STANDARDS ON AUDITING

A Presentation by: Group – 8

S.Jaykishan

Chartered Accountants

POINTS TO BE COVERED

EXTERNAL CONFIRMATION
(SA 505)

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

Subsequent Events
(SA 560)

EXTERNAL CONFIRMATION (SA 505)

Effective Date:-This SA is effective for audit of financial statements for period beginning on or after April 1, 2010.

Definitions

For purposes of the SAs, the following terms have the meanings attributed below:

(a)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.

(b)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.

(c)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.

(d)Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

(e)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.

OBJECTIVE

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

Areas where External Confirmation is required-

a) Bank information and other information from bankers.

b) Account receivable balances

c) inventories held by third parties.

d) Property title deeds held by third parties.

e) Investments purchased but delivery not taken.

f) Loan from lenders.

g) Account payable balances.

h) Loan outstanding share application money.

REQUIREMENTS OF SA 505

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

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

EXTERNAL CONFIRMATION PROCEDURES

MANAGEMENT'S REFUSAL TO ALLOW THE AUDITOR TO SEND A CONFIRMATION REQUEST

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

(a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

(b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures.

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

NEGATIVE CONFIRMATIONS

Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, 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:

(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.

(d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

(a) Response to request is not reliable-

Consider its effect on nature timing and extent of the other audit procedures may involve fraud risk factors.

(b) Confirming party do not respond-

The auditor should perform alternative audit procedures.

(c) No confirmation obtained when auditor determines the response is necessary and alternative procedure will not provide evidence-

Auditor required to express modified opinion.

ANALYSIS OF RESULTS OF EXTERNAL CONFIRMATION PROCEDURE

AUDIT CHECKLIST FOR SA-505

Auditor should keep following points while performing Audit procedure-

(a) What are the various assertions to be addressed. Assertions are the implicit or explicit representations made by the management responsible for presentation of Financial Statements.(such as Occurrence, Completeness , Accuracy, Rights & Obligations.)

(b) What are the identified risks of material misstatement, including fraud risks.

(c) What are the methods of communication (for example, in paper form, or by electronic or other medium).

(d) The layout and presentation of the confirmation request.

(e) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

IMPACT OF COVID-19

Due to the impact of COVID-19 it is more likely that this key audit procedure which provides significant independent audit evidence may be ineffective due to the inadequate responses or non-responses to the confirmation request sent out.

In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence.

Examples of alternative audit procedures the auditor may perform include:

- For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
- For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

A non-response to a confirmation request may indicate a previously unidentified risk of material misstatement. In such situations, the auditor may need to revise the assessed risk of material misstatement at the assertion level, and modify planned audit procedures, in accordance with SA 315.

AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES (SA 540)

Scope

Some financial statement items cannot be measured precisely, but can only be estimated. The degree of estimation uncertainty affects the risk of material misstatement of financial statements. A difference between the outcome of an accounting estimate and the amount originally recognized in the financial statements does not necessarily represent a misstatement of financial statements. This is particularly the case for fair value accounting estimates.

The **objective** of the auditor is to obtain sufficient appropriate audit evidence whether:

i) Accounting estimates, including fair value accounting estimates are reasonable and

ii) Related disclosure in financial statements are adequate.

DEFINITIONS

1) **Accounting Estimate –** It is the closest approximation of an account balance, in the light of best available information, in the absence of precise means of measurement, at a given point of time.

- Examples:
  - Provision for bad and doubtful debts
  - Useful life of asset
  - Method of depreciation

2) **Fair Value Accounting Estimate -** Where this SA addresses only accounting estimates involving measurement at fair value, the term Fair Value Accounting Estimates is used.

- Examples:
  - Net Realisable Value of Inventory
  - Equity share based payments
  - Revaluation of assets
  - Impairment of assets

RISK ASSESSMENT PROCEDURES AND RELATED ACTIVITIES:

Auditor shall obtain an understanding of the following in order to identify and assess the risks of material misstatement for accounting estimates:

(i) The requirements of the applicable financial reporting framework (FRF) relevant to accounting estimate, including related disclosures

(ii) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be disclosed in financial statements

(iii) How management makes accounting estimates (methods, assumption, use of expert etc.) and evaluation of the data on which they are based.

THE AUDITOR SHOULD EVALUATE THE REASONABLENESS OF AN ESTIMATE.

The following points are relevant for performing Risk Assessment Procedures:

1. Obtain an understanding of how management developed the estimate.
2. Review & test the process used by management to develop the estimate.
3. Identify whether there are controls over the preparation of accounting estimates & supporting data that maybe useful in the evaluation.
4. Identify the source data & assumptions used by management & check whether such data are relevant, reliable & sufficient for the purpose, based on information obtained in other audit tests.
5. Review the judgements made by management in making such estimates & identify whether there are indicators of possible management bias.
6. Evaluate whether the assumptions are consistent with each other, with the supporting data, relevant historical data & industry data.
7. Review subsequent events or transactions, if any.
8. Check the arithmetical accuracy of management, while translating assumptions & key factors into accounting estimate.
9. Consider using the work of an expert regarding certain assumptions.
10. In case of any conflicts with management's estimate, develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

INDICATORS OF POSSIBLE MANAGEMENT BIAS

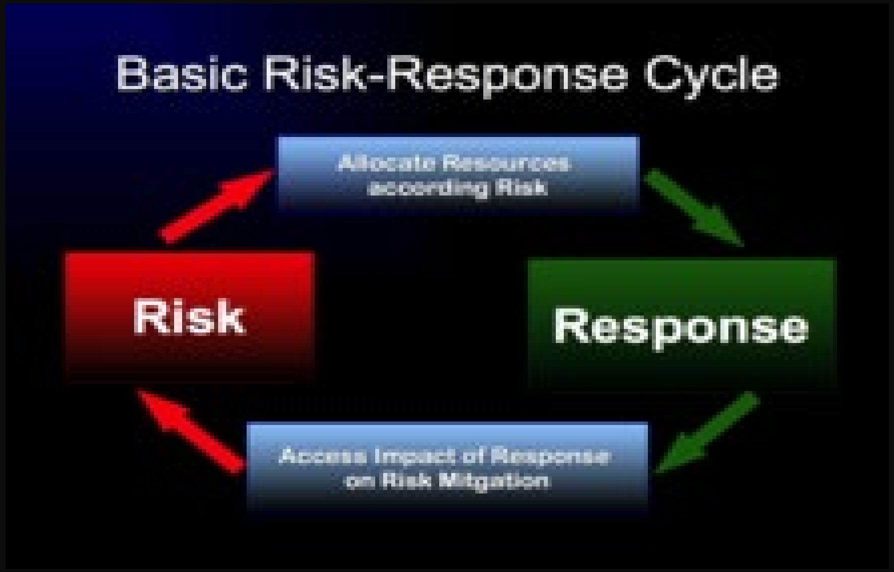
The term Management Bias may be defined as a lack of neutrality by management in the preparation and presentation of information. The auditor should review the judgment and decisions made by management in the making of accounting estimates to identify whether there are indicator of possible management bias. Following are some indicators of possible management bias:

(i) Changes in accounting estimate, or the method of making it, where management has made a subjective assessment that there has been a change in circumstances.

(ii) Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions

(iii) Selection or construction of significant assumption that yield a point estimate favorable for management objectives.

RESPONSE TO ASSESSED RISKS



Based on assessed risks of management, the auditor shall determine:

(i) Whether management has appropriately applied the applicable FRF

(ii) Whether the methods are appropriate and have been applied consistently.

<u>General Responses to Assessed Risks</u>

(i) Determine whether events occurring upto date of auditor's report provide audit evidence regarding Accounting Estimates

(ii) Test the operating effectiveness of the controls

(iii) Develop a point estimate or a range to evaluate management's point estimate

SPECIFIC RESPONSES TO SIGNIFICANT ESTIMATION UNCERTAINTIES

For accounting estimates that give rise to significant risks, following should be evaluated:

(i) How management has considered alternative assumption or outcomes and why it has rejected them

(ii) How management has addressed estimation uncertainty in making the accounting estimates

(iii) Whether the significant assumptions used by management are reasonable

Further, if in auditor's judgment, management has not adequately addressed the effects of estimation uncertainty, the auditor shall develop a range with which to evaluate the reasonableness of the accounting estimates.

DISCLOSURE REQUIREMENTS

(i) The auditor shall obtain sufficient appropriate audit evidence about whether the accounting estimates and their disclosure in the financial statements is appropriate.

(ii) For accounting estimates that give rise to significant risks, adequacy of disclosure of their estimation uncertainty in the financial statements should be checked.

(iii) Whether management has disclosed the range of estimates due to alternative assumptions and the reasons of not making such assumptions (If material difference in assumptions.)

AUDIT CHECKLIST FOR SA 540

The Auditor should evaluate whether the management has identified all accounting estimates that could be material to the financial statements.

The following points are relevant:

1. Analysing the assertions of management to determine the need for estimates.
2. Analysing the reason of change in estimates or assumption on which estimates are based.
3. Checking of facts and disclosure concerning identified litigation, claims & assessments, and other contingencies.
4. Check various statutory reports, and similar materials from applicable statutory agencies.
5. Obtain Written Representation from management whether management believes that significant assumption made by it in making accounting estimates are reasonable.
6. Documentation of basis of Auditor's conclusion about-
    a. Reasonableness of accounting estimates and their disclosures
    b. Indicators of management biasedness (if any)

IMPACT OF COVID-19

Assessing Financial Impact and their Reasonable Estimation as per SA 540

The financial statements have various items which would have been affected by the outbreak of COVID-19, such as:

1. Employment termination benefits.
2. Allowance for expected credit losses.
3. Valuation of defined benefit plans and obligations – due to significant changes in employee strength.

The above items are likely to have significant accounting estimates to be made by the management.

Hence, the auditor should use procedures as prescribed by SA 540, Auditing Accounting Estimates to check whether

(a) the change in accounting estimates or estimates are due to the impact of COVID-19 and determine reasonableness of such change.

(b) Ensure that unnecessary changes in estimates or assumptions are not made by management which may affect the true and fair view of Financial Statements.

SUBSEQUENT EVENTS

Standards on Auditing-560

SCOPE AND OBJECTIVES

Scope – SA 560 deals with the auditor's responsibility relating to subsequent events in an audit of financial statements.

Objectives – The objectives of the auditors are:-

a) To obtain sufficient appropriate audit evidences about whether events occurring **between the date of financial statements and date of auditor's report** that require adjustment of or disclosure are appropriately in reflected financial statements.

b) To respond appropriately to the facts that become known to the auditor **after the date of auditor's report** that had they been known to the auditor at that date , may have caused the auditor to amend the auditor's report .

MEANINGS OF TERMS USED IN THIS SA

1) **Date of FS** – Date of end of latest period covered by financial statements.

2) **Date of Approval of FS** – Date on which board of directors approve the financial statements.

3) **Date of Auditor’s Report** – Cannot be earlier than the date of approval of financial statements.

4) **Date of Issuance of FS** – Date when audit report and audited financial statements are made available to third parties.

5) **Subsequent Events** – Events occurring between the date of financial statements and date of auditor’s report and the facts that become known to the auditor after the date of Auditor’s Report.

TYPES OF SUBSEQUENT EVENTS

`

SUBSEQUENT EVENTS

ADJUSTING EVENTS

These are those events which provides clarification and evidences of transactions which took place prior to Balance Sheet date but were not much clear.
Example: Provision for law suits gets confirmed by court , Provision for doubtful debts confirmed by debtor's insolvency.
Hence , Accounting is required for such events.

NON-ADJUSTING EVENTS

These are those events which are not related to transactions prior to Balance sheet date .
Example: Loss by fire.
No Accounting is required but if it is so material then client must disclose it in director's report.

AUDIT CHECKLIST FOR SA-560

For events occurring between date of financial statements and date of auditor's report;

1.) Obtaining an understanding of procedures that has been established by management to ensure that subsequent events are identified.

2.) Inquiring of management and where appropriate with those charged with governance as to whether subsequent events have occurred which might affects financial statements.

3.) Reading minutes of the meetings of the entity's owner , management and those charged with governance that have been hold after the date of financial statements and inquiring about the matters discussed.

4.) Reading the entity's latest subsequent interim financial statements , if any.

5.) The auditor shall request management to give written representations that all events occurring subsequent to date financial statements and for which the applicable financial reporting framework requires adjustment have been adjusted and disclosed.

When as a result of the procedures performed above the auditor identifies events that require adjustment of, or disclosure in the financial statements, the auditor shall determine whether each such event is appropriately reflected in financial statements.

FACTS WHICH BECOME KNOWN TO THE AUDITOR AFTER THE DATE OF THE AUDITOR'S REPORT

If a fact becomes known to the auditor after the date of the auditor's report which may have caused the auditor to revise the auditor's report, the auditor shall:

- a)Discuss the matter with the management.
- b)Determine whether the financial statements need amendments and ,if so,
- c)Inquire how management intends to address the matter in the financial statements.

Now if the management amends the financial statements, the auditor shall:

a)Extend the audit procedures to the date of the new auditor's report; and

b)Provide a new auditor's report on the amended financial statements.


18476(1)
18437(1)
4th
18594 (1)
18589 (4)
18567 (2)
18514 (1)
18390 (1)
18590(2)
18585(2)
18591(1)
18588(1)

THANK YOU