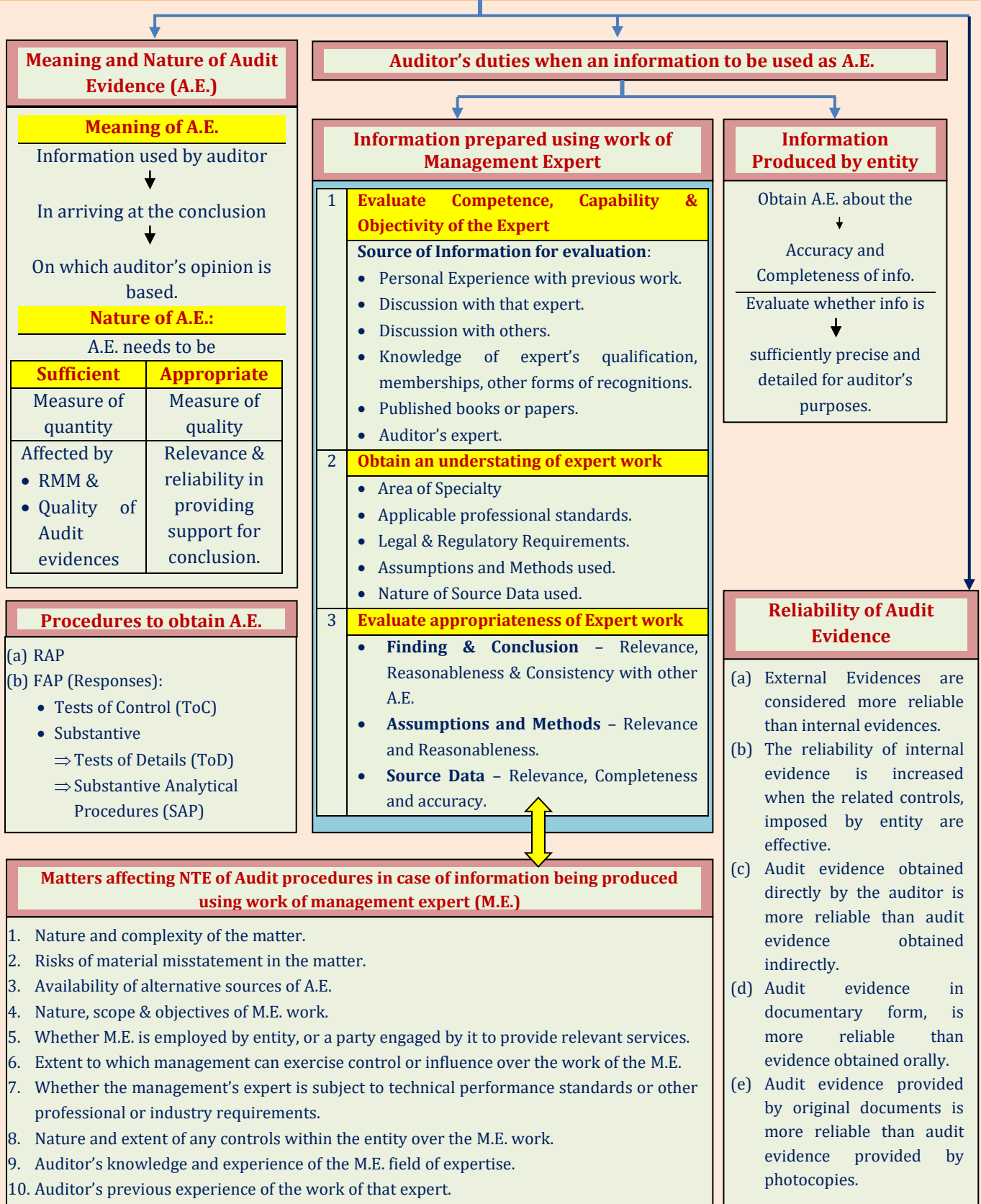


Audit Evidence

5.1 - SA 500 "Audit Evidence"



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



Inventory – Existence & Condition

General Procedures

When inventory is material to the F.S.
 ↓
 the auditor shall obtain SAAE
 ↓
 regarding **existence & condition** by

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

Special Procedures

- | | |
|---|---|
| 1 | Inventory counting conducted at date other than B/S date |
| | Perform audit procedures to obtain audit evidence
↓
about whether changes in inventory between the count date and the date of the F.S. are properly recorded. |
| 2 | Auditor unable to attend Inventory Count |
| | Make or observe some physical counts on an alternative date,
↓
and perform audit procedures on intervening transactions |
| 3 | Attendance at inventory count is impracticable |
| | Perform alternative audit procedures to obtain S.A.A.E. regarding existence and condition of inventory.
↓
If it is not possible to do so, modify the opinion in the auditor's report in accordance with SA 705. |
| 4 | Inventory under custody and control of Third Party |
| | Obtain S.A.A.E by performing the following:
(a) Request confirmation from third party.
(b) Perform Inspection/other audit procedure. |

Litigation & Claims – Completeness

Auditor is required to identify litigation and claims by following procedures:

- **Inquiry:** of Mngt. & others within entity, including in house legal counsel.
- **Review** – minutes of meetings of TCWG, communication between entity & external legal counsel.
- **Review** – legal expenses account.

If management refuses to permit auditor to communicate with legal counsel / external legal counsel refuses / auditor unable to collect SAAE by performing alternate procedures

↓

Modify Opinion in accordance with SA 705

Segment Reporting – Presentation & Disclosures

Obtain SAAE regarding presentation & disclosure of segment information in accordance with the applicable FRF by:

(a) Obtaining an understanding of the methods used by management in determining segment information, and

- Evaluate whether such methods are likely to result in disclosure in accordance with the applicable FRF; and
- Where appropriate, testing the application of such methods; and

(b) Performing analytical procedures or other audit procedures appropriate in the circumstances.

- Examples of Matters relevant in obtaining an understanding of methods used by management for determining segment information**
- (1) Sales, transfers and charges between segments, and elimination of intersegment amounts.
 - (2) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
 - (3) The allocation of assets and costs among segments.
 - (4) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

SA - 505 "External Confirmation"

The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.



Meaning & Type of E.C.

Audit Evidence obtained as a direct written response to auditor from 3rd Party in
 ⇒ Paper
 ⇒ Electronic
 ⇒ Other form.

2 Types	
+ ve Request	- ve request
Request that 3 rd Party respond directly to auditor	Request that 3 rd Party respond directly to auditor
indicating whether it agrees or disagrees	only if it disagrees
With the info in request or providing requested info.	with the information in the request

- Areas where External Confirmation may be obtained:**
- (a) Bank balance & Other confirmation from bankers
 - (b) Account Receivable/Account Payable Balances
 - (c) Stock Lying with Third Parties
 - (d) Property Title Deed held by third parties
 - (e) Investments Purchased but delivery not taken.
 - (f) Loan from Lenders
 - (g) Terms of agreement or Transaction with Third Parties

External Confirmation Procedures

Determining the information to be confirmed.
 ↓
 Selecting the Appropriate Third Party.
 ↓
 Designing the confirmation request.
 ↓
 Sending the request including follow up.

Factors to be considered while designing E.C. request:

- Assertions being addressed.
- Specific identified RMM.
- Layout and presentation of request.
- Prior Experience of audit.
- Method of Communication.
- Management Authorization.
- Ability of confirming party to provide the requested information

Audit Procedures in Special Circumstances

Mngt. refuses to allow the auditor to send request

- Inquire the reasons
- Evaluate the implications on RMM
- Perform Alternative Audit procedure.

• Refusal appears to be unreasonable	• Communicate to TCWG.
• Unable to collect audit evidence	• Determine its effect on Opinion

Responses to E.C. request

• Creates Doubt	Obtain Further Evidences
• Not Reliable	Consider its effect on NTE of other procedures
• No Response	Perform Alternative procedure
• Unable to collect evidence	Determine its effect on Opinion
• Exception occurs	Investigate to determine misstatement

Limited use of -ve Request

-ve confirmation request provides less persuasive evidence than the positive Confirmation request.

↓

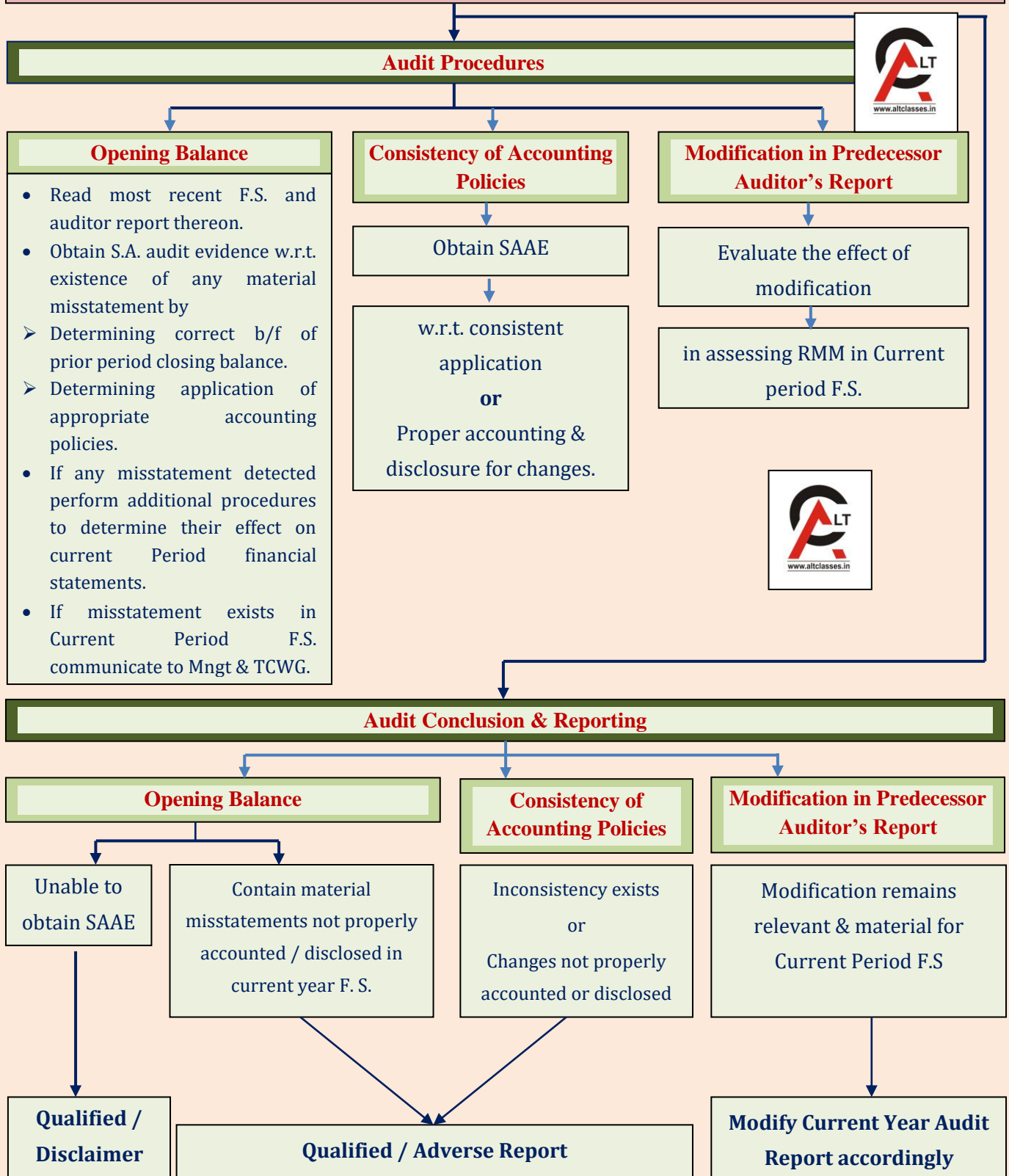
Circumstances in which negative request may be used as sole substantive procedure:

- Low RMM.
- Population consists of large number of small, homogeneous account balances.
- Expectation of low exception rate.
- Auditor not aware of circumstances that 3rd party disregard request.

SA 510 "Initial Audit Engagements - Opening Balances"

Meaning of Initial Audit Engagement: An Engagement in which financial statements for prior period are not audited or were audited by predecessor auditor.

Meaning of Opening balance - A/c balance that exist at beginning of period & also includes disclosures exists at beginning of period.



SA 530 "AUDIT SAMPLING"



Sampling Risk

Risk that auditor's conclusion based on a sample may be different from conclusion if the entire population were subjected to same audit procedure.

Non Sampling Risk

Risk that auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Test of controls

Controls are more effective than they actually are

Controls are less effective than they actually are

Tests of details

Material misstatements does not exist when in fact it does.

Material misstatement exists when in fact it does not

Affects **audit effectiveness** & is more likely to lead to inappropriate audit opinion.

Affects **audit efficiency** as it would lead to additional work to establish that initial conclusions were incorrect.

Stratification and its Uses

Process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics.

Uses of Stratification

- (i) Improved Audit efficiency. Stratification reduces variability of items within each stratum & hence allow sample size to be reduced without increasing sampling risk.
- (ii) When performing TODs, population is often stratified by monetary value. This allows greater audit effort to be directed to larger value items, as these items may contain greatest potential misstatement in terms of overstatement.
- (iii) Results of audit procedures applied to sample of items within a stratum can only be projected to items that make up that stratum. To draw a conclusion on entire population, auditor will need to consider RoMM in relation to whatever other strata make up entire population.
- (iv) If a class of transactions or account balance has been divided into strata, misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering possible effect of misstatements on total class of transactions or account balance.

Auditor's Duties

- 1 **Sample design, size and selection of items**
 - (i) While designing, consider purpose of audit procedure and characteristics of population.
 - (ii) Sample size should be sufficient to reduce sampling risk to an acceptably low level.
 - (iii) Selection should be in such a way that each sampling unit in population has a chance of selection.
- 2 **Perform audit procedures**
 - (i) Perform audit procedures, appropriate to the purpose, on each item selected.
 - (ii) If audit procedure is not applicable to selected item, perform procedure on a replacement item.
 - (iii) If auditor is unable to apply designed audit procedures/alternative procedure to a selected item, consider that item as a deviation.
- 3 **Evaluation of results of audit sampling**
 - Evaluate results of sample and determine whether use of audit sampling has provided a reasonable basis for conclusions about population that has been tested.
 - If any error or misstatement identified, investigate its nature & cause, & evaluate their possible effect on purpose of audit procedure and other areas of audit.
 - In analysing deviations and misstatements identified, auditor would also need to consider qualitative aspects of the misstatements identified by him.

SA 550 "Related Parties (RP)"



Auditor's Duties

ET Discussions

Risk Assessment procedures

SA 315 & SA 240 require ET Team discussion.

Matters to be addressed in ET Discussion

- 1 **Understanding the Entity's RP relationship and Transactions**
 - a. Auditor to inquire management regarding:
 - Identity of entity's RP, changes from prior period.
 - Nature of relationships between entity and RP.
 - Type & purpose of transactions with RP.
 - b. Obtain understanding whether management has established controls to:
 - Identify, account for & disclose RP relationships & transactions.
 - Authorise & approve significant transactions with RP.
 - Authorise & approve significant transactions outside normal course of business.

- Matters include:
 - ⇒ Nature & extent of entity's relationships & transactions with RPs.
 - ⇒ Emphasis on maintaining professional skepticism throughout audit w.r.t. potential for material misstatement associated with RPs relationships & transactions.
 - ⇒ Circumstances that may indicate existence of RP relationship & transaction that mngt. has not identified or disclosed to auditor.
 - ⇒ Records or documents that indicate existence of RP relationship or transactions.
 - ⇒ Importance that mngt. & TCWG attach to identification, appropriate a/cing for, and disclosure of RP relationship & transaction and related risk of mngt. override of relevant controls.

- 2 **Maintaining Alertness for RP Information when Reviewing Records/Documents**
 - Auditor to remain alert when inspecting records w.r.t. info indicating existence of RP relationships or transactions not previously identified or disclosed.
 - If auditor identifies significant transactions outside entity's normal course of business, inquire of management about (a) Nature of these transactions, and (b) Whether RP could be involved.

Possible Sources for identification of RP Information:

1	Income Tax Returns	7	Shareholder's Register
2	Internal Audit Report	8	Life insurance Policies
3	Contracts with Management	9	Statement of conflict of interest
4	Contracts outside normal course of business	10	Information supplied to regulatory authorities
5	Contracts renegotiated	11	Specific Invoices from advisors
6	Register of Investments		

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

1. Complex equity transactions, such as corporate restructurings or acquisitions.
2. Transactions with offshore entities in jurisdictions with weak corporate laws.
3. The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
4. Sales transactions with unusually large discounts or returns.
5. Transactions with circular arrangements, e.g., sales with commitment to repurchase.
6. Transactions under contracts whose terms are changed before expiry.

- In addition, discussion in context of fraud may include specific consideration of how RPs may be involved in fraud. For example:
 - ⇒ How special-purpose entities controlled by mngt. might be used to facilitate earnings mngt.
 - ⇒ How transactions between entity & known business partner of a key member of mngt. could be arranged to facilitate misappropriation of assets.

- 3 **Identifying Fraud risk factors**

Domination of management by a single person or small group without compensating controls is a fraud risk factor.

Indicators of dominant influence:

 - RP has vetoed significant business decisions taken by management or TCWG.
 - Significant transactions are referred to RP for final approval.
 - No/little debate among mgmt./TCWG regarding business proposal initiated by RP.
 - Transactions involving RP are rarely independently reviewed / approved.

Responses to Assessed Risks

- 1 **Identification of unidentified / undisclosed RP or RP transaction.**
 - Communicate to other members of ET.
 - Request management to identify the transactions with the newly identified RP.
 - Inquire for mngt. failure to identify RP/disclose RP relationship & transactions.
 - Reconsider risk that other unidentified RP or undisclosed RP transactions may exist.
 - If non-disclosure appears intentional, evaluate implications for audit.
- 2 **Identified significant RP Transactions outside Entity's Normal course of Business.**
 - Inspect underlying contracts to evaluate business rationale.
 - Examine the terms on which transactions takes place.
 - Collect evidences w.r.t. approval and authorisation of transaction.
 - Collect evidences for appropriate accounting & disclosure in compliance of FRF.
- 3 **Assertions that RP Transactions were conducted on arm Length price.**
 - Collect SAAE w.r.t. management assertion of Arm's length transaction.
 - Compare transaction prices with prices for identical transactions prevailing in ordinary course of business.
 - Engage expert to determine market value.