

## BASIC CONCEPTS IN AUDITING

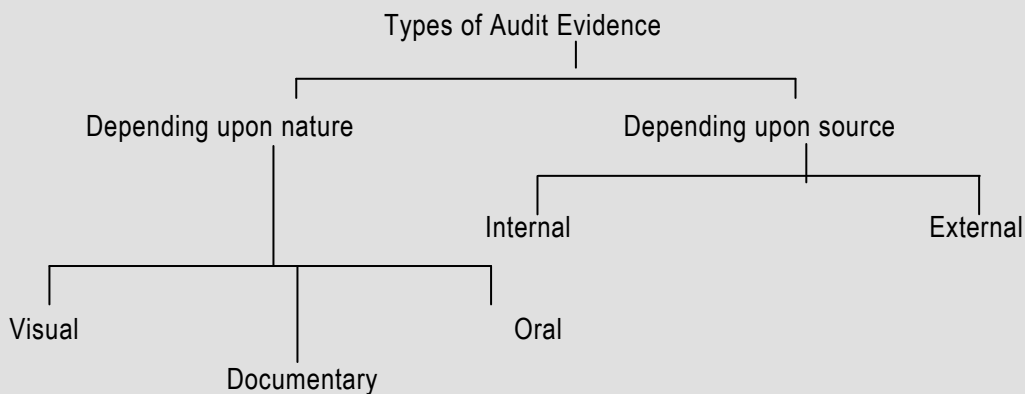
### BASIC CONCEPTS

**Auditor's Independence:** Independence is the keystone upon which the respect and dignity of a profession is based. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest.

**True and Fair:** The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

**Audit Evidence:** Audit evidence refers to information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

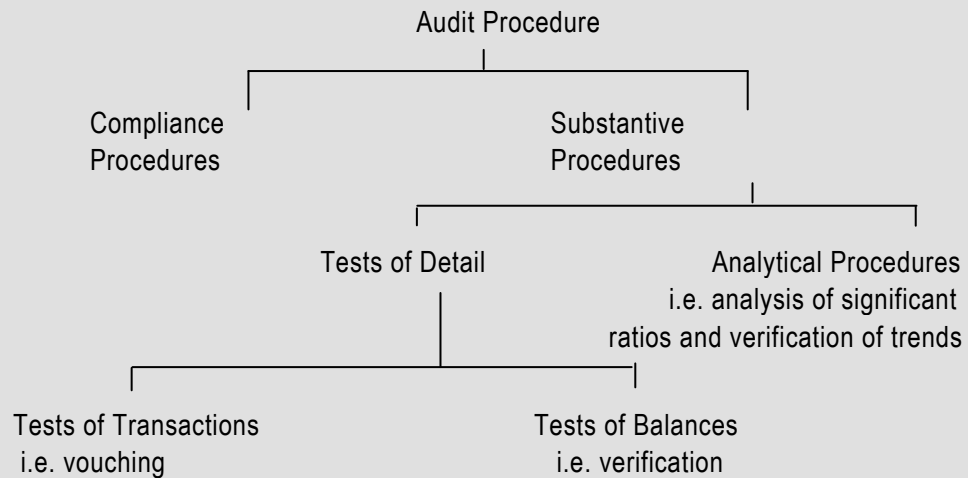
### Types of Audit Evidence



## Auditing and Assurance

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### Audit Procedures to Obtain Audit Evidence



**Accounting policies** refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

**Fundamental Accounting Assumptions:** AS 1 states that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The following have been generally accepted as fundamental accounting assumptions:

- (i) Going Concern
- (ii) Consistency
- (iii) Accrual

### Question 1

*What is the importance of having the accounts audited by independent professional auditors?*

### Answer

#### Importance of Audit by an Independent Professional Auditor

The principal advantage of an independent audit lies in the fact that the society is able to get an informed, objective and forthright opinion on the financial statements of enterprises which are used in making significant economic decisions by interested segments of the society, e.g., shareholders, creditors, bankers, etc. Irrespective of the fact whether audit is

compulsory, statutory or voluntary, the audit of accounts by an independent professional auditor becomes important for every individual and every type of organisation.

It is only through audited accounts by an independent professional auditor that the shareholders of a company are assured that the funds invested by them are safe and they are being used for only the purposes for which they were raised and collected. The chief utility of audit lies in ensuring reliable financial statements on the basis of which the state of affairs may be easy to understand. Information contained in the statement of accounts of a business are primarily intended for the owners.

However, many others make use of the information for different purposes.

- Management of the business uses it for decision-making purposes.
- Lenders and creditors examine it to establish the degree of safety of their money.
- Government levies tax putting a *prima facie* reliance on the statements and regulates the socio-economic state of affairs on a summary view of the information contained in various accounting statement made available to it.
- Investors review the information for making investment decisions
- Financial analysts can use the information to assess the performance of an entity.

Financial statements are of great significance to workers as well; they want to be assured that reasonable and legitimate share of the revenue earned by the organisation has been paid to them as bonus and the distribution pattern has not violated the norms of social justice.

To ensure the acceptable degree of reliability and accuracy of the financial statements, examination and appraisal of accounts and the financial picture by an independent auditor is necessary.

In the company form of organisation, there is a divorce between ownership and management - shareholders are so scattered that they have no direct control on the day-to-day administration of the company while in a proprietary concern, accounts may be audited to get funds from financial institution, etc. and a partnership firm may get its accounts audited to decide questions such as valuation of goodwill at the time of admission, retirement and death of a partner.

The report of an independent auditor is, therefore, the only real safeguard available to the various parties interested in the financial affairs of the entity. It is due to the independence of the auditor, leading to an objective report, that the risk of people being misled by untrue or fraudulent financial statement is minimized. As a by-product, managements get attuned to open and truthful financial statements.

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### Question 2

Write short notes on the following:

- (a) Preliminary Expenses
- (b) Fundamental Accounting Assumptions

### Answer

- (a) **Preliminary Expenses:** This term is applied to expenses incurred in connection with the formation of a limited company. They generally include the following expenses:

- (i) Legal costs in drafting the memorandum and articles of association;
- (ii) Capital duty and other fees on registration of the company;
- (iii) Cost of printing the memorandum and articles of association;
- (iv) Cost of statutory books and the companies seal, etc; and
- (v) Any other expense incurred to bring into existence the statutory books of the company.

Preliminary expenses in so far as they have not been written off to date must be shown separately in the balance sheet of the company under the heading "Miscellaneous Expenditure".

The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined.

- (b) **Fundamental Accounting Assumptions:** As per AS 1 on "Disclosure of Accounting Policies" accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements. There is no single list of accounting policies which are applicable to all circumstances.

The choice of the appropriate accounting principles and the methods of applying those principles in specific circumstances call for judgement by the management. The profit or loss can be significantly affected by the accounting policies followed. Therefore disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

In this context, AS 1 states that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The following have been generally accepted as fundamental accounting assumptions:

- (a) **Going Concern:** The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
- (b) **Consistency:** It is assumed that accounting policies are consistent from one period to another.
- (c) **Accrual:** Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

Thus, if the fundamental accounting assumptions, viz., Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

### Question 3

- (i) What is "Audit Evidence"?
- (ii) What are the various methods of obtaining audit evidence? Mention the same in brief.
- (iii) Discuss the principles, which are useful in assessing the reliability of audit evidence.

### Answer

- (i) **Audit Evidence:** Auditor needs evidence to obtain information for arriving at his judgement. SA 200 on "Basic Principles Governing and Audit", mention audit evidence as one of the basic principles and requires that 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.

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit.

SA 500 "Audit evidence" refers to information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both

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information contained in the accounting records underlying the financial statements and other information.

The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

The audit evidence may be of varied nature and can assume various forms. For example, a signature on the voucher of a designated official, the payee's receipt, etc. Even the information obtained by the auditor by discussing with the officials of the company also constitutes audit evidence.

- (ii) **Methods of Obtaining Audit Evidence:** The auditor obtains evidence by one or more of the following methods:

### **Inspection**

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

### **Observation**

Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel,

or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

### **External Confirmation**

An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition.

### **Recalculation**

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

### **Reperformance**

Reperformance involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.

### **Analytical Procedures**

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. See Proposed SA 520 (Revised) for further guidance.

### **Inquiry**

Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

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Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

### (iii) Reliability of Audit Evidence

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

### Question 4

*Explain the advantages of "Audit Working Papers".*

#### Answer

Audit working papers constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and clients' record.

These include retention of permanent record in the nature of a document to show the actual audit work executed the nature of the, work, the extent of the work and important points, facts, dates and decisions having bearing on the audit of the accounts audited. The working papers, if properly maintained, can be used as defence in case of need. The audit working papers are found very useful in the following aspects as they:

- (i) aid in the planning and performance of the audit;
- (ii) aid in the supervision and review of the audit work;
- (iii) provide evidence of the audit work performed to support the auditor's opinion; and
- (iv) act as an evidence in the Court of law when a charge of negligence is brought against the auditor.

### Question 5

*Comment on "For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence as per SA 510".*

#### Answer

SA 510 "Initial Engagements-Opening Balances", with the auditor's responsibilities relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

**Initial Engagement:** As per the SA 510 "Initial Audit Engagements – Opening Balances",

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An engagement in which either:

- (i) The financial statements for the prior period were not audited; or
- (ii) The financial statements for the prior period were audited by a predecessor auditor.

The situation mentioned in (i) above arises when the auditor is appointed to take up the audit for the first-time or no audit was carried out of the financial statements of the entity for the immediately preceding period. The situation mentioned in (ii) above arises whenever there is a change of auditor. For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss<sup>1</sup>;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following:
  - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
  - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
  - (iii) Performing specific audit procedures to obtain evidence regarding the 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:

- (a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- (b) 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.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial

statements by:

- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss<sup>2</sup>;
- (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (c) Performing one or more of the following
  - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
  - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
  - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with SA 315.

### Question 6

*Write a short note on – Disclosure of Accounting Policies.*

### Answer

**Disclosure of Accounting Policies:** The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements.

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<sup>2</sup> Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that prior period items should be separately disclosed in the Statement of Profit and Loss in a manner that their impact on the current profit or loss can be perceived.

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The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by some cases.

The purpose of AS 1 is to promote better understanding of financial statements by establishing through an accounting standard and the disclosure of significant accounting policies and the manner in which such accounting policies are disclosed in the financial statements.

Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes which form part of financial statements.

Any change in accounting policy, which has a material effect, should be disclosed. The amount by which any item is in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies, which has not material effect on the financial statements for the current period, which is reasonably expected to have material effect in latter periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

### Question 7

*How would you proceed to check the misappropriation of cash in a trading concern?*

### Answer

#### **Steps to check misappropriation of cash:**

Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc.

The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for.

It is, therefore, the duty of the auditors to see that in the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the fore goings.

Some of the methods through which cash may be misappropriated include:

- (a) Omission cash receipts:
  - (i) cash sales not recorded;
  - (ii) teeming and lading;
  - (iii) casual receipts of miscellaneous nature not entered; and
  - (iv) sale proceeds of fully written off assets not recorded.
- (b) Recording of less amounts than that actually received.
- (c) Recording of more amounts than that actually expended, e.g., discounts or rebates not taken into account while making payments, etc. Inclusion of fictitious payments in cash book e.g. wages paid to 'ghost' or 'dummy' workers, salary paid to apprentices whose tenure of services expired, etc.
- (d) Intentional errors in totaling, balancing and carrying over of cash book balances.

With a view to check misappropriation of cash, the existence of internal check system is quite essential. In particular, the following may be noted:

- (i) Ascertaining the existence of system of cash receipts and disbursements of cash sales and purchases and existence of internal checks at various stages is quite important. In particular, the separation of duties and incompatible functions, e.g., an employee who receives and deposits cash and cheques should not prepare sales invoices, or reconcile bank accounts, and authorised signatory should not approve vouchers for payment.
- (ii) Checking of cash receipts with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by itself would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as

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evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated.

- (iii) Checking of date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.
- (iv) Verify cash sales with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof, as entered in the Cash Book.
- (v) Check receipt of cash from the customers against price of good sold with the counterfoils of receipt issued to them. Also compare entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in customers' accounts, which ought to have collected in whole, are cleared in small instalments.

### Question 8

*What are Audit working papers and why should they be carefully preserved by the Auditor?*

### Answer

**Audit Working Papers:** As per SA 230(Revised) "Audit Documentation" Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

Working papers are the

- (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides they serve a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with Proposed SA 220 (Revised).
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, working papers available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel

### Question 9

*Explain the compliance procedure and also substantial procedures as Audit methods of collecting evidences for forming an audit opinion.*

### Answer

**Collection of evidences to form audit opinion:** Auditor should obtain sufficient and appropriate audit evidences and test them before framing an opinion about the assertions the financial statements reveal. For this, the auditor checks evidences through (a) Compliance procedure and (b) Substantial procedure.

Compliance procedures are tests designed to obtain reasonable assurance that those internal control on which audit reliance is to be placed are in effect. It seeks to test that (a) there exists internal control, (b) the existing internal control is effective and (c) and the internal control is working without break or lacunae during the period under review.

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When internal control is found to be to an acceptable level, the accounting entries generated in such a system is more reliable than in one where the control is weak.

Mere satisfaction about the existence of internal control may not be sufficient for auditors to express opinion about the assertions the financial data in the form of balances and transactions. These i.e. transactions and balances need to be tested. This is done by audit procedure called substantial checking.

Substantial procedures are designed to obtain audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

The substantial procedures involve (a) checking of transactions and balances and (b) analytical review. The checking of transaction and balances involves vouching of sales, purchases, payments, receipts and scrutiny of ledgers.

The analytical procedure involves critically examining the accounts in an overall manner and it may entail computation of ratios, trend analysis so as to dwell in length for examination of unusual or unexplained deviations.

### Question 10

*Discuss the concept of "True and Fair".*

### Answer

#### Concept of "True and Fair":

The concept of "true and fair" is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

What constitutes "true and fair" has not been defined in the legislation. However, section 211(5) of the Companies Act, 1956 states that the balance sheet and profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company if they do not disclose any matters which are not required to be disclosed by virtue of the provisions of Schedule VI to the Companies Act, 1956, or by virtue of any notification or any order.

Therefore the auditor must see that the accounts are drawn up as per requirements of the provisions of Schedule VI, and whether they contain all matters required to be disclosed

therein. In case of companies governed by special Acts, say, banking, electricity, etc. the auditor should see, whether the relevant disclosure requirements are complied with.

Thus, what constitutes a true and fair view is a matter of the auditor's judgement in the particular circumstances of the case. In specific terms to ensure truth and fairness, an auditor has to see:

- (i) that the assets are neither undervalued or overvalued;
- (ii) no material asset is omitted;
- (iii) the charge on assets, if any, is disclosed;
- (iv) material liabilities should not be omitted, and liabilities are neither undervalued or overvalued;
- (v) accounting policies have been followed consistently;
- (vi) all unusual, exceptional, non recurring items have been disclosed separately;
- (vii) accounts have been drawn as per requirement of Schedule VI to the Companies Act; and
- (viii) the accounts have been drawn in compliance to the relevant accounting standards. In case of deviation from accounting standards, disclosure should be made of the reasons for such deviation and financial effects, if any arising due to such deviation

### Question 11

*Explain with reference to the relevant Standard on Auditing Appropriateness of going concern assumption?*

### Answer

**Appropriateness of Going Concern Assumption:** As per SA 570 "Going Concern" when planning and performing audit procedures and in evaluating results thereof, the auditor should consider the appropriateness of going concern assumption underlying the preparation of financial statements.

Though an auditor's report helps to establish the credibility of financial statements, it is not a guarantee as to the future viability of the entity.

An entity's continuance as a going concern for the near future, generally around one year after the balance sheet date is assumed in the preparation of financial statement in the absence of any information to the contrary.

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However, the auditor should consider the risk that the going concern assumption may no longer be appropriate. Examples of indications of risks that the continuance as a going concern may be questionable are:

### **Financial Indications:**

- (a) Negative net worth or negative working capital.
- (b) Substantial operating losses, and negative cash flows from operations.
- (c) Adverse key financial ratios.
- (d) Excess short-term borrowings to finance long-term assets.
- (e) Arrears of dividend.
- (f) Increase of creditors, and inability to pay them on due dates.
- (g) Inability to repay the long-term loans on maturity.
- (h) Entering into a scheme of arrangement with creditors for reduction of liability.

### **Operating Indications:**

- (i) Loss of key management personnel without replacement.
- (ii) Shortage of important supplies.
- (iii) Loss of major market.
- (iv) Industrial unrest.

### **Other Indications:**

- (i) Non compliance with statutory requirements.
- (ii) Sickness of entity under any statutory definition.
- (iii) Changes in laws or any government policy, adversely affecting the working of the entity.
- (iv) Pending legal proceedings against the entity, which will adversely affect the entity.

### **Question 12**

*What are accounting estimates according to the Standards on Auditing 540? Give examples.*

### **Answer**

According to the SA 540, "Audit Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure" accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other

amounts that require estimation. Where as per SA 540 addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.

Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

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

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

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

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

Additional examples of accounting estimates are:

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

### Question 13

*Write short note on Auditor's Independence*

**Answer**

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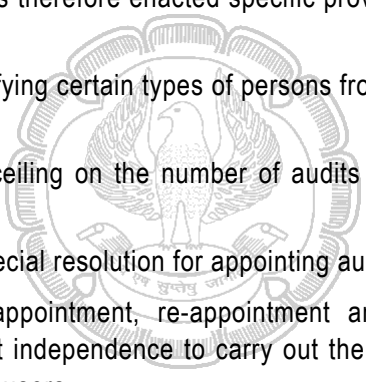
## Auditing and Assurance

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**Auditor's Independence:** Independence is the keystone upon which the respect and dignity of a profession is based. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest. The independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometime imposed by law. In the context of auditors, his independence is necessary so as to enable him to express unbiased opinion on financial statements. The user of the financial statement will rely on the opinion of the auditor only when he is convinced about his independence. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons.

The chartered accountant is not known personally to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act, 1956, has therefore enacted specific provisions to give concrete shape to this vital concept:

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- (i) The provisions disqualifying certain types of persons from undertaking audit of limited companies.
  - (ii) Provisions relating to ceiling on the number of audits that can be undertaken by a chartered accountant.
  - (iii) Provisions requiring special resolution for appointing auditors in certain cases.
  - (iv) Other provisions on appointment, re-appointment and removal of auditors, are designed with sufficient independence to carry out the audit in the larger interest of shareholders and other users.
  - (v) Power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence.

### Question 14

*Answer the following:*

- (i) *Explain, what do you mean by Analytical procedures. How such procedures are helpful in auditing?*
- (ii) *Explain concept of 'Materiality'*

### Answer

- (i) **SA 520 'Analytical Procedures':** Analytical procedures mean the analysis of significant ratios, and trends, including the resulting investigation of fluctuations and

relationships that are inconsistent with other relevant information or which deviate from predicted amounts".

The fluctuation or relationship are investigated when the ratio or trend analysis show deviant data or relationship. The analytical procedures include consideration for comparison of financial information of the entity with other relevant figures and also consideration for relationship.

Analytical procedures are used for the following purposes:

- (a) to assist the auditor in planning the nature, timing and extent of other audit procedures;
- (b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and
- (c) as an overall review of the financial statements in the final review stage of the audit.

The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business. The conclusion drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

However in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

- (ii) **Concept of Materiality:** This concept is fundamental to the process of accounting. It covers all the stages from the recording to classification and presentation. It is therefore, an important and relevant consideration for an auditor who has constantly to judge whether a particular item or transaction is material or not.

SA 320 on Materiality in Planning and Performing an Audit deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450<sup>3</sup>, explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. Financial statement materially effected if such statement is erroneously stated or omitted to be stated therein and economic

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<sup>3</sup> SA 450, "Evaluation of Misstatements Identified during the Audit"

## Auditing and Assurance

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decision of the users taken on the basis of such information is influenced by such misstatement or omission.

Auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

### Question 15

*Write short note on Management representation as audit evidence*

### Answer

#### **The management representation as audit evidence:**

- (1) During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to some specific enquiries.
- (2) The auditor also should obtain representation from management, where considered appropriate and necessary.
- (3) The management representation is taken to corroborate audit evidence, but representations by management can not be a substitute for other audit evidences that the auditor could reasonably expect to be reasonably available.
- (4) In certain cases, where knowledge of facts is confined to management, a representation by management may be the only audit evidence, which can reasonably be expected to be available.
- (5) If a management representation is contradicted by an available other audit evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by management.

### Question 16

*How the work of an expert should be evaluated before accepting the same as an Audit evidence?*

### Answer

**Using the work of an expert:** As per the SA 620 "Using the Work of an Expert", when the auditor intends to use the work of an expert he should evaluate the following before accepting the same as audit evidence:

- (i) Professional qualification of the expert;

- (ii) Experience and reputation of expert in related field;
- (iii) Independence and objectivity of the expert;
- (iv) The objectives and scope of the expert's work;
- (v) Expert's relationship with the client, if any;
- (vi) The source data used;
- (vii) Assumptions and method used;
- (viii) the results of the expert's work in the light of auditor's overall knowledge of the business and of the result of his audit procedures.

### Question 17

*What is meant by external confirmation? Mention four situations where external confirmation may be useful for auditors.*

### Answer

**External confirmation:** It is the process of obtaining and evaluating audit evidence through a direct communication from a third party, who is not related to the entity – in response to a request for information about a particular item affecting assertions made by management in the financial statements.

The auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. Following are examples of situations where external confirmations may be useful.

- (i) Bank balances and other information from bankers
- (ii) Account receivables balances
- (iii) Stock held by third parties
- (iv) Account payable balances.

### EXERCISES

#### Question 1

State with reasons your views on the following:

- (a) An assistant of X & Co. Chartered Accountants detected an error of Rs. 5 per interest payment which recurred number of times. The General Manager (Finance) of T Ltd. advised him not to request for passing any adjustment entry as individually the errors were of small amounts. The company had 2,000 Deposit Accounts and interest was paid quarterly.
- (b) The company produced photocopies of fixed deposit receipts as the original receipts were kept in the iron safe of the director finance who was presently out of the country on company business.

#### Question 2

State any ten areas in which different accounting policies may be encountered.

#### Question 3

State with reasons (in short) whether the following statements are true or false

- (i) An auditor is considered to lack independence, if the partner of the audit firm owns the building in which the client's business is situated.
- (ii) One of the techniques used for gathering evidence is substantial review.