

NATURE OF AUDITING

BASIC CONCEPTS

As per SA 200 “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

The principal aspect to be covered in an audit concerning final statements of account are the following:

- (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 profit and loss account 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.
- (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.

Auditing and Assurance

Basic principles governing an Audit

SA-200 describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. 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:

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

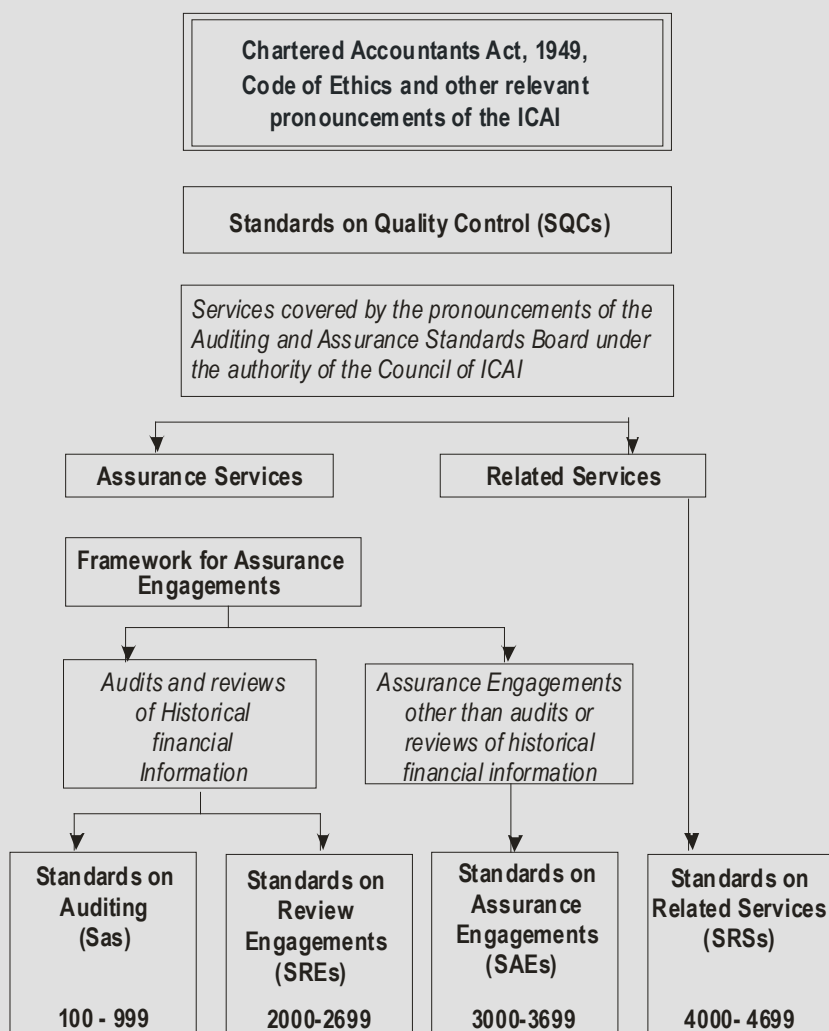
Types of Audit

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.,

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.

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Auditing and Assurance

Question 1

Comment on the “Auditor is entitled to rely on work performed by others”.

Answer

Relying on work performed by others

SA 200 on, “Basic Principles Governing an Audit” envisages manifold circumstances when an auditor would have to depend upon the work performed by others. Such other parties may be experts, other auditors including branch auditors or his own assistants.

Overall Responsibility

SA 200 while laying down “Work Performed by Others” as one of the basic principle governing an audit makes it clear that in cases where the auditor is required to delegate a part of his work to his assistants or use the work performed by other auditors/experts, he continues to remain responsible for expressing his opinion on the financial statements. Thus, he can rely on work performed by others provided he exercises reasonable skill and care and he has no reason to believe that he should not have so relied.

The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

In case of statutory assignments, like relying on audit report of branches conducted by other auditors, he should expressly state the fact of such reliance.

Question 2

Comment on the “An opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted the affairs of the enterprise”.

Answer

According to SA 200A on “Objective and Scope of the Audit of Financial Statements” states that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. Further, the SA states that such an opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise.

It is not possible for an auditor to provide absolute assurance in relation to the **future viability, efficiency and effectiveness** on account of the following:

The objective of an audit is to enable an auditor to express his opinion on the financial statements. The auditor’s opinion helps in determining the true and fair view of the financial

statements and the operating results of an enterprise. The objective of the audit process is not to examine transactions from the view points of efficiency, effectiveness or the future viability.

The audit process cannot confirm the viability of the operating effectiveness as the subject matter of audit i.e. financial statements itself are outcome of several judgements and accounting estimates on the part of the enterprise.

It must also be appreciated that the process of auditing suffers from certain inherent limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures.

It may however be noted that over a period of time, the scope of audit extended quite considerably by inclusion of certain matters of proprietary nature in Section 227 of the Companies Act, 1956 as well as international regulations such as Sarbanes Oxley Compliance.

The auditor has been primarily concerned with carrying out what may be termed as verificatory audit. Thus, the auditor did not sit on judgement on management decisions, policies or the commercial prudence of transactions. However, with the introduction of aforesaid provisions, the auditor is required to express opinion on certain aspects of management decisions involving propriety aspects as well.

Question 3

- (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) The responsibility for the prevention and detection of fraud and error rests with management through the implementation and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error. In forming his opinion, the auditor carries out procedures designed to obtain evidence that will provide reasonable assurance that the financial information is properly stated in all material respects. Consequently, the auditor seeks reasonable assurance that fraud or error which may be material to the financial information has not occurred or that; if it has occurred, the effect of fraud is properly reflected in the financial information or the error is corrected. The auditor, therefore, plans his audit so that he has a reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error. The degree of assurance of detecting errors would normally be higher than that of

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detecting fraud, since fraud is usually accompanied by acts specifically designed to conceal its existence. Due to the inherent limitations of an audit there is a possibility that material misstatements of the financial information resulting from fraud and, to a lesser extent, error may not be detected. 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) An independent audit whether performed in terms of relevant statutory legislation 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:** 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 nature that an audit suffers from control risk on account of inherent limitations of internal control risk and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

Question 4

Write a short note on – Errors of Commission.

Answer

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

Errors in posting,

Errors in Casting,

Errors in carrying forward,

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 Rs.360 from Mr A posted in his account at Rs.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 Profit and Loss A/c (over statement of expenditure).

Question 5

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

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Answer

In planning and performing his 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 6

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 7

State with reasons your views on the following:

- (a) *The auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements.*
- (b) *The Auditor does not agree with affirmations made in the financial statements.*

Answer

(a) Failure to obtain sufficient information

The auditor is required to obtain necessary information and explanation which he considers essential for performing his duties as an auditor. However, there may be instances when an auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements.

Such a situation may happen either due to limitation on the scope of duties of auditors imposed by the management or the auditor is not able to verify books of account or evidence due to circumstances beyond one's control.

Under the first instance, a situation may also arise when an auditor is not permitted to verify inventory at different locations, say, out side the city in which the company's office is located. It would also amount to restriction on the scope of the duties of an auditor.

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The second category may involve a situation when the books of accounts of a company are seized by the Income-tax authorities then the auditor would be unable to conduct an audit of the same.

In view of these situations, the auditor would not be able to obtain sufficient information to reach at any conclusion. Under the circumstances, he would not be in a position to express any opinion on the financial statements.

Therefore, the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient audit evidence to form an opinion.

(b) Disagreement with affirmations made in financial statements

The financial information contained in the financial statements represents affirmations made by the management in respect of various assets and liabilities included therein as to their valuation, existence, completeness, proper presentation and disclosure by the management to arrive at the final amounts being included in the financial statements.

It is quite likely that an auditor may not agree with such affirmations made in the financial statements. The auditor issues a negative report when he is of the opinion that based on his examination, he does not agree with affirmations made in the financial statements.

In other words, in his opinion, the financial statements do not present a true and fair view of the state of affairs and the working results of the organisation. An adverse or negative report is issued when the reservation or objections of the auditors are so material that he feels that overall view of the accounts as presented would be a serious distortion.

It may be noted that in actual practice it is quite common to come across qualified reports while adverse reports are quite rare.

Question 8

“The auditors should consider the effect of subsequent events on the financial statement and on auditors 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 balance sheet and the date of the audit 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

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:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring 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.
- (c) Reading 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.

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- (d) Reading the entity's latest subsequent interim financial statements, if any.
- (e) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
- (f) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
- (g) 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 9

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

Answer

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	Basic Principles Governing an Audit	April 1, 1985
3	SA 200 A	Objective and Scope of the Audit of Financial Statements	April 1, 1985
4	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
5	SA 220	Quality Control for Audit Work	April 1, 1999
6	SA 230	Audit Documentation	April 1, 2009
7	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
8	SA 250	Consideration of Laws and Regulations in An	April 1, 2009

Nature of Auditing

		Audit of Financial Statements	
9	SA 260	Communication with Those Charged with Governance	April 1, 2009
10	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Government and Management	April 1, 2010
11	SA 299	Responsibility of Joint Auditors	April 1, 1996
12	SA 300	Planning an Audit of Financial Statements	April 1, 2008
13	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008
14	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
15	SA 330	The Auditor's Responses to Assessed Risks	April 1, 2008
16	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010
17	SA 450	Evaluation of Misstatements Identified during the Audits	April 1, 2010
18	SA 500	Audit Evidence	April 1, 2009
19	SA 501	Audit Evidence-Additional Considerations for Specific Items	April 1, 2005
20	SA 505	External Confirmation	April 1, 2003
21	SA 510	Initial Audit Engagements-Opening Balances	April 1, 2010
22	SA 520	Analytical Procedure	April 1, 1997
23	SA 530	Audit Sampling	April 1, 2009
24	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	April 1, 2009
25	SA 550	Related Parties	April 1, 2010
26	SA 560	Subsequent Events	April 1, 2009
27	SA 570	Going Concern	April 1, 2009
28	SA 580	Written Representations	April 1, 2009

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29	SA 600	Using the Work of Another Auditor	April 1, 2002
30	SA 610	Using the Work of Internal Auditors	April 1, 2010
31	SA 620	Using the Work of an Expert	April 1, 1991
32	SA 700	The Auditor's Report on Financial Statements	April 1, 2003
33	SA 710	Comparatives	April 1, 2003
34	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 1, 2010
35	SRE 2400	Engagements to Review Financial Statements	April 1, 2005
36	SAE 3400	The Examination of Prospective Financial Information	April 1, 2007
37	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information	April 1, 2004
38	SRS 4410	Engagements to Compile Financial Information	April 1, 2004

(Note: Candidates may mention any twelve SAs. A list is given for the information of candidates including the four standards introduced recently, viz.,)

Question 10

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

Answer

Auditor's Responsibilities for Detection of Fraud and Error: The primary objective of an auditor is to express an opinion on the financial statements. However, the auditor while conducting the audit is required to consider the risk of material misstatements in the financial statements resulting from fraud or error.

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 significant 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.

Question 11

State briefly the qualities of Auditors.

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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, 1956, 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 that goes to make a good person contribute to the making of a good auditor. In addition, he 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 12

(a) Give your comment on the following:

Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2009-10. The closing stock of the company as on 31.3.2009 amounting to Rs. 100 lacs continued as it is and became closing stock as on 31.3.2010. The auditors of the company propose to exclude from their audit programme the audit of closing stock of Rs. 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) Profit and Loss Statement
Travelling Expenditure Rs.50,000
- (ii) Balance Sheet
Debtors Rs.2,00,000

Answer

(a) **Verification of Stocks** SA 510 "Initial Audit Engagements – Opening Balances", requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

- (a) the closing balances of the preceding period have been correctly brought forward to the current period;
- (b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and
- (c) appropriate accounting policies are consistently applied.

When the financial statements for the preceding period were audited by the another 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. 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 stock 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 stock 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 stock from his audit programme.

(b) (i) **Travelling Expenditure: Rs.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 Rs.50,000 during the year.
- It has been treated as revenue expenditure and charged to profit and loss account.

(ii) **Debtors: Rs.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.

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- These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

Question 13

Write short note on the following:

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

Answer

- (a) **General Purpose Financial Statements:** 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 14

Answer the following:

- (i) What is an Audit Engagement letter?
- (ii) Discuss the situations where it is necessary to issue audit engagement letter each year for repetitive audits.

Answer

- (i) **Audit engagement letter** : Audit engagement letter is a communication issued by auditor to the auditee (the client) expressing therein *inter alia*, the fact of acceptance of his audit engagement, the objectives and scope of his audit, the extent of auditor's responsibilities and management responsibility for compilation of accounting, application of accounting principles, standards, fees.
- (ii) **Need for the Issue of Audit Engagement Letter**: It is not necessary to issue audit engagement letter each year for repetitive audit. It is enough if the same had been issued at the time of taking initial engagement.

When it is repetitively issued : However, the auditor may think of issuing a fresh engagement letter in one or more circumstances described below :

- (i) When it appears that the client has misunderstood the objective and scope of audit.
- (ii) Where there has been change in management, board, or ownership so that it is felt that it is pertinent to remind them of the engagement terms again.
- (iii) Where any revision by way of addition, deletion, or modifications had been contemplated in the engagement letter originally issued.
- (iv) Where significant changes had occurred in nature, volume of the business transactions of the client which warrant the scope and terms of engagement to be altered to be in tune with them.
- (v) Where there has been necessity to modify audit approach to be in line with the pronouncements of ICAI, the Companies Act and the like.

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Question 15

State the matters which the statutory Auditor should look into before framing opinion on accounts on finalisation of audit of accounts? Discuss over all 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 16

Write short notes on Audit versus Investigation.

Answer

Auditing versus Investigation: 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.

Question 17

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

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Answer

Basic Principles Governing an Audit: SA 200 on, "Basic Principles Governing an Audit" describes the basic principles which govern the auditor's professional responsibilities and the same should be complied with whenever an audit is carried out.

The Council has clarified that it is a duty of the member of the Institute to ensure that the, "Statements" relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.

The basic principles are discussed below briefly:

- (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.

Question 18

What are the inherent limitations of audit?

Answer

Inherent limitations of Audit: The objective of an audit of financial statements, prepared within 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 himself 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 inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. Such limitations arise, first of all, on account of exercise of judgment in the auditor's work in deciding the extent of audit procedures and exercising judgement also in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Secondly, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these

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factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected. Another reason which may contribute to inherent limitation is the fact that the entire audit process is generally dependent upon the existence of an effective system of internal control. In such an event, it is clearly evident that there will always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations since any system of internal control is ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls; for example, by directing subordinates to record transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal control system also contribute to inherent limitations of an audit. Therefore, it is quite apparent from above that an audit suffers from certain inherent limitations.

EXERCISES

Question 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.

Question 2

State with reasons your views on the following:

Mr. X, a partner of X & Co., Chartered Accountants died of a heart attack on 30.03.99 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.

Question 3

"Generally an audit is not concerned with the propriety of business conduct", Comment.

Question 4

Distinguish between Auditing, Accounting and Investigation.