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Nature of Auditing

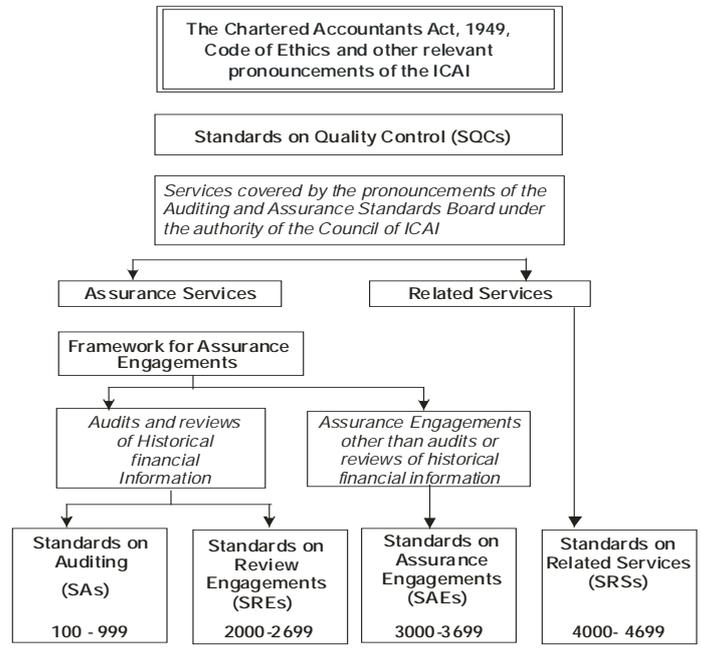
BASIC CONCEPTS	
Definition	“An audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon”.
Aspects to be covered in Audit	<p>The principal aspect to be covered in an audit concerning final statements of account are the following:</p> <ul style="list-style-type: none">(i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.(ii) Reviewing the system and procedures.(iii) Checking of the arithmetical accuracy of the books of accounts.(iv) Verification of the authenticity and validity of transactions in the books of accounts.(v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature.(vi) Comparison of the Balance Sheet and Statement of Profit and Loss or other statements with the underlying record.(vii) Verification of the title, existence and value of the assets appearing in the Balance Sheet.(viii) Verification of the liabilities stated in the Balance Sheet.

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	<p>(ix) Checking the result shown by the Statement of Profit and Loss and to see whether the results shown are true and fair.</p> <p>(x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.</p> <p>(xi) Reporting to the appropriate person/body.</p>
Basic principles governing an Audit*	<p>Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. The basic principles as stated in this guideline are:</p> <ol style="list-style-type: none">1. Integrity, objectivity and independence.2. Confidentiality.3. Skills and competence.4. Work performed by others.5. Documentation.6. Planning.7. Audit Evidence.8. Accounting System and Internal Control.9. Audit conclusions and reporting. <p>(*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(Revised) and SA 220. But in general abovementioned principles are basic principles only.)</p>
Types of Audit	<p>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.,</p> <ol style="list-style-type: none">1. Audit required under law.2. Voluntary audit.

A diagrammatic representation of the structure of Standards under the new Preface is given below:

Diagrammatic Representation of the Structure of Standards Under the New Preface



The SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. While discharging their attest function, it will be the duty of members of the Institute to ensure that the SAs are followed.

Question 1

- (a) 'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defence as an auditor?
- (b) 'Doing a statutory audit is full of risk'. Narrate the factors which cause the risk.

Answer

- (a) **Detection of Fraud after Completion of Statutory Audit:** As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error.

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.

The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

- (b) **Factors Causing Risk Under Statutory Audit:** 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. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

An independent audit whether performed in terms of applicable financial reporting framework or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks.

Factors which may cause such risk in conducting an audit are discussed below-

- (i) **Exercising judgement on the part of the auditor:** The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.
- (ii) **Nature of audit evidence:** Much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such an evidence may far exceed the benefits.
- (iii) **Inherent limitations of internal control:** Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite clear that an audit suffers from control risk on account of inherent limitations of internal control and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

Question 2

Write a short note on – Errors of Commission.

Answer

Errors of Commission: When a transaction has been mis-recorded either wholly or partially it is called as a error of commission. Error of commission can happen in the following ways-

- (i) Errors in posting,
- (ii) Errors in Casting,

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- (iii) Errors in carrying forward,
- (iv) Errors occurring during extraction of balances, etc.

Posting errors may be of a wrong account, wrong amount or wrong file. For example, amount received from Mr X and credited to Mr Y, purchase of ₹ 360 from Mr A posted in his account at ₹ 630 or sales returns from Mr X posted as the debit of his account, etc.

The first type of errors will not affect the trial balance, however, the other two will affect the agreement of trial balance.

Casting errors are the errors committed while making the totals. This error affects the trial balance.

Error of carry forward and errors of extraction of balances also affect the trial balance.

Error of duplication is another type of error of commission which means recording the same transaction twice.

Such errors however, do not affect the trial balance but they will affect the Statement of Profit and Loss (over statement of expenditure).

Question 3

Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.

Answer

Conditions Which Increases the Risk of Fraud or Error: In planning and performing an examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are-

- (i) Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all *dak* and marking it to the relevant sections or two persons are responsible for receipt of *dak* but the same is not followed in actual practice, etc.
- (ii) Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.
- (iii) Unusual pressures within the entity, for example, industry is doing well but the company is not performing accordingly, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.
- (iv) Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.

- (v) Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

Question 4

Write a short note on - Operational Audit.

Answer

Operational Audit: Operational Audit involves examination of all operations and activities of the entity.

The objects of operational audit include the examination of the control structure and of the relation of department controls to general policies. It provides an appraisal of whether the department is operating in conformity with prescribed standards and procedures and whether standards of efficiency and economy are maintained. It is concerned with formulation of plans, their implementation and control in respect of production and marketing activities.

Traditionally, internal audit focused on accounting operations of the entity. However, operational audit covers all other operation such as marketing, manufacturing, etc.

Thus, operational audit in its initial stages developed as an extension of internal auditing. The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation.

Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey.

Question 5

"The auditors should consider the effect of subsequent events on the financial statement and on auditor's report" according to SA 560 – Comment.

Answer

Effect of Subsequent Events: SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of 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. It lays down the standard that the auditor should

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consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events. The auditor should-

- (i) obtain an understanding of any procedures management has established to ensure that subsequent events are identified.
- (ii) inquire of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
 - Whether sales or acquisitions of assets have occurred or are planned.
 - 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.
 - Whether there have been any developments regarding contingencies.
 - Whether there have been any developments regarding risk areas and contingencies.
 - Whether any unusual accounting adjustments have been made or are contemplated.
 - 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.
 - Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - Whether any events have occurred that are relevant to the recoverability of assets.
- (iii) Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
 - (iv) Read the entity's latest subsequent interim financial statements, if any.
 - (v) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
 - (vi) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.

- (vii) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

Question 6

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

Answer

Standards on Auditing: The Council of the ICAI has issued following Standards on Auditing (SAs)-

S. No	SA	Title of Standard on Auditing	Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
4	SA 220	Quality Control for Audit of Financial Statements	April 1, 2010
5	SA 230	Audit Documentation	April 1, 2009
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements	April 1, 2009
8	SA 260	Communication with Those Charged with Governance	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	April 1, 2010

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10	SA 299	Responsibility of Joint Auditors	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008
13	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
14	SA 330	The Auditor's Responses to Assessed Risks	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010
16	SA 450	Evaluation of Misstatements Identified during the Audits	April 1, 2010
17	SA 500	Audit Evidence	April 1, 2009
18	SA 501	Audit Evidence - Specific Considerations for Selected Items	April 1, 2010
19	SA 505	External Confirmations	April 1, 2010
20	SA 510	Initial Audit Engagements-Opening Balances	April 1, 2010
21	SA 520	Analytical Procedures	April 1, 2010
22	SA 530	Audit Sampling	April 1, 2009
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	April 1, 2009
24	SA 550	Related Parties	April 1, 2010
25	SA 560	Subsequent Events	April 1, 2009
26	SA 570	Going Concern	April 1, 2009
27	SA 580	Written Representations	April 1, 2009
28	SA 600	Using the Work of Another Auditor	April 1, 2002
29	SA 610	Using the Work of Internal Auditors	April 1, 2010
30	SA 620	Using the Work of an Auditor's Expert	April 1, 2010
31	SA 700	Forming an Opinion and Reporting on Financial Statements	April 1, 2012
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report	April 1, 2012

33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	April 1, 2012
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements	April 1, 2011
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 1, 2010
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework	April 1, 2011
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 1, 2011
38	SA 810	Engagements to Report on Summary Financial Statements	April 1, 2011

(Note: Candidates may mention any twelve SAs. The list is given for the information of candidates.)

Question 7

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

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

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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.

Question 8

State briefly the qualities of an Auditor.

Answer

Qualities of an Auditor: 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 9

Give your comment on the following:

(a) Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2015-16. The closing inventory of the company as on 31.3.2015 amounting to ₹ 100 lacs continued as it is and became closing inventory as on 31.3.2016. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of ₹ 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.

(b) What are the obvious assertions in the following items appearing in the Financial Statements?

(i) Statement of Profit and Loss

Travelling Expenditure	₹ 50,000
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(ii) Balance Sheet

Trade receivable	₹ 2,00,000
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Answer

(a) **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 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.

- (b) (i) Travelling Expenditure ₹ 50,000
- Expenditure has been actually incurred for the purpose of travelling.
 - Travelling has been undertaken during the year under consideration.
 - Total amount of expenditure incurred is ₹ 50,000 during the year.
 - It has been treated as revenue expenditure and charged to Statement of Profit and Loss.
- (ii) Trade receivable ₹ 2,00,000
- These include all sales transaction occurred during the year.
 - These have been recorded properly and occurred during the year.
 - These constitute assets of the entity.
 - These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

Question 10

Write short notes on the following:

- (a) *General Purpose Financial Statements.*
- (b) *Going Concern Concept.*

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 management's use of the going concern assumption in the preparation and presentation of the financial statements.

Question 11

State the matters which the statutory Auditor should look into before framing an opinion on accounts on finalisation of audit of accounts. Discuss overall audit approach.

Answer

Formation of Opinion on Accounts: The principal aspect to be covered in an audit to form an opinion, an auditor has to look into following matters-

- (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.
- (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.

- (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) Comparison of the Balance Sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
- (vii) Verification of the title, existence and value of the assets appearing in the Balance Sheet.
- (viii) Verification of the liabilities stated in the Balance Sheet.
- (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
- (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties of auditor are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

Question 12

Write a short note on Audit versus Investigation.

Answer

Auditing versus Investigation: 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.

Audit is generally objected to find out whether the accounts show true & fair view. It is a critical examination of books of accounts.

Investigation on the other hand is 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 extends scope beyond books of accounts.

For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view. 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.

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 13

"Auditor's professional responsibilities are governed by basic principles which should be complied with whenever an audit is carried out". Comment.

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 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 14

What are the inherent limitations of audit?

Answer

Inherent 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

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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.

Question 15

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

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 16

Discuss the types of audits required under law.

Answer

Types of Audits 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.

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Question 17

Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI – Discuss.

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 18

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.*

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 19

Discuss with reference to SAs:

- (a) *The auditor shall communicate all significant findings with those charged with Governance.*
- (b) *Factors affecting form, contents and extent of audit.*
- (c) *While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?*
- (d) *What are the auditor's responsibilities in respect of corresponding figures?*

Answer

- (a) **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-
 - (i) 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;
 - (ii) Significant difficulties, if any, encountered during the audit;
 - (iii) Unless all of those charged with governance are involved in managing the entity:
 - (1) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
 - (2) Written representations the auditor is requesting; and
 - (iv) 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.
- (b) **Factors Affecting Form, Contents and Extent of audit:** As per SA-230 on "Audit Documentation", the form, content and extent of audit documentation depend on the following factors-
 - (i) The size and complexity of the entity.
 - (ii) The nature of the audit procedures to be performed.
 - (iii) The identified risks of material misstatement.
 - (iv) The significance of the audit evidence obtained.
 - (v) The nature and extent of exceptions identified.

- (vi) 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.
- (vii) The audit methodology and tools used.
- (c) **Risk Factors while applying Sampling Techniques:** As per SA 530 “Audit Sampling”, sampling risk is 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 tests 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 test of controls, the controls are less effective than they actually are, or in the case of tests 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.
- (d) **Auditor’s Responsibilities in Respect of Corresponding Figures:** As per SA 710 “Comparative Information—Corresponding Figures and Comparative Financial Statements”, in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether-
 - (i) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
 - (ii) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period’s financial statements, the auditor shall also follow the relevant requirements of SA 560 “Subsequent Events”.

As required by SA 580, “Written Representations”, the auditor shall request written representations for all periods referred to in the auditor’s opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year’s Statement of Profit and Loss.

Question 20

Write short notes on the following:

- (a) Identification of significant related party transaction outside business.
 (b) Self-revealing errors and four illustrations thereof.

Answer

- (a) **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:
- (1) 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;
 - (2) The terms of the transactions are consistent with management's explanations; and
 - (3) 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.
- (b) **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 Sundry Creditors 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 21

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

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”, the following are 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 22

Discuss the following:

- (a) *"Statements" and "Guidance Notes" of ICAI- whether mandatory or recommendatory?*
- (b) *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.*
- (c) *The discipline of behavioural science is closely linked with the subject of auditing.*

Answer**(a) Statements and Guidance Notes of ICAI –whether Mandatory or Recommendatory:**

- (i) **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.

- (ii) **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.

(b) Inquiring 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.
- (c) **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.

Question 23

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?*
- (b) *"Operating Conditions" that may cast doubt about going concern assumption.*
- (c) *The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement?*

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, the auditor shall-

- (i) 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 24

Write a short note on Defalcation of cash with examples.

Answer

Defalcation of Cash: Defalcation of cash has been found to perpetrate generally in the following ways -

(i) *By inflating cash payments.*

Examples of inflation of payments:

- (1) *Making payments against fictitious vouchers.*
- (2) *Making payments against vouchers, the amounts whereof have been inflated.*
- (3) *Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.*
- (4) *Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.*

(ii) *By suppressing cash receipts. Few Techniques of how receipts are suppressed are:*

- (1) *Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, money received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.*
- (2) *Adjusting unauthorised or fictitious rebates, allowances, discounts etc. to customer' accounts and misappropriating amount paid by them.*
- (3) *Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.*

- (4) *Not accounting for cash sales fully.*
 - (5) *Not accounting for miscellaneous receipts e.g. sale of scrap, quarters allotted to the employees etc.*
 - (6) *Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.*
- (iii) *By casting wrong totals in the cash book.*

Question 25

- (a) *Mention any four information which assists the auditor in accepting and continuing of relationship with the client as per SA 220.*
- (b) *State the significant difficulties encountered during audit with reference to SA-260 (communication with those charged with governance).*
- (c) *The auditor may exercise his judgement to identify which risks are significant risks. Explain the above in context of SA-315.*

Answer

- (a) *Information which assist the Auditor in accepting and continuing of relationship with Client: As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:*
 - (i) *The integrity of the principal owners, key management and those charged with governance of the entity;*
 - (ii) *Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;*
 - (iii) *Whether the firm and the engagement team can comply with relevant ethical requirements; and*
 - (iv) *Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.*
- (b) *Significant Difficulties Encountered During the Audit: As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:*
 - ◆ *Significant delays in management providing required information.*
 - ◆ *An unnecessarily brief time within which to complete the audit.*

- ◆ *Extensive unexpected effort required to obtain sufficient appropriate audit evidence.*
 - ◆ *The unavailability of expected information.*
 - ◆ *Restrictions imposed on the auditor by management.*
 - ◆ *Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.*
- (c) *Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.*

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following-

- (i) *Whether the risk is a risk of fraud;*
- (ii) *Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention;*
- (iii) *The complexity of transactions;*
- (iv) *Whether the risk involves significant transactions with related parties;*
- (v) *The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and*
- (vi) *Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.*

Question 26

What are the objectives and functions of Auditing and Assurance Standards Board (AASB)?

Answer

Objectives and Functions of the Auditing and Assurance Standards Board: The following are the objectives and functions of the Auditing and Assurance Standards Board-

- (i) *To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.*
- (ii) *To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.*
- (iii) *To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.*
- (iv) *To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.*
- (v) *To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.*
- (vi) *To formulate General Clarifications, where necessary, on issues arising from Standards.*
- (vii) *To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.*

Question 27

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

The basic objective of audit does not change with reference to nature, size or form of an entity.

Answer

Correct: An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

Question 28

Discuss the following:

- (a) *Advantages of independent audit.*
- (b) *Is detection of fraud and error duty of an auditor?*

Answer

- (a) *Advantages of 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 statement before it gives assistance or issues a license for a particular trade.*
- (b) *Detection of Fraud and Error - Duty of an Auditor: As per SA-240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an*

active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability. Broadly, the general principles laid down in this regard are:

- (i) 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. As described in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", 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.*
- (ii) 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.*
- (iii) 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.*
- (iv) 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. The requirements in this SA are 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.*

It may be concluded from the above that detection of fraud and error is not the duty of the auditor provided that he complies with the requirements given in Standards on Auditing, maintains professional skepticism throughout the audit and is not grossly negligent in the performance of his duties as an auditor.

Question 29

Write a short note on Fraudulent financial reporting.

Answer

Fraudulent Financial Reporting: Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting.

In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Fraudulent financial reporting may be accomplished by the following:

- (i) Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.*
- (ii) Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.*
- (iii) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.*

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

Question 30

With reference to SA 320, indicate the factors which may affect the identification of an appropriate bench mark in determining materiality for the financial statement as a whole.

Answer

Factors that may affect the Identification of an Appropriate Benchmark in Determining Materiality: As per SA 320 "Materiality in Planning and Performing an Audit", determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following-

- (i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);*
- (ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);*

- (iii) *The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;*
- (iv) *The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and*
- (v) *The relative volatility of the benchmark.*

Exercise

1. *State your opinion on the following:*
 - (a) *The duties of auditors are limited to the verification of the arithmetical accuracy of the books of accounts.*
 - (b) *The audit of financial statements relieves management of its responsibilities.*
 - (c) *Some material misstatements remained unreported by auditors.*
2. *State with reasons your views on the following:*

Mr. X, a partner of X & Co., Chartered Accountants died of a heart attack on 30.03.16 after completing the entire routine audit work of T Ltd., Mr. Y one of the partners of the firm, therefore signed the accounts of T Ltd. without reviewing the finalization work done by the assistants.
3. *"Generally an audit is not concerned with the propriety of business conduct". Comment.*
4. *Distinguish between Auditing, Accounting and Investigation.*