1
Nature of Auditing

Question 1

Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements.

(5 Marks, November, 2014)

Answer

Enquiring from Management to Evaluate Subsequent Event: As per SA 560, "Subsequent Events", in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-

(i) Whether new commitments, borrowings or guarantees have been entered into.

(ii) Whether sales or acquisitions of assets have occurred or are planned.

(iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.

(iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.

(v) Whether there have been any developments regarding contingencies.

(vi) Whether any unusual accounting adjustments have been made or are contemplated.

(vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

(viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.

(ix) Whether any events have occurred that are relevant to the recoverability of assets.

Question 2

State with reasons (in short) whether the following statements are correct or incorrect:

(a) The primary objective of an audit is to detect fraud and errors in Financial Statements.

(b) An Auditor's external expert is not subjected to quality control policies and procedures of an audit firm. *(2 Marks each, November, 2014)*

Answer

(a) Incorrect: Detection of fraud and errors in the financial statements is not the primary objective of audit. The primary objective of an audit is to obtain reasonable assurance about whether the financial statements are free from material misstatements thereby enabling the auditor to express an opinion on the financial statements.

(b) Correct: As per SA 620 "Using the Work of an Auditor's Expert", an auditor's external expert is not a member of the engagement team and is not, therefore, subject to quality control policies and procedures of the audit firm.

Question 3

Discuss with reference to SAs:

(a) "The degree of reliance that a Statutory Auditor can place on the work of the Internal Auditor is a matter of individual judgement".

(b) Explain the audit procedures when Principal Auditor is using the work of another Auditor.

(8 Marks each, November, 2014)

Answer

(a) Reliance on the Work of Internal Auditor: The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include-

Objectivity:

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.

- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence:

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care:

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

(b) Using the Work of Another Auditor: As per SA 600, "Using the Work of Another Auditor" when the principal auditor plan to use the work of another auditor-

(i) The principal auditor should perform procedures to obtain sufficient audit evidence, that the work of the other auditor is adequate for the principal auditor's purpose, in the context of the specific assignment.

(ii) The principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

(iii) When principal auditor decides to use the work of another auditor he should perform following procedures:

(1) Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit.

(2) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

(iv) The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedure and findings which may be in the form of a completed questionnaire or check list.

(v) The principal auditor may conclude that it is not necessary to apply procedures because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of the other auditor's practices.

(vi) The principal auditor should consider the significant findings of the other auditor.

(vii) Discuss with the other auditor and the management of the component, audit findings or other matters of supplemental tests of the records or the financial statement of the component.

(viii) Principal auditor should document the significant findings of the component whose financial statements was audited by the other auditor, name of the auditor, conclusions reached that the individual component is not material, performed procedures and conclusions reached, how he deals with the qualifications or adverse remarks contained in the other auditor's report.

Question 4

Write a short note on Self-revealing errors and four illustrations thereof.

(4 Marks, November, 2014)

Answer

Self-Revealing Errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts.

A few illustrations of such errors are given hereunder, showing how they become apparent -

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(ii)	Wrong totaling of the Purchase Register.	Control Account (*e.g.*, the Trade Receivables Account) balances and the aggregate of the balances in the

		personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

Question 5

"Statements" and "Guidance Notes" of ICAI-whether mandatory or recommendatory? Discuss.

(5 Marks, May, 2014)

Answer

Statements and Guidance Notes of ICAI – whether Mandatory or Recommendatory

Statements- The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute to ensure that statements are followed and complied with.

Guidance Notes- 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

Question 6

State with reasons (in short) whether the following statement is correct or incorrect:

'Errors of commission' is where a transaction has been omitted either wholly or partially.

(2 Marks, May, 2014)

Answer

Incorrect: When a transaction has been omitted either wholly or partially it is known as "Error of Omission" whereas "Error of Commission" is where a transaction has been mis-recorded either wholly or partially.

Question 7

Discuss with reference to SAs:

(a) What do you mean by "Written Representations"? As an auditor, how you will deal if management does not provide requested written representations? (5 Marks, May, 2014)

(b) "Operating Conditions" that may cast doubt about going concern assumption.

(5 Marks, May, 2014)

(c) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement? (6 Marks, May, 2014)

Answer

(a) Written Representations: As per SA 580, "Written Representation", is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. These representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Requested Written Representations not provided by Management: If management does not provide one or more of the requested written representations,

(i) the auditor shall discuss the matter with management;

(ii) 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

(iii) take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

(b) Operating Conditions casting doubt about Going Concern Assumption: The following are examples of operating events or conditions that, may cast significant doubt about the going concern assumption-

(i) Management intentions to liquidate the entity or to cease operations.

(ii) Loss of key management without replacement.

(iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).

(iv) Labour difficulties.

(v) Shortages of important supplies.

(vi) Emergence of a highly successful competitor.

(c) Professional Skepticism: As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

Question 8

Discuss the following:

(a) The discipline of behavioural science is closely linked with the subject of auditing.

(b) As per SA 530, requirements of audit sampling, sample design, sample size and selection of items for testing. *(5 Marks each, November, 2013)*

Answer

(a) The Discipline of Behavioural Science is closely linked with the Subject of Auditing: The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also

possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

(b) 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.

According to the said SA, 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 9

State with reason (in short) whether the following statements are correct or incorrect.

(a) Branch auditor of a company should give photocopies of his working papers on demand by Company Auditor.

(b) Events occurring after the balance sheet date must be disclosed in the financial statements. *(2 Marks each, November, 2013)*

Answer

(a) Incorrect: As per SA 230 on "Audit Documentation", audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Main auditor does not have right of access to the working papers of the branch auditor. In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working papers and therefore, the branch auditor is under no compulsion to give photocopies of his working papers to the principal auditor of the Company.

(b) Incorrect: As per AS-4 on "Contingencies and Events Occurring After the Balance Sheet Date", events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

Question 10

With reference of SA 250 give some examples or matters indicating to the auditor about non compliance of laws & regulations by management. (8 Marks, November, 2013)

Answer

Non-compliance of Laws and Regulations by Management: As per SA 250 on "Consideration of Laws and Regulation in an Audit of Financial Statements", following are the examples or matters indicating to the auditor about non-compliance with laws and regulations by management-

(i) Investigations by regulatory organisations and government departments or payment of fines or penalties.

(ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees.

(iii) Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.

(iv) Purchasing at prices significantly above or below market price.

(v) Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.

(vi) Unusual payments towards legal and retainership fees.

(vii) Unusual transactions with companies registered in tax havens.

(viii) Payments for goods or services made other than to the country from which the goods or services originated.

(ix) Payments without proper exchange control documentation.

(x) Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.

(xi) Unauthorised transactions or improperly recorded transactions.

(xii) Adverse media comment.

Question 11

Write a short note on Identification of significant related party transaction outside business.

(4 Marks, November, 2013)

Answer

Identification of significant Related Party transaction outside Business: As per SA 550 on "Related Parties", for identified significant related party transactions outside the entity's normal course of business, the auditor shall-

(i) Inspect the underlying contracts or agreements, if any, and evaluate whether:

   (a) 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;

   (b) The terms of the transactions are consistent with management's explanations; and

   (c) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

(ii) Obtain audit evidence that the transactions have been appropriately authorized and approved.

Question 12

Discuss with reference to SAs:

(i) The auditor shall communicate all significant findings with those charged with Governance.

(ii) Factors affecting form, contents and extent of audit documentation.

(5 Marks each, May, 2013)

Answer

(i) Communication of Findings with 'Those Charged with Governance': As per SA-260 "Communication with Those Charged with Governance", the auditor shall communicate the following significant findings from the audit, with those charged with governance-

   (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

   (b) Significant difficulties, if any, encountered during the audit;

   (c) Unless all of those charged with governance are involved in managing the entity:

      (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

(ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

(ii) Factors affecting Form, Contents and Extent of Audit Documentation: As per SA-230 on "Audit Documentation", the form, content and extent of audit documentation depend on the following factors-

(a) The size and complexity of the entity.

(b) The nature of the audit procedures to be performed.

(c) The identified risks of material misstatement.

(d) The significance of the audit evidence obtained.

(e) The nature and extent of exceptions identified.

(f) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.

(g) The audit methodology and tools used.

Question 13

Comment on the following:

(a) Selling and distribution cost included in the cost of inventories.

(b) Computer software which is the integral part of the related hardware can be treated as intangible assets or fixed assets?

(c) Define shortly arm's length transaction. *(2 Marks each, May, 2013)*

Answer

(a) As per AS-2 on Valuation of Inventories, in determining the cost of inventories, it is appropriate to exclude selling and distribution costs; and recognise them as expenses in the period in which they are incurred. Therefore, it is not appropriate to include selling and distribution cost in the cost of inventories.

(b) As per AS-26 on Intangible Assets, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. Therefore, computer software which is the integral part of the related hardware should be treated as fixed asset.

(c) 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.

Question 14

Explain the basic principles governing audit. *(8 Marks, May, 2013)*

Or

Discuss the basic principles governing audit. *(10 Marks, November, 2009)*

Or

What are the basic principles which govern the Auditor's professional responsibilities while doing Audit? *(5 Marks, November, 2008)*

Answer

Basic Principles Governing an Audit: The basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried are described below-

(i) Integrity, objectivity and independence: The auditor should be straight forward, honest and sincere in his approach to his professional work. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever is actual effect, as being incompatible with integrity and objectivity.

(ii) Confidentiality: The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) Skills and Competence: The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence along with a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

(iv) Work performed by others: When the auditor delegates work to assistants or uses work performed by other auditors and experts, he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(v) Documentation: The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) Planning: *The* auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

(vii) Audit evidence: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) Accounting system and Internal Control: The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

(ix) Audit Conclusions and Reporting: The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a clear written opinion on the financial information and should comply the legal requirements. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

(Note: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200 and SA 220. But in general abovementioned principles are basic principles only.)

Question 15

(a) What are the factors that are to be considered while designing a confirmation request?

(b) Distinguish between Auditing and Investigation. *(8 Marks each, November, 2012)*

Answer

(a) Designing of Confirmation Request: As per SA - 505 "External Confirmations", the 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. The following factors should be considered while designing a confirmation request-

(i) The assertions being addressed.

(ii) Specific identified risks of material misstatement, including fraud risks.

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

(iv) Prior experience on the audit or similar engagements.

(v) The method of communication.

(vi) Management's authorisation to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.

(vii) The ability of the confirming party to provide the requested information.

(b) Distinction between Auditing and Investigation*:* Auditing is different from investigation which is another significant service, a professional accountant renders. Investigation is a critical examination of the accounts with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into

investigation. Investigation may be undertaken in numerous areas of accounts, *e.g.*, the extent of waste and loss, profitability, cost of production, etc. It normally concerns only specified areas, but at times, it may involve the whole field of accounting. Its essence lies in going into the matter with some pre-conceived notion suited to the objective. The techniques fit the circumstances of the case. For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view.

Audit never undertakes discovery of specific happenings and is never started with a pre-conceived notion about the state of affairs. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe: fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the *prima facie* findings of the auditor.

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Whereas, investigation aims at establishing a fact or a happening or at assessing a particular situation.

However, as per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 16

Discuss "Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI". *(5 Marks, May, 2012)*

Answer

Engagement Standards: The following standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards-

(i) Standards on Auditing (SAs), to be applied in the audit of historical financial information.

(ii) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.

(iii) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.

(iv) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

Question 17

Explain the meaning of term "Subsequent Events" as used in the SA 560. Should all types of subsequent events be considered by the auditor in his attest functions? (8 Marks, May, 2012)

Answer

Meaning of Subsequent Events: SA 560 on "Subsequent Events", defines the term 'subsequent events" as 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.

"Subsequent events" also refer to significant events which occurred up to the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

Consideration of Subsequent Events by the Auditor: SA 560 requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor's report. However, the exact manner of treatment would depend upon whether the event falls in the category of 'adjusting event' or 'non-adjusting event'. As per Accounting Standard (AS) 4, events occurring after the date of the balance sheet are of two types, viz., adjusting events which provide further evidence of conditions that existed at the date of the balance sheet; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the date of the balance sheet.

Therefore, an auditor is required to consider all subsequent events while discharging his duties and determine whether those shall have to be adjusted or simply required to be disclosed. However, the auditor should perform work as near as practicable to the date of the auditor's report.

Question 18

What are the advantages of an independent audit? (8 Marks, May, 2012)

Answer

Advantages of an Independent Audit: The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below-

(i) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(ii) It acts as a moral check on the employees from committing defalcations or embezzlement.

(iii) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(iv) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(v) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

(vi) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

(vii) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(viii) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(ix) Government may require audited and certified statements before it gives assistance or issues a license for a particular trade.

Question 19

Explain the process of external confirmation. Give some examples where external confirmation can be used as audit evidence. *(8 Marks, November, 2011)*

Answer

External Confirmation: According to SA 505 on " External Confirmation, it is the process of obtaining and evaluating through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by the management in the financial statements. When using external confirmation procedures, the auditor shall maintain control over external control requests, including-

(i) Determining the information to be confirmed or requested;

(ii) Selecting the appropriate confirming party;

(iii) 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

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

(v) Selecting the items for which confirmations are needed.

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

(i) Bank balances and other information from bankers.

(ii) Accounts receivable balances.

(iii) Inventories held by third parties.

(iv) Property title deeds held by third parties.

(v) Investments purchased but delivery not taken.

(vi) Loans from lenders.

(vii) Accounts payable balances.

(viii) Long outstanding share application money.

(ix) Terms of Agreement or transaction with the third parties.

Question 20

(a) Discuss the areas in which different accounting policies may be adopted.

(6 Marks, November, 2011)

(b) Discuss the types of audits required under law. *(5 Marks, November, 2011)*

Answer

(a) Areas in which Different Accounting Policies are adopted: Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

There is no single list of accounting policies which are applicable to all circumstances. The different circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise require for considerable judgment by the management of the enterprise.

The following are examples of the areas as given in AS- 1, Disclosure of Accounting Policies in which different accounting policies may be adopted by different enterprises-

(i) Method of depreciation, depletion and amortization.

(ii) Valuation of fixed assets.

(iii) Valuation of inventories.

(iv) Valuation of goodwill.

(v) Valuation of investment.

(vi) Treatment of retirement benefits.

(The above list is not exhaustive. There may be other examples as well.)

(b) Types of Audit required under Law: Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

The organisations which require audit under law are the following:

(i) Companies governed by the Companies Act, 2013;

(ii) Banking companies governed by the Banking Regulation Act, 1949;

(iii) Electricity supply companies governed by the Electricity Supply Act, 1948;

(iv) Co-operative societies registered under the Co-operative Societies Act, 1912;

(v) Public and charitable trusts registered under various Religious and Endowment Acts;

(vi) Corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India;

(vii) Specified entities under various sections of the Income Tax Act, 1961;

(viii) Audit required under Sales-tax and VAT by various State Government.

Question 21

Comment on the following in relation to SAs:

(a) "The work performed by each assistant needs to be reviewed by personnel of at least equal competence."

(b) "Audit documentation serves a number of additional purposes."

(c) "Management is responsible for compliance with laws and regulations."

(d) "Auditor shall establish an overall strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan." (5 Marks each, May, 2011)

Answer

(a) Reviewing the Work Performed by Assistant: Under SQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members. However, it has placed the final responsibility of review of audit engagement on engagement partner.

As per SA 220 "Quality Control for an Audit of Financial Statements", "Engagement partner" is the partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Reviews at appropriate stages, during the audit engagement allow significant matters to be resolved on a timely basis, to the engagement partner's satisfaction on or before the date of the auditor's report.

The engagement partner shall ensure that reviews being performed are in accordance with the firm's review policies and procedures. A review consists of consideration whether, for example:

(i) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(ii) Significant matters have been raised for further consideration;

(iii) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(iv) There is a need to revise the nature, timing and extent of work performed;

(v) The work performed supports the conclusions reached and is appropriately documented;

(vi) The evidence obtained is sufficient and appropriate to support the auditor's report; and

(vii) The objectives of the engagement procedures have been achieved.

(b) Audit Documentation: According to SA 230 on "Audit Documentation", audit documents once collected serves a number of additional purposes. These purposes are as follows-

(i) Assisting the engagement team to plan and perform the audit.

(ii) Assisting members of the engagement team responsible for supervision to direct and supervise the audit work and to discharge their review responsibilities in accordance with SA 220 "Quality Control for an Audit of Financial Statements".

(iii) Enabling the engagement team to be accountable for its work.

(iv) Retaining a record of matters of continuing significance to future audits.

(v) Enabling the conduct of quality control reviews and inspections.

(vi) Enabling the conduct of external inspections in accordance with applicable legal regulatory or other requirements.

(c) Management's Responsibility for Compliance with Laws and Regulations: According to SA 250 on "Consideration of Laws and Regulations in an Audit of Financial Statements", it is management's responsibility, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations. Laws and regulations may affect an entity's financial statements in different ways for example, most directly; they may affect specific disclosures required of the entity in the financial statements. The following are the procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations-

(i) Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.

(ii) Instituting and operating appropriate systems of internal control.

(iii) Developing, publicising and following a code of conduct.

(iv) Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.

(v) Engaging legal advisors to assist in monitoring legal requirements.

(vi) Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

(vii) Ensuring employees are properly trained and understand the code of conduct.

(d) Establishment of Overall Strategy for Development of Audit Plan: According to SA 300, "Planning an Audit of Financial Statements" the auditor shall establish an overall audit strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan.

In establishing the overall audit strategy, the auditor shall:

(i) Identify the characteristics of the engagement that define its scope;

(ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(iii) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(v) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Question 22

(a) Discuss Limitations of audit. *(8 Marks, May, 2011)*

Or

What are the inherent limitations of audit? *(8 Marks, November, 2005)*

(b) Discuss perquisites and fundamental principles to be possessed by an auditor.

(8 Marks, May, 2011)

Answer

(a) Limitations of Audit: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from-

(i) The Nature of Financial Reporting: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

(ii) The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example-

(1) There is the 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. 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.

(iii) Timeliness of Financial Reporting and the Balance between Benefit and Cost: 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. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(iv) Other Matters that Affect the Limitations of an Audit: In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include -

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

(b) Prerequisites or Fundamental Principles to be possessed by an Auditor: It is in the best interest of the accountancy profession to make known to users, of the services provided by an auditor that they are executed at the highest level of performance and are in accordance with ethical requirements that strive to ensure such performance. In order to achieve the objectives of accountancy profession, the auditor have to observe a number of prerequisites' or fundamental principles as under-

(i) Integrity: An auditor should be straight forward and honest.

(ii) Objectivity: An auditor should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override professional judgments.

(iii) Professional competence and due care: An auditor should perform his duty with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

(iv) Confidentiality: An auditor should respect the confidentiality of information acquired during the course of an audit and should not use or disclose any such information to third parties without proper and specific authority or unless there is a legal or professional right or duty to disclose.

(v) Professional behavior: An auditor should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession.

(vi) Technical Standard: An auditor should carry out professional services in accordance with the relevant technical and professional standards.

Question 23

Comment as an auditor on the following situations:

(a) Mr. X, a partner in X & Co., a firm of a Chartered Accountants, died on 31-3-2010 after completing routine audit work of XYZ Company Ltd. Mr. Y another partner of the firm of Chartered Accountants signed the financial statements of XYZ Company Ltd., without reviewing the finalization work done by the assistants.

(b) M.N.P. Company Ltd. purchased a machinery for ₹ 1.00 crore. The State Government granted the company a subsidy of ₹ 40 lakhs to meet partial cost of machinery. The company credited the subsidy received from the State Government to its Profit and Loss Account for the year ended March 31, 2010. (5 Marks each, November, 2010)

Answer

(a) Relying on Work Performed by Others: SA 220, Quality Control for an Audit of Financial Statements, an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; Significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, when the auditor delegates work to assistants or uses work performed by other auditors/experts he will continue to be responsible for forming and expressing his opinion on the financial statements. However, he will be entitled to rely on the work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. The auditor should carefully direct supervise

and review work delegated to assistants. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

Conclusion: In the instant case, Mr. X, a partner of the firm had completed routine audit work and died on 31 March, 2010. Mr. Y another partner of the firm has signed the financial statement of XYZ Company Ltd. without reviewing the finalization work done by the assistants. Mr. Y will be fully responsible for negligence, he cannot take the shelter that Mr. X had done the work.

Hence, Mr. Y has negligently performed his duties.

(b) Accounting Treatment for Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.

Following are two methods of presentation of grants related to specific fixed assets in financial statements as acceptable alternatives.

(i) Under the first alternative the grant is shown in the balance sheet as a deduction from the gross value of the assets concerned. The grant is recognized in statement of profit and loss over the useful life of the depreciable life of asset by way of a reduced depreciation charge.

(ii) Under second alternative, it is treated as a deferred income which should be recognized in statement of profit and loss over useful life of asset in proportion in which depreciation will be charged on the assets concerned. Deferred income pending its apportionment to statement of profit and loss should be disclosed in the balance sheet with a suitable description i.e. Deferred Government Grant.

Conclusion: In the instant case, M.N.P. Company Ltd. received a subsidy from government worth ₹ 40 lakhs towards meeting partial cost of machinery. The company credited the same to its Statement of Profit and Loss.

Accounting treatment of grant received towards partial cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report bringing out the quantification impact clearly.

Question 24

(a) "The auditor is faced with sampling risk in both tests of control and substantive procedures."

Comment on this statement with reference to SA 530 on "Audit Sampling".

(b) What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures". *(8 Marks each, November, 2010)*

Answer

(a) Sampling Risk: As per SA 530 "Audit Sampling", 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 a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

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 substantive procedure i.e. 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 substantive procedure i.e. 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.

(b) Extent of Reliance on Analytical Procedures: As per SA 520 "Analytical Procedures", the application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(i) Materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material.

(ii) Other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel

questions raised from the application of analytical procedures to an ageing schedule of customers' accounts.

(iii) Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(iv) Assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

(v) The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Question 25

Write short notes on the following:

(a) Reliability of external confirmations.

(b) Factors governing modes of communication of auditor with those charged with governance.

(c) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption. *(4 Marks each, November, 2010)*

Answer

(a) Reliability of External Confirmations: As per SA 505 “External Confirmation”, the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures.

The factors that affect the reliability of confirmations include:

(i) The control which the auditor exercises over confirmation request and responses;

(ii) The character of respondents; and

(iii) Any restrictions included in the response or imposed by the management.

(b) Factors Governing Modes of Communication of Auditor with Those Charged with Governance: As per SA 260, “Communication with Those Charged with Governance” the

auditor may decide whether to communicate orally or in writing. Effective communication may involve structured presentations and written reports as well as less structured communications, including discussions. The form of communication may be affected by such factors as-

(i) Whether the matter has been satisfactorily resolved.

(ii) Whether management has previously communicated the matter.

(iii) The size, operating structure, control environment, and legal structure of the entity.

(iv) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.

(v) Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.

(vi) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(vii) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(viii) Whether there have been significant changes in the membership of a governing body.

(c) Procedures to be performed by the Auditor in Expressing Opinion on 'Going Concern' Assumption: As per SA 570, "Going Concern", the following are the relevant procedures that are relevant in this connection-

(i) Analyse and discuss cash flow, profit and other relevant forecasts with management.

(ii) Analyse and discuss the entity's latest available interim financial statements.

(iii) Review the terms of debentures and loan agreements and determine whether any of the terms have been breached.

(iv) Read minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

(v) Inquire of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

(vi) Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.

(vii) Evaluate the entity's plans to deal with unfilled customer orders.

(viii) Perform audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

(ix) Confirm the existence, terms and adequacy of borrowing facilities.

(x) Obtain and review reports of regulatory actions.

(xi) Determine the adequacy of support for any planned disposals of assets.

Question 26

Comment on the following:

(a) A partnership firm revalued its fixed assets like land and building. The firm adequately disclosed the revalued amounts in the Balance Sheet.

Do you, as an auditor, approve the disclosure given by the partnership firm?

(b) R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director?

(c) Responsibility for properly determining the quantity and value of inventory rests with the management. *(4 Marks each, November, 2010)*

Answer

(a) Disclosure of Revalued Fixed Assets of a Partnership Firm: As per AS 10 "Accounting for Fixed Assets", revalued amounts substituted for historical costs of fixed assets, method adopted to compute the revalued amounts, nature of indices used, year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts should be disclosed in the financial statements.

In the instant case, the partnership firm revalued its fixed assets like building and land and adequately disclosed the revalued amounts in the Balance sheet. The firm did not disclose the method adopted by it for arriving at the revalued figures.

Conclusion: The firm had disclosed the revalued amounts in the balance sheet but the method and nature of indices used etc. are not disclosed. Thus, this act of the firm is in contravention with the AS 10 for "Accounting for Fixed Assets'.

Hence, the auditor cannot approve the disclosure given by the partnership firm and shall have to qualify the report.

(b) Ownership and Custody of Working Papers: As per SA-230 "Audit Documentation", the working papers are the property of the auditor, the auditor may, at his discretion make portion of or extracts from his working papers available to the client.

In the instant case the managing director of the company has demanded copies of the working papers from the auditor. He has no right to obtain copies of the working papers from the auditor because they are the property of the auditor. However the auditor may at his discretion make portions of or extracts from the working paper to the managing director of PQR & Company Ltd.

Conclusion: The auditor is not bound to oblige the managing director by supplying copies of the audit working papers.

(c) Management's Responsibility for Determining Quantity and Value of Inventory: "Guidance Note on Audit of Inventories" specifies that the responsibility for properly determining the quantity and volume of inventories rests with the management of the entity. Therefore it is the responsibility of the management of the entity to ensure that inventories included in financial statements are physically in existence and represent all owned by the entity.

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the compliance of "Accounting Standard 2: Valuation of Inventories" and adequacy of the method and procedures of physical verification followed by the entity. He is also required to determine whether the procedure for identifying defective, damaged, obsolete and slow moving items are well designed and operate properly that proper books of accounts should be made following the accounting standards.

The responsibility of management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents depends on the facts and circumstances of each case.

Clause (ii) of Para 3 of CARO, 2015 also requires specific comment by auditor as to the adequacy and reasonableness of the physical verification of inventory by the management. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for.

Question 27

State with reasons (in short) whether the following statement is True or False:

When an auditor identifies a Misstatement resulting from fraud, it is his responsibility to communicate it to the regulatory and enforcement authorities apart, from those charged with governance. *(2 Marks, May, 2010)*

Answer

True: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", if an auditor identifies a fraud or has obtained information that indicates that a fraud may exist, it is his responsibility to communicate the matter with those charged with the governance on a timely basis and, in some circumstances, when so required by laws or regulations, to regulatory and enforcement authorities also.

However, as per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 28

'The extent of audit procedure performed on corresponding figure is less compared to audit of current period figures', reporting. Justify the statement with regard to auditor's duties for reporting of comparatives under SA 710. *(5 Marks, May, 2010)*

Answer

Comparatives: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements" the following are the broad principles-

(i) The auditor should obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework.

(ii) When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

(iii) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification in the audit report is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

   (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

   (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

(iv) If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

(v) If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Question 29

'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.'

Justify this statement in the light of responsibilities of Joint Auditors under SA 299.

(5 Marks, May, 2010)

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" prescribes the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act. Main features of the said SA are discussed below-

- Division of Work: Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- Coordination: Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible as under-

(i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute;

(v) for ensuring that the audit report complies with the requirements of the relevant statute;

(vi) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him. Similarly, the nature, timing and extent of the enquiries to be made in the course of audit as well as the other audit procedures to be applied are solely the responsibility of each joint auditor;

(vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a responsibility of all the joint auditors unless they agree upon a specific pattern of distribution of this responsibility;

(viii) each joint auditor is entitled to assume that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 30

State with reasons (in short) whether the following statements are True or False:

(i) The auditor, in the interest of the users, while explaining the nature of his reservation, can describe the work of the expert with his name, in the audit report without obtaining prior consent of the expert.

(ii) Analytical procedures are unable to help the Auditor in determining the nature, timing and extent of other audit procedures at the planning stage.

(iii) A Company which has been unable to negotiate borrowings from its bankers claims that it will be able to continue as a 'going concern'. (2 Marks each, November, 2009)

Answer

(i) False: As per SA 620, "Using the Work of an Auditor's Expert", if the auditor, in the interest of the users includes the name of the expert in his audit report, he can do so only after obtaining the prior permission of the auditor's expert.

(ii) True: As per SA 520 "Analytical Procedures" states that 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.

(iii) False: In the case of the company which has not been able to negotiate its borrowings with its bankers, there will be a substantial doubt in its ability to continue as a going concern without such financial support.

Alternative Answer – True: If the company is not able to negotiate borrowings from its bankers for reasons like delay/failure in the submission of adequate documents/

information or for other reasons other than the company's financial status then the statement is true.

Question 31

State with reasons (in short) whether the following statements are True or False:

(i) The principle of confidentiality precludes auditor to disclose the information about the client to a third party at all circumstances without any exception.

(ii) It is no part of subsequent auditor's duty to verify opening balances of Ledger accounts of current years, on the basis of Balance Sheet audited by Previous Auditor.

(iii) AAS 25 (SA 710) on 'comparatives' is applicable to corresponding previous years figures and not to comparative Financial statement.

(iv) AS 10 "Accounting for fixed assets" is also applicable to wasting assets like quarries, minerals and oil and natural gas.

(v) When Government grants are received in the form of assets such as land, plant and equipments etc., free of cost, then, such assets should be entered in the books of accounts at nominal value.

(vi) Contingent liabilities are provided for in the accounts if they crystallize between the end of the accounting year and the date of signing the audit report.

(vii) A branch auditor is a joint auditor according to AAS 12 (SA 299) and his relationship with the company auditor is governed by the said Standard. (2 Marks each, June 2009)

Answer

(i) False: The principle of confidentiality is one of the basic principles of auditing. Auditor is generally not expected to divulge the information of his client to others. But it is not the case always. He can disclose the information to others if (a) permitted by his client and (b) if he has to disclose it as per any statutory obligation dictated by any law.

(ii) False: According to SA 510 "Initial Audit Engagements—Opening Balances", it is the duty of the auditor to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements.

(iii) False: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", there are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in SA 510 "Initial Audit Engagements—Opening Balances" regarding opening balances also apply.

(iv) False: AS 10 "Accounting for Fixed Assets" clearly states that this Accounting Standard is not applicable to wasting assets like quarries, minerals oil and natural gas.

(v) True: According to AS 12 "Accounting for Government Grants", when Government grants in the form of non-monetary assets such as land, plant and equipments etc. are received free of costs then such assets should be entered in the books of account at nominal value.

(vi) True: AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a provision should be recognised when, an enterprise has a present obligation as a result of a past event; it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation.

Furthermore, As per AS 4 "Contingencies and Events Occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events, occurring between the balance sheet date and the date on which the financial statements are approved, that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

(vii) False: Branch auditor is not a joint auditor within the meaning of SA 299 "Responsibility of Joint Auditors". He is another auditor within the meaning of SA 600 "Using the Work of Another Auditor".

Question 32

(a) M, Statutory Auditor of ABC Ltd wants to verify cash on hand as on 31st March, 2009. The Management informs Mr. M. that it is not possible to cooperate, as cashier has been hospitalised. Advise Mr. M. on how to deal with the situation. (4 Marks, June 2009)

(b) As an auditor of a Limited Company, you observe that during the month of March, 2009, sales invoices were not recorded in books of accounts. You also observe that payment of wages was much higher compared to last year. Keeping in mind the above, analyse possible ways of manipulation of accounts. (6 Marks, June 2009)

Answer

(a) Limitation on the Scope of Audit: The scope of audit may be limited for varied reasons, (i) the entity may impose restriction on scope of audit, (ii) the limitation may be imposed by circumstances.

When the audit is carried out under and as per statute, the auditor should not accept the assignment when his duties are curtailed by agreement, unless required by any Law.

When audit is carried out in accordance with the entity's terms voluntarily, the auditor may indicate his scope in his audit report.

Sometimes, the circumstances may impose restrictions on audit scope. For example, if the auditor is appointed after the year end, he may not be able to participate in inventory checking. Or sometimes, the records required may not be available so that the auditor may not be able to check details in the manner he liked. Such limitations in scope may warrant an auditor to express disclaimer of opinion or qualified opinion in his audit report depending upon the circumstances.

The non co-operation of ABC Limited will amount to limitation on scope of auditors.

(b) Manipulation of Accounts: Accounts are falsified in order to conceal the true position of the business for some purpose. They are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed-

(i) to avoid incidence of income-tax or other taxes by showing profits at a lower figure.

(ii) for delaying a dividend when there are insufficient profits by showing profits at inflated figures.

(iii) to withhold declaration of dividend even there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost).

(iv) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the following nature:

(i) Recording fictitious sales or omission of sales.

(ii) Recording fictitious purchases or suppression of purchases.

(iii) Over valuation or under valuation of stock.

(iv) Recording fictitious expenses or omission of expenses.

(v) Taking credit for accrued income not likely to be received or omission of income.

(vi) Revenue expenses changed to capital and vice-versa.

SA 240 "The Auditor's Responsibilities relating to fraud in an Audit of Financial Statements" states that the Auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. If an auditor identifies a fraud or has obtained information that indicates that a fraud may exist, it is his responsibility to communicate the matter with those charged with the governance on a timely basis and, in some circumstances, when so required by laws or regulations, to regulatory and enforcement authorities also. In addition, as per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure. The auditor is also required to comment under clause (xii) of Para 3 of CARO, 2015 whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

An auditor who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

Question 33

(a) A Limited Company has filed a suit against debtor from whom ₹ 25 lakhs are receivable. A judgement is received from court in favour of the company after the date of Balance Sheet. Discuss auditor's duty in this regard. (6 Marks, June, 2009)

(b) While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer. (4 Marks, June, 2009)

Answer

(a) Subsequent Events:

(i) Subsequent events are events occurred after balance sheet date but before the date of audit report.

(ii) In case of audit of components, such as branch or division, the subsequent events are events after the balance sheet date and before the date of audit report of that component.

(iii) The subsequent events, according to AS 4 "Contingencies and Events Occurring after the Balance Sheet Date" and as reproduced in SA 560 "Subsequent Events" are of two types – (a) those which provide further evidence of conditions that existed at the balance sheet date and (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

(iv) Depending upon the type of subsequent events, the auditor should decide on adjustment of accounts based on evidential value gathered for conditions that existed as on the date of balance sheet date or disclosure of the conditions that arose subsequent to the date of balance sheet.

(v) The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. These procedures would include inquiring of management as to whether any subsequent events have occurred which might affect the financial statements, reading minutes of Board subsequent to accounting period, contacting lawyers for knowing progress of pending Cases, inquiry with the company management, scrutinizing subsequent interim accounts etc.

(vi) The auditor should perform these procedures as near as practicable to the date of his audit report.

(vii) If the management does not account for the subsequent events in the financial statements where they are to be accounted, the auditor should appropriately comment his report by a qualification or disclaimer.

(b) Using the Work of Management's Expert: 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,-

(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.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

If auditor finds that civil engineer cannot be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm the value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

Question 34

State with reasons (in short) whether the following statements are True or False:

(i) AAS-11 is related to Audit Materiality.

(ii) Audit Working Papers to be kept at least for 3 (three) years.

(iii) AAS-6 has a purpose to Establish Standards to form procedures to be followed to have an understanding of the Accounting and Internal Control system.

(2 Marks each, November, 2008)

Answer

(i) This Question is redundant in view of the latest Engagement and Quality Control Standards.

(ii) False: As per SA 230 on "Audit Documentation", the retention period for audit working papers ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

(iii) This Question is redundant in view of the latest Engagement and Quality Control Standards.

Question 35

The Central Government sanctioned ₹ 20 lakh as Grant to a Hospital for the purchase of certain equipments and paid ₹ 10 lakh as advance. The hospital took ₹ 10 lakh as income in the Profit and Loss account for the year. As an Auditor how would you react?

(6 Marks, November, 2008)

Answer

Accounting for Government Grants: As per AS-12 "Accounting for Government Grants", government grant received for specific asset should be treated in either of the following way-

(i) Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in the Statement of Profit and Loss on a systematic and rational basis over the useful life of the asset.

OR

(ii) Grant to be shown as a deduction from gross value of the asset concerned in arriving at its book value and depreciation is charged on reduced value of fixed asset.

In the view of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the Statement of Profit and Loss and has distorted the Statement of Profit and Loss by treating the capital item as revenue. The auditor should accordingly qualify the report.

Question 36

Discuss in brief AAS-10 "using the work of another Auditor". *(5 Marks, November, 2008)*

Answer

This Question is redundant in view of the latest Engagement and Quality Control Standards.

Question 37

State with reasons (in short) whether the following statements are True or False:

(i) Procedural error arises as a result of transactions having been recorded in a fundamentally incorrect manner.

(ii) AAS-24 deals with responsibility of the auditor of the service organisation.

(iii) For the purpose of AAS-10 "Principal Auditor" means the partner of the firm signing the Audit report.

(iv) An expert for the purpose of AAS-9 is a person, firm or association of persons possessing special skill, knowledge and experience in auditing.(2 Marks each, May, 2008)

Answer

(i) False: Procedural error arises when there is error in implementation of the procedure. If transaction has been recorded in a fundamentally incorrect manner it will result in error of principle.

(ii) This Question is redundant in view of the latest Engagement and Quality Control Standards.

(iii) This Question is redundant in view of the latest Engagement and Quality Control Standards.

(iv) This Question is redundant in view of the latest Engagement and Quality Control Standards.

Question 38

As an auditor how would you react to the following situations/comments?

(i) Director (Finance) of KK Ltd. informed their newly appointed statutory auditor that they have sound Internal control system implemented by a renowned professional firm and he is satisfied with its effectiveness and functioning and therefore, the statutory auditor should concentrate on verifying only the routine books and financial statements.

(8 Marks, May, 2008)

(ii) TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. It's production head, an expert, have also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. (6 Marks, May, 2008)

(iii) PP Ltd., a garment exporter, asked their Internal auditor, a practicing chartered accountant, to conduct physical verification of the year end inventory and the report of such verification was handed over to the statutory auditor for their view and use. Can Statutory auditor rely on such report? (6 Marks, May, 2008)

Answer

(i) As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

The report of the auditor is based on his examination of financial statements and the underlying documents and evidences. It is for the auditor to decide based on his evaluation of the internal control as to its existence and effectiveness. The nature, timing and extent of audit procedure are based on such evaluation.

In the instant case, management has no right to guide and place any restriction on the work of the auditor as it would amount to restriction on the scope of the audit. The auditor should ask the management not to impose such restriction on his scope of the audit that impairs his ability to examine and express an opinion and if the management does not agrees, he should issue a qualified opinion or disclaimer, as appropriate.

(ii) As per SA 570 on "Going Concern", it is the responsibility of the Auditor to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, TT Ltd. has suffered continuous losses and having negative net worth also. Besides, its production head have also left the company resulting in steep fall in production. Thus there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

(iii) As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors is likely to be adequate for the purpose of the audit, the external auditor shall evaluate: the objectivity of the internal audit function; technical competence of the internal auditors; whether the work of the internal auditors is likely to be carried out with due professional care; and whether there is likely to be effective communication between the internal auditors and the external auditor. To determine the

adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether the internal auditors have adequate technical training and proficiency; work was properly supervised, reviewed and documented; any reports prepared are consistent with the results of the work performed etc.

In the instant case, the statutory auditor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The ultimate responsibility to express opinion on the financial statement is that of the statutory auditor.

Question 39

What does AAS-3 say about utility, ownership, custody and retention of working papers?

(4 Marks, May, 2008)

Answer

This Question is redundant in view of the latest Engagement and Quality Control Standards.

Question 40

What is the importance of having the accounts audited by an independent auditor?

(5 Marks, May, 2008)

Answer

Advantages of having the Accounts Audited by an Independent Auditor are:

(i) It safeguards the financial interest of persons not associated with the management like partners or shareholders.

(ii) It acts as a moral check on the employees from committing fraud.

(iii) It is helpful in settling tax liability, negotiations for loans and for determining purchase consideration for sale/merger.

(iv) It is also helpful in settling trade or labour disputes for higher wages/bonus.

(v) It helps in detection and minimizing wastages and losses.

(vi) It ensures maintenance of adequate books and records, statutory register etc.

Question 41

State with reasons (in short) whether the following statements are True or False:

(i) AAS-9 is applicable when an auditor seeks legal opinion from an advocate.

(ii) If there is difference of opinion among the joint auditors with regard to any matter, majority joint auditors opinion will prevail while reporting.

(iii) If internal control is satisfactory, external evidence is more reliable than internal evidence. *(2 Marks each, November, 2007)*

Answer

(i) This Question is redundant in view of the latest Engagement and Quality Control Standards.

(ii) False: As per SA 299 "Responsibility of Joint Auditors", where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

(iii) False: As per SA 330 "the Auditor's Responses to Assessed Risks", an effective control environment allows the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity.

Question 42

Strong Ltd. holding 60% of the equity shares in Weak Ltd. purchased goods worth ₹ 50 Lakhs from Weak Ltd. during the financial year 2006-07. The Managing Director of Strong Ltd. is of the opinion that it is normal business activity and there is no need to disclose the same in the final accounts of the Company. Comment. *(6 Marks, November, 2007)*

Answer

Related Party Disclosures: As per definition given in the AS 18 "Related Party Disclosures", parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, Strong Ltd. is the holding company of Weak Ltd. as it holds more than 50% of the voting power of Weak Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties.

In the instant case since there is related party transaction the contention of Managing Director of Strong Ltd. is not correct and the auditor should insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor should express a qualified opinion.

Question 43

State with reasons (in short) whether the following statements are True or False:

(a) As per AS-13, Investment should be classified into Current investments and Marketable investments.

(b) If the auditor believes that the concern will not continue as going concern, he should issue disclaimer of opinion.

(c) As per AAS-2, one of the objectives of the audit is to detect fraud.(2 Marks each, May, 2007)

Answer

(a) False: As per AS-13, Investments are classified into current and long term investment. Investments other than current investments are classified as long term investments, even though they may be readily marketable.

(b) False: As per SA 570 "Going Concern", if the auditor believes that the management's use of going concern assumption in the financial statements is inappropriate and the entity will not be able to continue its operation in future, the auditor should express an adverse opinion.

(c) This Question is redundant in view of the latest Engagement and Quality Control Standards.

Question 44

As an auditor comment on the following situations:

(a) As an auditor of PQR Ltd. you have asked your audit assistant to draw the audit programme. The assistant drew up the audit programme without going through the monthly report of the Internal Auditor on the plea that he is a Chartered Accountant and have found no serious irregularities and internal control system is running perfectly.

(8 Marks, May, 2007)

(b) Mr. T. a Chartered Accountant, was first time appointed the Auditor of XYZ Ltd. Mr. T. carried the audit procedure for verifying the opening balances only, but not the previous year's accounting policies as it is not needed. (6 Marks, May, 2007)

(c) *Mr. K. auditor of ABC Ltd. Is of the opinion that "Auditing and Assurance Standards" are meant only for references and it is not necessary to follow such Auditing and Assurance Standards.* *(6 Marks, May, 2007)*

Answer

(a) Professional Judgment in Planning and Performing the Audit of Financial Statements: The contention of the audit assistant is not valid and contrary to the view and guidelines given in SA 200.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. He shall exercise professional judgment in planning and performing an audit of financial statements. Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, conditions that may indicate possible fraud, circumstances that suggest the need for audit procedures in addition to those required by the SAs. Professional skepticism is necessary to the critical assessment of audit evidence which includes questioning contradictory audit evidence, and the reliability of documents; and responses to inquiries, and other information obtained from management and those charged with governance.

The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control.

In the instant case, the Auditor has not exercised the professional judgment in planning and performing the audit of financial statements.

Reliance based on position of the person and blindly accepting the soundness of the internal control violates the basic principles.

Only by evaluation, the auditor will know whether the internal audit and related internal control is effective or not.

(b) Initial Audit Engagements: Contention of Mr. T, the auditor, is not correct and contrary to the SA 510 on "Initial Audit Engagements – Opening Balances".

As per the said SA, it is the duty of the auditor to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements; and 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.

Hence, in view of the above guidelines of SA 510, Mr. T should verify the accounting policies also to ensure its consistency.

(c) This question is redundant in view of the latest Engagement and Quality Control Standards.

Question 45

As an Auditor, comment on the following situations/statements:

(a) SMT Enterprises entered into a contract for sale of its goods worth ₹ 24 lacs with ST Ltd. The goods were inspected, approved and finalised by the inspection team of ST Ltd. ST Ltd. made the whole payment of ₹ 24 lacs. However, it requested SMT Enterprises to dispatch the goods in six equal monthly instalments from October, 2005 to March, 2006. In the month of January, 2006, due to natural calamity, ST Ltd. informed SMT Enterprises to stop dispatches of the remaining three instalments until further notice. At the time of finalising its accounts for the financial year 2005-06, SMT Enterprises booked sales amounting to ₹ 12 lacs and showed remaining ₹ 12 lacs as Advance Against Sales.

(5 Marks, November, 2006)

(b) X Ltd. had a major break down in its plant in the month of February, 2006. In the month of March, 2006 it entered into an agreement with an engineering firm for the purpose of repairing its plant for a consideration of ₹ 180 lacs. The engineering firm started the repairing work in the month of April, 2006 and completed it in the same month. X Ltd. made the provision for said expenditure on repairs in its books of account for the financial year 2005-06 on the plea that the event of break down leading to repair expenditure had taken place in the financial year 2005-06, binding contract for repairs was entered into during the financial year 2005-06 and repair work was also completed before the financial statements were approved by the Board of Directors of the company. (5 Marks, November, 2006)

(c) The management tells you that WIP is not valued since it is difficult to know the same in view of multiple processes involved and in any case opening and closing WIP would be more or less the same. (4 Marks, November, 2006)

Answer

(a) Revenue Recognition: As per AS 9 "Revenue Recognition", revenue from sales can be recognised only if the following conditions are fulfilled-

(i) The seller of goods has transferred to the buyer, the property in the goods for a price and all significant risks and rewards of ownership have been transferred to a degree usually associated with ownership; and

(ii) There is no significant uncertainty exists regarding the amount of consideration that will be derived from the sale of the goods.

In the light of above two conditions, in the given case, SMT Enterprise had transferred the property in the goods at an agreed price and all significant risks and rewards. Thus sale is fully completed. Mere postponement of delivery until further notice as requested by ST LTD., does not alter the status of sale.

As the sale is completed, entire amount of ₹ 24 lakhs should be recognized in the F.Y. 2005-2006 only. SMT Enterprise recognising only ₹ 12 lacs sales in F.Y. 2005-2006 is not correct.

(b) Provision for Expenditure on Repairs: As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability which can be measured only by using a substantial degree of estimation.

In the instant case, though the event of break down and binding contract for repairs was entered into F. Y. 2005-06, but as the Engineering firm has not started performing the work of repair until the date of balance sheet, liability can not be said to have been arisen as on the date of balance sheet.

In view of the above, provision made by X Ltd. for expenditure on repairs in its books of account of F.Y. 2005-06, for repair work to be done in the next F.Y. 2006-07 is absolutely wrong, as there was no obligation. The auditor should bring this wrong provision to the notice of the authorities of X Ltd. and report accordingly.

(c) Valuation of WIP: AS 2 deals with the principles and methods for determining the value at which inventories should be carried in the financial statements. Thus, items hold in the process of production is included in the definition of inventory.

Work in Process (WIP) is normally, valued by taking the basic cost of materials, labour and proportionate factory overhead incurred upto the stage of completion. In view of the above, the argument that the value of opening and closing WIP is more or less same is not tenable as the cost of material, labour and overhead might be different and accordingly, arriving at the different valuation of opening and closing WIP is possible.

In the given case, the management should have determined the stage of completion of the production and valued the work in process accordingly.

Further, the auditor should ensure that physical verification of inventory has been conducted at reasonable intervals by the management; are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported; whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.

Question 46

RT Ltd. received ₹ 50 lacs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of ₹ 50 lacs as income in its Profit and Loss Account for the year. What are your views on the accounting treatment of the above receipt of ₹ 50 lacs? (4 Marks, November, 2006)

Answer

Accounting Treatment of Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. There are two method of accounting. Under one method, the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. Depreciation is charged on reduced value of fixed assets. Under other method, grants related to depreciable assets are treated as deferred income which is recognized in the Statement of Profit and Loss on a systematic and rational basis over the useful life of the assets.

In the given question, accounting treatment of grant received towards part cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report.

Question 47

What are the basic principles governing an audit as laid down in AAS 1? Explain in brief.

(10 Marks, November, 2006)

Answer

The question is redundant in view of the latest Engagement and Quality Control Standards.

Question 48

How the work of an expert should be evaluated before accepting the same as an Audit evidence? *(8 Marks, November, 2006)*

Answer

Evaluation of Work of an Expert: SA 620, "Using the Work of an Auditor's Expert" discusses the auditor's responsibility in relation to and the procedure the auditor should consider in using the work of an expert as audit evidence. When the auditor delegates work or uses work performed by experts, he will continue to be responsible for forming and expressing his opinion on the financial information. In such cases, the auditor should obtain reasonable assurance that work performed by experts is adequate for his purpose. When the auditor intends to use the work of an expert, he should evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including-

(i) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

(iii) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(i) Agree with that expert on the nature and extent of further work to be performed by that expert; or

(ii) Perform further audit procedures appropriate to the circumstances.

Question 49

Write short notes on the following:

(i) Current Investments.

(ii) First in First out (FIFO) method.

(iii) Accounting Estimates. *(4 Marks each, November, 2006)*

Answer

(i) Current Investment: It means an Investment that is by nature readily saleable & realisable and is intended to be held for not more than one year, from the date on which such investment is made.

As per AS 13, the valuation of current investment at lower of cost and fair value provides a prudent method of determining the carrying amount to be stated in the balance sheet.

Any reduction to fair value and any reversal of such reduction are to be included in the Statement of Profit and Loss. It is essential to disclose in financial statement the accounting policies for determination of carrying amount of investment and income therefrom. Disclosure of profit/loss on disposal of current investment and changes in carrying amount of investment is also necessary.

(ii) First-In-First-Out (FIFO) Method: It is a cost formula used in assigning the cost to inventories which are ordinarily interchangeable. The FIFO formula assumes that the items of inventories which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those which have been most recently purchased or produced. This method of valuation of inventory is not applied where items of inventory are not ordinarily interchangeable.

(iii) Accounting Estimates: According to the SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure", accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. SA 540 addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement

item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.

Additional examples of accounting estimates are:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

Question 50

The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately. As an auditor, comment. *(5 Marks, May, 2006)*

Answer

Disclosure of Surplus on Sale of Investments: AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the statement on profit and loss. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements.

In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their

disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

Question 51

What are the meaning and purposes of Sampling? Explain in the light of AAS-15, Audit Sampling. *(8 Marks, May, 2006)*

Answer

The question is redundant in view of the latest Engagement and Quality Control Standards.

Question 52

Write a short note on "Initial Engagements". *(4 Marks, May, 2006)*

Answer

Initial Engagement: As per SA 510 "Initial Audit Engagements – Opening Balances", 'Initial Audit Engagement' means 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.

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.

Question 53

As an auditor, comment on the following:

(a) M/s Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2004-05 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2003-04 was less charged by ₹ 75 lacs on account of arithmetical error on the part of Insurance Company. M/s Bonafide Ltd. paid the said sum of ₹ 75 lacs during the accounting year 2004-05 by debiting the same to Prior Period Expenses. *(5 Marks, November, 2005)*

(b) As on 31.3.2005, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalisation of the accounts for the year ended 31.3.2005 (the accounts were finalised on 14th June, 2005), the company won the case and had no liability whatsoever in this

regard. The company has made a provision for this contingent liability in its accounts for the year ended 31.3.2005, which, it says, will be reversed in the next year.

(5 Marks, November, 2005)

Answer

(a) Prior Period Expenses: Accounting Standard 5 defines the prior period items as income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts or oversight.

In this case, there has been arithmetical mistake of ₹ 75 lacs in computing the amount of premium. Though, there was no error or omission on the part of M/s Bonafide Ltd. and the error was on the part of the Insurance Company. But it is the management of the enterprise which is responsible for preparation of financial statements. Thus, the expenditure of ₹ 75 lacs pertain to prior period and to be debited to Prior Period Expenses.

Therefore, the accounting treatment accorded by the management is appropriate. The auditor should, however, ensure that the nature of mistake, i.e., insurance premium as well as amount of ₹ 75 lacs has been disclosed separately in such a manner that its impact on the current profit or loss can be perceived.

(b) Events occurring after the Balance Sheet Date: As per facts of the case, on 31.3.2005, there was a claim against the company for damages by a customer for not providing after sales service. It is a condition prevailing as on the date of balance sheet. Part I of Schedule III to the Companies Act, 2013 requires disclosure of claims against company not acknowledged as debt as a footnote under caption contingent liability if the same had not been provided for in the balance sheet. However, as on that date, the company had provided for the contingent liability perhaps in view of expectation that such a claim may crystallize as liability against it. The winning of the case by the company in its favour (before the accounts were approved) after the date of the balance sheet constitutes additional evidence that will be of help in deciding the treatment of the matter in the accounts as per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date". However, no provision would be needed as the case had been won by the company, since confirmed by subsequent event happening after the balance sheet date. The disclosure of facts of the case is, however, necessary with a view to keeping users of financial statements informed about the nature of event as well as the fact that no provision is necessary.

Question 54

Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2004-05. The closing stock of the company as on 31.3.2004 amounting to ₹ 100 lacs continued as it is and became closing stock as on 31.3.2005. The auditors of the company propose to exclude from

their audit programme the audit of closing stock of ₹ 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. Comment.

(5 Marks, November, 2005)

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.

The auditor is also required to comment under clause (i) of Para 3 of CARO, 2015 whether physical verification of inventory has been conducted at reasonable intervals by the management.

Question 55

Under what circumstances change in accounting policies is permissible?

(8 Marks, November, 2005)

Answer

Change in Accounting Policies: Same accounting policies are adopted for similar events or transactions in each period so as to enable the user to compare the financial statements of an enterprise over a period of time. However, Accounting Standard 5, "Net Profit or Loss for the

period, Prior Period Items and Changes in Accounting Policies" provides that accounting policies can be changed under the following circumstances-

(1) if the adoption of a different accounting policy is required by statute; or

(2) for compliance with an accounting standard; or

(3) if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise. AS 5 also requires any change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by AS 5 should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. For instance, how an enterprise should deal with intangible items appearing in its balance sheet when it applies AS 26, Intangible Assets, for the first time.

Question 56

Write short notes on the following:

(a) General Purpose Financial Statements.

(b) Going Concern Concept. *(4 Marks each, November, 2005)*

Answer

(a) General Purpose Financial Statements: As defined in SA 700 "Forming an Opinion and Reporting on Financial Statements", General purpose financial statements are Financial statements prepared in accordance with a general purpose framework.

A financial reporting framework designed to meet the common financial information needs of a wide range of users is called General purpose framework.

The term "General Purpose Financial Statements" normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as

their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Accounting Standards are applicable to all General Purpose Financial Statements.

(b) Going Concern Concept: AS 1 "Disclosure of Accounting Policies", lays down that the "Going Concern", is one of the fundamental accounting assumption underlying financial statements. This Going Concern concept envisages that the entity will continue for the foreseeable future. Accounts are prepared on this concept unless there are indication that going concern concept is not holding good for a particular entity. On account of this basic concept of going concern, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified, the entity may not be able to realise its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. AS 1, "Disclosure of Accounting Policies", also requires that no specific disclosure is required in case the same has been followed in the preparation of financial statements. In case this assumption is not followed, the fact should be disclosed.

SA 570 "Going Concern", establishes standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

Question 57

As an auditor, comment on the following situations/statements:

(a) You are the Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 20th July. The Sales Ledger balance at 31st March was ₹ 95,000. By 20th July ₹ 65,000 only had been received against this amount as full and final payment. (4 Marks, November, 2004)

(b) AAS Ltd. is procuring the packing materials from M/s XY and Co., a partnership firm consisting of Mr. X and Mr. Y. Mr. Y is the Managing Director of AAS Ltd. The total value of purchases made from XY and Co. by AAS Ltd. during the year 2003-04 had been ₹ 38 lakhs. (4 Marks, November, 2004)

(c) A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts. (4 Marks, November, 2004)

Answer

(a) Consideration of Subsequent Events: SA 560 "Subsequent Events" requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements. AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance

sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of trade receivables as also the realisability aspect. The auditor's duties in respect of trade receivables remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from trade receivables. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31. Accordingly, the auditor would have now to see that in respect of outstanding amount of ₹ 30,000, whether the amount of provision needs any revision.

(b) Transactions with Related Parties: SA 550 "Related Parties" establishes standards on auditor's responsibilities and audit procedures regarding related party transactions. In this case, the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in AS 18, "Related Party Disclosures" has been followed, as Managing Director is the interested party.

Further, the auditor has to ensure compliance of the Companies Act 2013 requirements, viz., transaction required to be entered into the Register pursuant to section 189 of the Companies Act, 2013 and having regard to the fact whether such prices were reasonable or not.

Accordingly, the auditor has to ensure that the AAS Ltd. has made proper disclosures in financial statements.

(c) Joint Assets: AS 10, "Accounting for Fixed Assets", issued by the Institute, prescribes that in case of fixed assets owned jointly by enterprises, the extent of the entity's share in such assets, and the proportion in the original cost, accumulated depreciation and written down value should be stated in the Balance Sheet. Accordingly, the treatment followed by the companies reflecting 50% of the value of the machinery and changing 50% depreciation in their respective books of account is proper. However, such jointly owned assets should be indicated separately in the Fixed Assets Register maintained by the company.

(Note: Alternatively, AS 10 also recommends that the pro-rata cost of such jointly owned assets may be grouped together with similar fully owned assets and appropriate disclosure of the same should be made.)

Question 58

What are the auditor's responsibilities for detection of Frauds and Errors?

(8 Marks, November, 2004)

Answer

Auditor's Responsibilities for Detection of Fraud and Error: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the

financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

(a) failure to obtain reasonable assurance,

(b) inadequate planning, performance or judgment,

(c) absence of professional competence and due care, or,

(d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error, which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

Further, as per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to comment under clause (xii) of Para 3 of CARO, 2015 whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

Question 59

What are accounting estimates according to Auditing and Assurance Standards—18 (AAS—18)? Give examples. *(8 Marks, November, 2004)*

Answer

The question is redundant in view of the latest Engagement and Quality Control Standards.

Question 60

State briefly the qualities of Auditors. *(4 Marks, November, 2004)*

Answer

Qualities of Auditors: The auditor should possess specific knowledge of accountancy, auditing, taxation, etc. which are acquired by him during the course of his theoretical education.

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 2013, Co-operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact; caution; firmness; good temper; judgement; patience; clear headedness and commonsense; reliability and trust, etc.

In short, all those personal qualities required to make a good person contribute to the making of a good auditor. In addition, the auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, SA 200 mentions integrity, objectivity and independence as one of the basic principles.

Auditing is a profession, calling for wide variety of knowledge to which no one has yet set a limit, the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Question 61

Write a short note on "Analytical review". *(4 Marks, November, 2004)*

Answer

Analytical Review: SA 500 on "Audit Evidence" defines analytical review as those tests of details which consist of studying significant ratios and trends and investigating unusual fluctuation and items. Thus, analytical reviews are substantive audit procedure with the help of which auditor can perform tests of details in more efficient and effective manner. Therefore, analytical reviews are nothing best analytical review procedures which have been considered at length in SA 520 on "Analytical Procedures". According to SA 520, analytical procedures include the consideration of comparisons of the entity's financial information with, for example, comparable information for prior periods or anticipated results of the entity, such as budgets or forecasts. Consideration of relationships 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 also constitute analytical review procedures.

Analytical review procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, assessment of inherent and control risks, etc.

Question 62

Mention any twelve title of Statements on AASs and the date from which it comes into force.

(6 Marks, May, 2004)

Answer

The question is redundant in view of the latest Engagement and Quality Control Standards.