of assets as per ISA 240 is:**

**“The Auditor’s Responsibilities Relating to Fraud in an audit of Financial Statements”**, misappropriation of assets involves the theft of entity’s assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

**Misappropriation of assets** can be accomplished in a variety of ways including stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization.

#### **Incentives/Pressures**

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- (i) Known or anticipated future employee layoffs.
- (ii) Recent or anticipated changes to employee compensation or benefit plans.
- (iii) Promotions, compensation, or other rewards inconsistent with expectations.

#### **Opportunities**

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- (i) Large amounts of cash on hand or processed.
  - (ii) Inventory items that are small in size, of high value, or in high demand.
  - (iii) Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
  - (iv) Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
- (i) Inadequate segregation of duties or independent checks.
  - (ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
  - (iii) Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.
  - (iv) Inadequate job applicant screening of employees with access to assets.
  - (v) Inadequate record keeping with respect to assets.
  - (vi) Inadequate system of authorization and approval of transactions (for example, in purchasing).

- (vii) Inadequate physical safeguards over cash, investments, inventory, or fixed assets. (viii) Lack of complete and timely reconciliations of assets.
- (ix) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- (x) Lack of mandatory vacations for employees performing key control functions.
- (xi) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- (xii) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

#### **Attitudes/Rationalizations**

- (i) Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- (ii) Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- (iii) Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- (iv) Changes in behaviour or lifestyle that may indicate assets have been misappropriated.

*2. Mr. A, in the course of audit of PQ Limited, wants to perform external confirmation procedures to obtain audit evidence. Guide Mr. A, listing out the factors that may assist him in determining whether external confirmation procedures are to be performed as substantive audit procedures.*

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

- (i) The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- (ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:
  - May not accept responsibility for responding to a confirmation request;
  - May consider responding too costly or time consuming;
  - May have concerns about the potential legal liability resulting from responding;
  - May account for transactions in different currencies; or
  - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.
- (iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

3.

*JKL Limited is engaged in the business of Construction and real estate having various projects across states. M/s YT & Co, Chartered Accountants have been appointed as Statutory Auditors. Audit Team from M/s YT & Co for audit of JKL Limited comprises of CA Z-Engagement Partner, CA Q, a paid assistant and 3 Articled Assistants. During preliminary verification, CA Z observed that huge amount of sub-contract payments were made to M/s JB Associates, a partnership firm in which Director of JKL Limited is a managing partner. The engagement team discussed that ISA 315 and ISA 240 shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or*

*error that could result from the JKL Limited's related party relationships and transaction. Highlight the matters that are to be addressed in the discussion by CA Z with engagement team members with reference to the relevant Standard on Auditing.*

**As per ISA 550 “Related Parties”**, the engagement team discussion that ISA 315 and ISA 240 require shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity’s related party relationships and transactions. Accordingly matters that are to be addressed in the discussion by CA Z among the engagement team include:

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

4.

*During the audit of Star Ltd. a company engaged in the production of paper, the auditor received certain confirmation for the balances of trade payables outstanding in the balance sheet through external confirmation by "Negative Confirmation Request". In the list of trade payables, there are number of small balances except one which is an old outstanding of ` 20 Million for which no confirmation was received. Comment with respect to Standards relating to the confirmation process and how to deal the non-receipt of confirmation.*

**External Confirmation:** As per ISA 505, “External Confirmation”, negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

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

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

Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise. In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ` 20 Million has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non-response for negative confirmation request does not mean that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.