

# Standards on Audit evidence (SA 500 to 599)

18 January 2014



## Standards (SA 500 to 599) covered under Audit Evidences

The following auditing standards relating to Audit Evidence have been issued under the Clarity Project by the Auditing and Assurance Standard Board (AASB) of the ICAI:

SA 500 (Revised) "Audit Evidence"

SA 501 (Revised) "Audit Evidence—Specific Considerations for Selected Items"

SA 505 (Revised) "External Confirmations"

SA 510 (Revised) "Initial Audit Engagements – Opening Balances"

SA 520 (Revised) "Analytical Procedures"

SA 530 (Revised) "Audit Sampling"

SA 540 (Revised) "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"

SA 550 (Revised) "Related Parties"

SA 560 (Revised) "Subsequent Events"

SA 570 (Revised) "Going Concern"

SA 580 (Revised) "Written Representations"

# SA 500 – Audit Evidence

- **This SA is applicable to all the audit evidence obtained during the course of the audit**
- **Other SAs like SA 570 on Going Concern, SA 520 on Analytical Procedures deal with audit evidence to be obtained in relation to a particular topic.**
- **What is Audit Evidence?**

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.
- **Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry.**
- **Requirements relating to information to be used as audit evidence**
  - Auditor should consider the relevance and reliability of the information to be used as audit evidence.
  - Verifying the accuracy and completeness of the information
  - Verifying whether the information is sufficiently precise and detail.
- **If there is inconsistency in or doubts over reliability of audit evidence, the auditor shall**
  - Determine modifications or additions to audit procedures to resolve the matter
  - Consider the effect of the matter, if any, on other aspects of the audit

## Using the work of Management's Expert

- **When using the work of a management's Expert, audit evidence that the auditor should obtain include:**
  - Evaluate the competence, capabilities and objectivity of that Expert
    - Whether the Expert is employed by the entity or is engaged by it
    - The extent to which management can exercise influence or control over the Expert
    - Auditor's previous experience of the work of the Expert
    - Knowledge of the Expert's qualification, membership of a professional body or industry association
  - Obtain an understanding of the work of that expert
    - Whether the auditor has expertise to evaluate the work of the Expert
    - Whether any professional or other standards, and regulatory or legal requirements apply
    - Evaluating the assumptions and methods used by the management
    - Evaluating the nature of internal or external data used by the Expert
  - Evaluate the appropriateness of his work as audit evidence for the relevant assertion.
    - Relevance and reasonableness of the Expert's findings or conclusions
    - Evaluating the relevance, completeness and accuracy of the source data used by the Expert.

## Selecting Items for Testing to Obtain Audit Evidence

- **The means available to the auditor for selecting items for testing include:**
  - Selecting all items (100% examination)
    - May be possible in tests of details
    - When the population consists of the small number of large value items
    - There is a significant risks and other means do not provide sufficient appropriate audit evidence.
    - It may be cost effective due to the nature of the calculation or process performed automatically by information systems
  - Selecting specific items
    - High value or key items – for example, unusual, suspicious or risk prone
    - All items over a certain amount
    - Items to obtain information such as the nature of transactions
  - Audit sampling
    - Covered specifically by SA 530

**Application of any one of the above or combination of these may be appropriate depending on the risks of material misstatement and the practicality and efficiency of different means**

## SA 501 – Audit Evidence – specific considerations for selected items

- **This SA provides information regarding audit evidence about:**
    - Existence and condition on inventory
    - Completeness of litigation and claims involving the entity
    - Presentation and disclosure of segment information in accordance with the applicable financial reporting framework
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## Inventory

- **The auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending a physical inventory counting and:**
  - Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting
  - Observe the performance of management's count procedures
  - Inspect the inventory
  - Perform test counts
  - Perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
  
- **Some practical challenges/ issues:**
  - What happens if the auditor is not able to attend inventory counts due to unforeseen circumstances
  - Inventory count is conducted at a date other than the date of the financial statements
  - Attending physical inventory count is impracticable
  - Inventory under the custody and control of the third party is material to the financial statements
  - Auditor has been appointed to do audit for the last 2-3 years

## Litigations and Claims

- **The auditor shall design and perform audit procedures to identify litigations and claims involving the entity which may give rise to a risk of material misstatement, including:**
    - Inquiry with the management including in-house legal counsel
    - Reviewing minutes of meetings of those charged with governance and the correspondence between the entity and its external legal counsel
    - Reviewing legal expenses accounts
    - Seek direct communication with the entity's external legal counsel
      - If a risk of material misstatement regarding litigations or claims has been identified
      - Audit procedures indicate that other material litigations or claims exists
- **Some practical challenges/ issues:**
    - Management refuses to give the auditor permission to communicate or meet the external legal counsel
    - What happens if the entity's external legal counsel does not respond
    - No legal counsel consulted or change of legal counsel

**Auditor should obtain a written representation from the management that all known actual or possible litigations and claims whose effects should be considered have been communicated to the auditors and disclosed/ accounted appropriately**



## SA 505 External Confirmations

- **What is an External Confirmation**

Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium

- **Requirements while performing External Confirmation Procedures**

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

- (a) Determining the information to be confirmed or requested – regarding account balances and their elements; also to confirm terms of agreements, contracts or transactions between an entity and other parties or to confirm the absence of certain conditions such as a ‘side agreement’;
- (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

- **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
  - guarantees
  - contingent liabilities
  - significant transactions outside the normal course of business
  - related party relationships and related party transactions

- **Factors to be considered while designing the confirmation requests:**
  - design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses
  - Prior experience on the auditor's similar engagements
  - management's authorization or encouragement to the confirming parties to respond to us. Confirming parties may only be willing to respond to a confirmation request containing management's authorization.
  - The ability of the intended confirming party to confirm or provide the requested information
  - Specific identified risks of material misstatement, including fraud risks
  - Appropriate format including assertions addressed
  - How do we check complete addresses and balances
  - Should we attach statement of account, terms and conditions and absence of side agreement
  - Ask an appropriate entity official to manually sign the request
  - Addressed to whom within the third party
  - Include detail to support the information being confirmed
  - Direct the confirmation request "to the attention of" a specific department or employee of the respondent
  - Contain return information for responses to be sent directly to us

- **Selecting the appropriate confirming party includes determining :**
    - Entire population/ specific items
    - Consider ROMM assessment
    - What is the history of errors
    - What is the rate of confirmations received
    - Prior experience
    - Evidence from other audit procedures
  
  - **Sending the requests:**
    - Mode of sending confirmations.....independent?
    - Independent courier / registered post
    - Client /office / another courier?
    - Have we retained copies of letter sent?
    - Proof of deliveries/ registered post receipts/ copies of emails
    - Reminders
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- **In case negative confirmation request has been used, it cannot be the only substantive audit procedure, unless all of the following are present:**
  - 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;
  - The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
  - A very low exception rate is expected; and
  - The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.
  
- **Challenges/ Issues an auditor may face when sending confirmation requests:**
  - Management may refuse to allow the auditor to send a confirmation request
  - Responses to confirmation requests is not reliable
  - Non-responses to confirmation requests sent
  - Response to a confirmation request is necessary to obtain sufficient appropriate audit evidence

## SA 570 – Going Concern

### **The Going Concern Assumption:**

One of the fundamental accounting assumptions used by the management for preparation and presentation of financial statements is 'Going concern'

This accounting assumption assumes that an enterprise will continue to exist long enough to carry out its objectives and commitments and will not liquidate in the foreseeable future

The auditor is required to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption

SA 570 envisages two scenarios:

- (a) Use of going concern assumption is appropriate but a material uncertainty exists
  - (b) Use of going concern assumption is inappropriate
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### **Scenario (a) Use of going concern assumption is appropriate but a material uncertainty exists:**

The auditor would need to evaluate whether a material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, including evaluating mitigating factors, if any

A material uncertainty exists when the magnitude of its potential impact and the likelihood of its occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and the implications of the uncertainty is necessary for a fair presentation of the financial statements

The disclosure would also include a statement to the effect that the entity may be unable to realize its assets and discharge its liabilities in the normal course of business

Where adequate disclosures have been made, the auditor would need to express an unmodified opinion and include an Emphasis of Matter paragraph to highlight the material uncertainty which casts a doubt on the entity's ability to continue as a going concern

In case where adequate disclosures have not been made, the audit report would need to be qualified

### **Scenario (b) Use of going concern assumption is inappropriate :**

If the auditor concludes that going concern assumption is inappropriate, the accounts cannot be prepared on a going concern basis

If these are in any case prepared on a going concern basis, the auditor would need to express an adverse opinion

A tabular presentation of the approach prescribed in the SA is as follows:

<b>Management’s use of going concern assumption</b>	<b>Whether events or conditions constitute a material uncertainty on ability to continue as a going concern</b>	<b>Adequacy of related disclosures in the financial statements</b>	<b>Impact on audit opinion</b>
<b>Appropriate</b>	<b>Does not exist</b>	<b>Adequate</b>	<b>Unmodified opinion</b>
<b>Appropriate</b>	<b>Exists</b>	<b>Adequate</b>	<b>Unmodified opinion (but include an Emphasis of matter para in the auditor’s report)</b>
<b>Appropriate</b>	<b>Exists</b>	<b>Disclosures are not made</b>	<b>Qualified opinion or Adverse opinion</b>
<b>Inappropriate</b>	<b>Exists</b>	<b>Not relevant</b>	<b>Adverse opinion</b>
<b>Inappropriate</b>	<b>Multiple Material uncertainties are significant to the financial statements as a whole</b>	<b>Not relevant</b>	<b>Disclaimer of opinion</b>



## SA 550 – Related Parties

### Responsibilities of the auditor

Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless 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 (for fair presentation frameworks); 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 one or more fraud risk factors are present as required by SA 240 because fraud may be more easily committed through related parties

### Definitions

Arm's length transaction—A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests

Related party – A party that is either:

- (i) A related party as defined in the applicable financial reporting framework; or
- (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
  - a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
  - b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
  - c. Another entity that is under common control with the reporting entity through having:
    - i. Common controlling ownership;
    - ii. Owners who are close family members; or
    - iii. Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another

**Identified Significant Related Party transactions outside the entity’s normal course of business**

The auditor shall:

- Inspect the underlying contracts or agreements and evaluate whether:
  - The business rationale (or lack thereof)
  - The terms of the transactions are consistent with management’s explanation
  - The transactions have been appropriately accounted for and disclosed
- The transactions have been appropriately authorised and approved.
- The transactions have been conducted on terms equivalent to those prevailing in an arm’s length transaction

In forming an opinion on the financial statements, the auditor shall evaluate:

- Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed
  - Whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation
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**Which transactions are outside the entity's normal course of business**

In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following:

- Whether the transaction:
  - Is overly complex (e.g., it may involve multiple related parties within a consolidated group).
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms
  - Lacks an apparent logical business reason for its occurrence
  - Involves previously unidentified related parties
  - Is processed in an unusual manner

The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out

**Requirements of a fair presentation frameworks**

In the context of a fair presentation framework, related party relationships and transactions may cause the financial statements to fail to achieve true and fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, true and fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend

## SA 510 Initial Audit Engagements – Opening Balances

- **What is Initial audit engagement?**

It is an engagement in which either:

- The financial statements for the prior period were not audited; or
- The financial statements for the prior period were audited by a predecessor auditor

- **What are opening balances?**

- Those account balances that exist at the beginning of the period.
  - Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period
  - Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments
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- **Audit procedures to be performed on opening balances:**

- Read the most recent financial statements, if any, and the predecessor's auditor's report thereon
- Determine whether the opening balances contain misstatements that materially affects the current period
- Performing relevant audit procedures depending on whether the prior period financial statements have been audited or not

- **Audit Conclusion and Reporting on Opening Balances**

- If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Determine whether the opening balances contain misstatements that materially affects the current period.
- If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate
- The auditor shall evaluate the consistency in application of accounting policies and if the current period's accounting policies are not consistently applied in relation to opening balances or a change in accounting policies is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified or an adverse opinion as appropriate

## SA 560 – Subsequent Events

### Key definitions

Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report

Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with SA 700.

Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements

Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third Parties



### Case Study

No Worries Limited ('NWL' or 'the Company') has a legal proceeding pending against it in a Court of Law for breach of a contract as at 31 March 2013. At the balance sheet date, the Company represented to the auditors that it had not breached the contract and provided the auditors legal opinion supporting its stand as the most likely outcome. Accordingly, the Company had not recognized any provision in its draft financial statements. A week prior to its board meeting on 31 May 2013, for adopting the accounts, and the consequent issue of the audit report, the judge in the case delivered a preliminary ruling that NWL was guilty and liable for damages of Rs 20 crores. A final judgment was made on 31 August 2013, a couple of weeks before the financial statements were to be approved in the annual general meeting of the Company.

Let us evaluate auditors responsibilities under the SA, in light of the example above, under the different situations contemplated under the SA:

1. Events Occurring Between the Date of the Financial Statements and the Date of the Auditor's Report
2. Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued
3. Facts Which Become Known to the Auditor After the Financial Statements have been Issued

## SA 580 – Written Representations

### **What is a written representation?**

A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records

### **Doubt as to the reliability of written representations:**

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter

If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of Management and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705

### **Requested written representations not provided:**

If management does not provide one or more of the requested written representations, the auditor shall:

- (a) Discuss the matter with management;
  - (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
  - (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705
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## SA 520 Analytical Procedures

- **What are Analytical Procedures**

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. The auditor's choice of procedures, methods and level of application is a matter of professional judgement

- **While designing and performing substantive analytical procedures an auditor shall do the following:**

- Determine the suitability of the procedures
  - Evaluate the reliability of the data being used
  - Develop an expectation of the recorded amount or ratios
  - Determine the amount of any difference of recorded amounts from expected values that is acceptable
- The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity

## SA 530 Audit Sampling

- **What is audit sampling**

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

- While designing an audit sample, an auditor shall consider the purpose of the audit procedure and the characteristic of the population
  - The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level
  - The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection
  - For tests of details, the auditor shall project misstatements found in the sample to the population
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**Thank you**

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