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Chapter 1

Introduction to Auditing

1.1 GENERAL PURPOSE FINANCIAL STATEMENTS

Financial Statements include the following:

- (a) **Profit & Loss Account:** Which indicates profit earned or loss incurred during a particular financial year. *It is made over a period of time.*
- (b) **Balance Sheet:** Which shows position of assets & liabilities at a particular date. *It is made at a particular date.*
- (c) **Cash flow & funds flow Statement:** Which shows movement of cash/ funds during a particular financial year (However these are not prepared by all entities). *inflow & outflow of cash.*
- (d) **Notes to accounts:** i.e. Disclosures or explanatory notes.

Users of financial statements

<u>Owner</u>	- For evaluating performance of business. - For evaluating profitability of business.
<u>Management</u>	- For evaluating their own performance. - For making decisions, <i>for future</i> - For judging tax liabilities. - For estimating expected future outcomes.
<u>Lenders & creditors</u>	- For judging credit worthiness of the entity. - For judging recoverability of their dues.
<u>Customers</u>	For determining general consistency of the business.
<u>Government</u>	- For calculation of direct tax. - For levying excise duty, VAT, etc.
<u>Employees</u>	- For determining reasonableness of wages & salaries etc. - For creating demand for bonus.
<u>Research analysts etc.</u>	- For evaluating trends. - For judging investment opportunities in the entity.

MR, ECG,

1.2 AUDITING

as per AAS	- Audit is an independent examination, - Of financial information, - Of any entity whether profit making or not, irrespective of its size & legal structure, - When such an examination is conducted with a view to express an opinion thereon.
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Features/ Characteristics of Audit	<i>Systematic & independent</i>	▪ Audit has to be conducted in a proper way. → <i>Properly planned</i> ▪ Auditor should be completely objective (unbiased) in his approach. ▪ He should not be influenced by the client.
	<i>Financial statements</i>	▪ Auditor's opinion is on financial statements including Profit and loss account, Balance sheet & Notes to accounts. ▪ The Preparation of financial statements is the responsibility of management of entity.
	<i>Entity</i>	▪ His client can be any entity whatever is the legal form i.e., it may be proprietorship, partnership, trust or company etc. ▪ The entity may be profit oriented or a charitable one.
	<i>Opinion</i>	▪ His opinion is on '<i>true & fair view</i>' of financial statements. ▪ For this, it is necessary that - Financial statement have been prepared using acceptable policies which are consistently applied, - Financial statements have been prepared as per relevant regulations, & - There is appropriate disclosure of all material items.
By Whom	In India, audit is to be conducted by a professional having good accounting & auditing background. A chartered accountant having certificate of practice is eligible to conduct audit.	

1.3 INDEPENDENT AUDIT

Meaning of Independence	(a) Independence means that the judgement of a person is not subordinate to wishes of another person. (b) It requires that he should not act under any influence. (c) Thus, he can work in a complete unbiased manner.	
Auditor's Independence	(a) The need for auditor independence is provided in AAS. (b) THE COMPANIES ACT, 1956 also contains specific provision to ensure auditor's independence. (c) Moreover, as per THE CHARTERED ACCOUNTANTS ACT, 1949 as amended by THE CHARTERED ACCOUNTANTS (AMENDMENT) ACT, 2006, independence of auditor is required.	
Why independence	(a) If auditor maintains high degree of independence, credibility of financial statements is enhanced. <i>He may not be in a position to express true & fair view.</i> (b) Independent audit report will be accepted & respected by all stakeholders.	
Advantages of independent audit	For management	(a) They can easily judge reasons for losses along with the reasons & try to control it. (b) They can ensure general reliability of accounting system.
	For Employees <i>check upon company bills etc.</i>	(a) It discourages them from committing frauds as it acts as a moral check on them. (b) They can judge reasonableness of payments w.r.t salary, bonus etc.

<i>For lenders</i>	- Bankers can place reliance on audited financial statements while making decision about credit worthiness of loan applicants. - Even after providing loan, the audited statements of borrower help the lender to judge recoverability of their funds.
<i>For Computing Tax</i>	- Audited statements enhances the reliability of computation of income earned by entity, thus helps in determining income tax. - Auditor also checks computation of excise duty & sales tax etc.
<i>For Owners</i>	- They get real picture of profits & losses earned. - From such statements, they come to know about their share in profit (as in partnership firms) and can expect dividend.
<i>For arbitration</i>	In case of dispute, audited statements help in settling claims.
<i>For insurer</i>	In case of loss or damage to property by fire, theft etc, it helps the insurer to settle the claim.
<i>For prospective investor</i>	On basis of past year's audited financial statements, they can devise expected profit trends for deciding whether to invest in the entity or not.

1.4 BASIC ASPECTS TO BE COVERED BY THE AUDITOR / AUDITORS FUNCTIONS

(a) <i>Internal Control</i>	Of Accounting system & Internal Control system to ensure about their appropriateness. ✓
(b) <i>Books</i>	Checking books of accounts to ensure their arithmetical accuracy. Posting & Carrying
(c) <i>Evidence</i>	Examining documentary evidence to support the books of accounts.
(d) <i>Full inclusion</i>	Checking whether all entries in the books of Accounting have been taken while preparing financial statements. (All material statement have been included)
(e) <i>Properness</i>	Examining whether information contained in financial statements is proper and it does not contain any erroneous or fraudulent entry.
(f) <i>Verification of Assets & liabilities</i>	Checking their completeness, existence, valuation & disclosure in financial statements. Note: Valuation, ownership, Title, condition & possession
(g) <i>Statutory compliance</i>	In case of audit of banks, General Insurance Companies etc., ensure compliance of financial statements with relevant statute.
(h) <i>Disclosure</i>	Examining whether the information in financial statements is disclosed properly as per accounting principles. As
(i) <i>Truth & fairness</i>	Checking whether financial statements as a whole represent true & fair view of profit /loss and of Assets & liabilities in the required form.

1.5 QUALITIES OF AUDITOR

(a) <i>Integrity</i>	Auditor should be honest, sincere & straightforward while performing his professional duties.
(b) <i>Impartiality</i>	He must adopt unbiased & impersonal approach.
(c) <i>Independence</i> <i>Free of Interest & Unbiased manner</i>	- He should not subordinate his judgement to the will of others (client or other person). - He should be free of any interest apparently as well as in reality. - He should audit the financial statements prepared by the management in unbiased way.

(d) Knowledge <i>For general knowledge + client business</i>	▪ He should have general knowledge of client's business and economic trends etc. ▪ Awareness about laws like Taxation laws & Contract Act, Partnership Act, Companies Act etc, is also required. ▪ He must continuously update his knowledge to conduct audit effectively.
(e) Communication skills	During conduct of audit, he has to interact with various officers & staff of organisation & third parties, thus he requires good oral & written communication abilities.
(f) Tact <i>He has to</i>	He must be able to deal with different person in different situation. He has to direct & supervise his own staff as well, thus he should be tactful.
(g) Judgement <i>Surprise work</i>	He should be capable of taking firm judgement as to which items are to be checked & what should be the sample size.
(h) Logical skills	He must be able to analyse & interpret problems so that he can accordingly deal with the same.
(i) Technical skills <i>Acc & Auditing</i>	He must have good hand on accounting & auditing etc. Moreover, he should be aware of latest development in auditing standards so that he can perform audit in effective manner.
(j) Confidentiality <i>is</i>	He should not disclose, confidential information acquired during conduct of his professional duties, to any third party except when ▪ Permitted by client or ▪ Required by law
(k) Caution	Whatever he does, he must do with proper skill & care.

1.6 RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

Accounting <i>for review & evaluation</i>	(a) Auditor provides opinion on financial statements. (b) For this, he has to review & evaluate the financial statements. (c) Thus he should have thorough & sound knowledge about Accounting principles & form and contents of financial statements. (d) It requires complete expertise of accounting concepts.
Mathematics <i>for calculating</i>	(a) Auditor deals with financial figures & amounts that appear in financial statements. (b) It requires knowledge of calculation procedure involved in computing various items for e.g., depreciation, provision for tax etc. (c) He has to make comparisons & perform ratio analysis. Thus, a good hand on maths is required.
Statistics <i>for sampling of Audit</i>	(a) Sampling is an important auditing technique. (b) For drawing random sample, he requires knowledge of probability theory & various statistical concepts.
Economics	(a) Before conducting audit, auditor needs to obtain knowledge regarding business & economic environment affecting the client. (b) Moreover, accounting records the data regarding economic activities (e.g., purchases, sales, income, payments etc). (c) Thus economic concepts are required to perform auditing in a meaningful way.
Law <i>Co. Act</i> <i>for legal requirement</i>	(a) Auditor has to check transactions w.r.t conformity with law. (b) For example, in audit of partnership firm, he has to check if interest on capital has been provided in accounts even in absence of such a provision in partnership deed. If it is so, he has to mention this in audit report (as it is in contravention of The Partnership Act). (c) Thus, he should have sound knowledge of laws affecting the client.

Computer

- (a) Now a days, most of the client maintain their accounts in computer information system.
 (b) Thus working knowledge on computer is required for auditors to conduct audit in an effective way.

Basic business operations

- (a) In financial statement of client, results of various operations / functions are shown.
 (b) For example finance, purchase, sale, personnel (payroll) etc.
 (c) Until auditor has knowledge about basic business operations, he cannot judge their financial results in effective way.

Behavioural science

- (a) Auditor has to deal with many personnel.
 (b) He has to obtain explanation from client's staff & management.
 (c) Moreover, he has to direct & supervise his own audit staff.
 (d) Thus, he should have tact of getting along with people.

Financial management

- (a) He should have knowledge of financial techniques like ratio analysis, funds flows analysis & working capital management etc. *ffr, w cap*
 (b) This will help him to understand & evaluate the financial statement in a better way.

Logic

- (a) Auditing is a systematic & logical process.
 (c) Thus, auditor's procedures must be logical according to given situation.

Language

- (a) Auditor is required to communicate orally as well as in writing (preparing audit report etc.).
 (b) Thus, he should have good command over language, which is in general use.

1.7 DIFFERENCE BETWEEN AUDITING AND ACCOUNTING

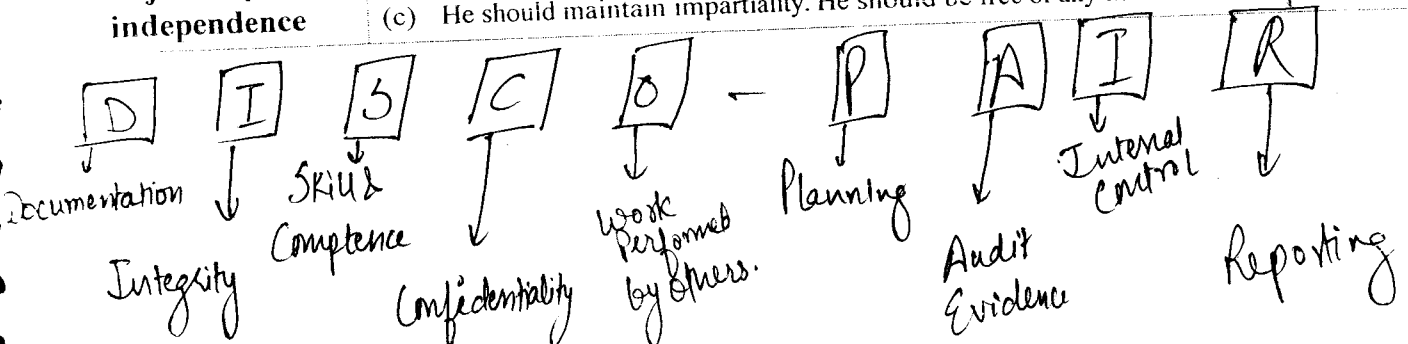
Basis	Accounting	Auditing
Meaning	Accounting is the art of Recording, Classifying & Summarizing financial Information	It is Independent Examination of financial information of an entity to express an opinion thereon
Function	It records financial aspects of entity	It reviews the accounting system
By whom	Any person having good knowledge of accounting <i>or, ay or may not be</i>	Statutory audit can only be conducted by a chartered accountant.
Principles	As per accounting standards <i>AS</i>	As per auditing standards <i>AAS</i>
Primary responsibility	To maintain accounts & prepare financial statements is the responsibility of <u>management</u>	To conduct audit in an effective way is the responsibility of <u>auditor</u>
Expertise	Accounting expertise	Accounting & auditing Expertise (both)
Time of occurrence	Accounts are prepared by the management prior to get them audited.	Auditing is examination of financial information, thus can't be conducted prior to accounting

1.8 AAS 1 - BASIC PRINCIPLES GOVERNING AN AUDIT

DISCO PAIR

1. Integrity, objectivity and independence

- (a) Auditor should be straightforward, honest and sincere in his professional work.
 (b) He should be fair and must not be biased.
 (c) He should maintain impartiality. He should be free of any interest.



2. Confidentiality	(a) He should maintain confidentiality of information acquired during his work. (b) He should not disclose any such information to a third party without specific permission of client or legal or professional duty to disclose.
3. Skill and competence	(a) He should perform work with due professional care. (b) Audit should be performed by persons having adequate training, experience and competence.
4. Work performed by others	(a) The auditor can delegate work to assistants or use work performed by other auditors and experts. (b) But he will continue to be responsible for his opinion on financial information. (c) The Auditor is entitled to rely on work performed by others, provided • He exercises adequate skills and care and • There is nothing to doubt.
5. Documentation <i>It also helps as a legal evidence by case where there is doubt about proper audit</i>	(a) He should document matters relating to the audit (maintain working papers). (b) Working papers are maintained to demonstrate that the audit was carried out in accordance with the basic principles.
6. Planning <i>It should be properly planned ↳ Timing, controlling ↳ better division of work</i>	(a) He should plan his work to conduct audit in effective and timely manner. (b) Plans should be based on knowledge of the clients business. (c) Plans should be further developed and revised during audit if circumstances require so.
7. Audit Evidence <i>External Internal Draws reasonable assurance</i>	(a) Auditor should obtain sufficient and appropriate audit evidence by performing compliance and substantive procedures. (b) Evidences enable the auditor to draw reasonable conclusion. (c) Compliance procedures mean the tests designed to obtain reasonable assurance that internal controls have been properly designed & operating effectively throughout the year. (d) Substantive Procedures are performed to obtain evidence as to the completeness, accuracy and validity of data produced by the accounting system.
8. Accounting system and internal control <i>System evaluate 20 & acc plan NTE of Audit</i>	(a) Internal control system ensures that the accounting system is adequate and that all the accounting information has been duly recorded. (b) The auditor should understand the accounting system and related internal controls adopted by the management. (c) He should study and evaluate internal controls system to determine the nature, timing and extent of other audit procedures.
9. Audit conclusions and reporting <i>↳ Report on P&L, B&S, Note to financials ↳ Truth & fairness ↳ AS have complied ↳ Material matters have been included</i>	(a) The auditor should review and assess the conclusions drawn from the audit evidences obtained through performance of procedures. (b) The audit report should contain clear written expression of opinion on the financial statements. (c) His report is on whether: ▪ The financial information has been prepared using acceptable accounting policies which have been consistently applied; ▪ The financial information complies with relevant regulation and statutory requirements; and ▪ There is adequate disclosure of all material matters. (d) The report should be as per legal requirement. When other than clean opinion is given, the audit report should state the reasons thereof.

1.9 OBJECTIVES OF AUDIT

Primary objective	As per AAS-1	Audit is conducted to express an opinion on financial statements. Thus, primary objective is Reporting.
	As per AAS-2	The objective of audit of financial statements is to enable the auditor to express an opinion on such financial statements.
	Reporting on what?	The auditor reports whether financial statements represent true & fair view.
	True & fair-Meaning	It can be examined by considering whether: (a) Financial statement have been prepared using consistent & acceptable accounting policies & (b) Financial statements comply with relevant rules & regulations & (c) Financial statements contain disclosure of all material matters.
	Detection of misstatement	(a) Auditor is expected to provide opinion on true & fair view of financial statement as above. (b) He cannot frame such opinion if he is not able to confirm / dispel the possibility of existence of fraud & error in financial statements. (c) Thus incidental/ secondary objective is detection of misstatement in financial statements.
	As per AAS-4	(a) Primary responsibility of prevention, detection & correction of fraud and error is that of management. (b) However, if there are doubtful situation that some material misstatement may exist, auditor should extent his procedure to confirm / dispel the doubt. (c) Audit may not reveal all the misstatement (due to inherent limitations of audit). (d) If auditor performs his work in accordance with basic principles governing an audit, he cannot be held liable for non-detection of misstatement in financial statements of client. (e) However, if he notices material misstatement resulting from fraud, he should communicate the same at appropriate level of management. (f) If misstatements are found, he should ensure their appropriate disclosure either in financial statements by the management or in his audit report.
Secondary objective	As per case of "Kingston cotton mills company"	(a) Unless doubtful situations are there, auditor is totally justified in relying upon the management / employees of the client. (b) He is a watchdog not a blood hound.

1.10 AAS-2 - OBJECTIVE AND SCOPE OF THE AUDIT OF FINANCIAL STATEMENTS

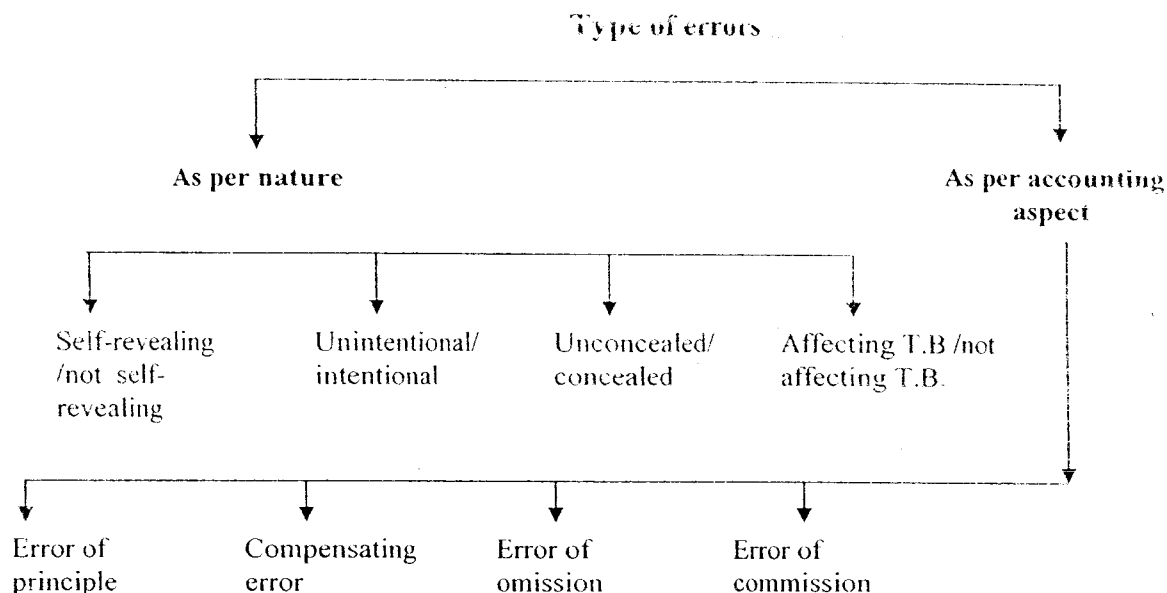
Objective of an Audit	(a) The objective is to enable the auditor to express an opinion on financial statements prepared by management of entity. (b) For this, it is essential that financial statements are prepared as per the recognized accounting policies and practice and relevant statutory requirement and they should disclose all material matters. (c) However, his opinion does not constitute an assurance as to future viability of the enterprise or the efficiency or effectiveness with which its management has conducted the affairs of the enterprise.
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Responsibility for the financial statements	(a) The management is responsible for maintaining an upto date and proper accounting system and finally to prepare financial statements. (b) The auditor is responsible for forming and expressing an opinion on the financial statements. (c) The audit of the financial statement does not relieve the management of its responsibility.
Scope of an audit	The auditor decides the scope of his audit having regard to: ⇒ The requirement of the relevant legislation ⇒ The pronouncements of the institute (ICAI) ⇒ Terms of engagement However, the terms of engagement can not supersede the pronouncement of the institute or the provisions of relevant legislation.
Inherent limitations of audit. What are these? <i>gud</i> <i>Persuasive → Having the power to convince</i>	1. Test checking <i>→ Audit is based on sampling</i> <i>→ Possibility of error</i> (a) Auditor uses sampling during performance of audit. (b) Its not possible for him to conduct detailed checking due to time constraints and other practical problems. (c) As he does not check each & every item, it's impossible for him to detect all fraud & errors. 2. Nature of evidences <i>→ Conclusive rather than persuasive</i> (a) The evidences obtained by the auditor are <i>persuasive rather than conclusive</i>. (b) They can't ensure the auditor in a certain way. (c) They can enable auditor to draw only reasonable conclusions there from (not absolute conclusions). 3. Involvement of judgement (a) Auditor exercises judgement in evaluating the reasonableness of judgement & estimates made by the management in preparing the financial statements. (b) The judgement by auditor may not always be correct. 4. Inherent limitations of internal controls (a) Internal controls suffer from limitation such as collusion among employees or wrong use of authority by management etc. (b) If internal controls are weak, auditor may not be in a position to obtain assurance.
Limitation on scope-effect on audit report	If there are any constraints as regards the scope of audit, he should mention them in his audit report.
Organising an audit	1. Auditor should conduct audit in such a way that he would be able to obtain sufficient and appropriate audit evidences. 2. He should cover all-important aspects affecting financial statements of the client. 3. If there is indication of misstatement, he should extend his audit procedures.

1.11 TYPES OF ERRORS

As per nature	(a) <i>self revealing errors</i>	(a) These appear during preparation of accounts. (b) For example, if a cheque deposited is not shown. It becomes apparent during BRS.
	(b) <i>Non-self revealing errors</i>	(a) They do not appear themselves during preparation of accounts. (b) These can be known only by detailed analysis. (c) For e g: capital expenditure shown as revenue expenditure.

Accounting aspect	(c) Unintentional error	(a) These are not deliberate mistakes (b) It may be due to ignorance / oversight of facts. (c) For example, if Petty cashier forgets to record freight of Rs. 10/- in petty cash book.
	(d) Intentional errors	(a) Deliberate mistakes i.e. frauds. (b) Bad debts recovered not recorded in books, thus misappropriating the money so received by employee of the entity.
	(e) Unconcealed Errors	Same as unintentional error. No efforts are made to hide the error by person committing it.
	(f) concealed Error	(a) Whereby the person committing the error (fraud) is making ways to hide it. (b) These can be ascertained only by detailed checking.
	(g) Error affecting trial balance	(a) One sided error due to which trial balance does not tally. (b) For example: goods sold to 'A' entered in sales book but not in A's account.
	(h) Errors not affecting trial balance	(a) Two sided error such as compensating error or complete omission of transaction. (b) For example:- No provision for bad debts.
	(i) Error of principle	(a) Recording an entry in fundamentally incorrect manner. (b) For example: Capital expenditure charged to revenue. (c) No effect on trial balance. (d) But they may affect profit.
	(ii) Compensating Errors <i>When two errors nullify or compensate each other.</i>	(a) Which are nullified by the impact of another error. (b) For example.: expenses amounting to Rs. 6000 wrongly recorded at Rs. 8000 while another expense amounting to Rs. 2000 not recorded at all. (c) No effect on Trial Balance. (d) But may affect profits if one error arises in revenue A/c & other in a balance sheet item.
	(iii) Error of Omission <i>Not recorded at all.</i>	(a) Where transaction is not recorded in Accounts, wholly or partly. (b) For example, Sales of 1000 to A either not recorded wholly or shown in sales Accounts but not posted to A's account. (c) Full omission does not affect trial balance but partial omission does. (d) May affect profit.
	(iv) Error of commission <i>Wrong Amt Wrong Side</i>	(a) Incorrect recording of a transaction. (b) Maybe of following types: ▪ Posting error: - wrong Account/Amount/ Side. ▪ Casting Error:- Wrong totalling/balancing. ▪ Duplication error: - entry recorded twice. ▪ Carry forward error:- Wrong amount/ side. (c) For example: - Sales amounting to Rs. 1000/- recorded as 100/- or page total of wage sheets 500/- carried forward as Rs. 5500/-. (d) May or may not affect trial balance. Same is the case of impact on profit.



Conditions which increase the risk of misstatement in financial statement

1. Weakness in internal control system.
2. Doubt about competence and integrity of management.
3. Unusual pressure within entity e.g., entity facing problems in getting finance.
4. Unusual transactions e.g., transaction with related parties.
5. Problems in obtaining sufficient & appropriate audit evidence. For example, management deliberately not co-operating with the auditor.

1.12 AAS-4 - THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF FINANCIAL STATEMENTS

Fraud	Nature	Intentional
	By whom*	- Employees, or - Management, or - Those charged with governance, or - Third parties
	Example -	- Falsification of accounts - Misappropriation of assets - Suppression of transactions - Omission of effects of transactions - Wrong accounting procedures - Misapplication of accounting Policies

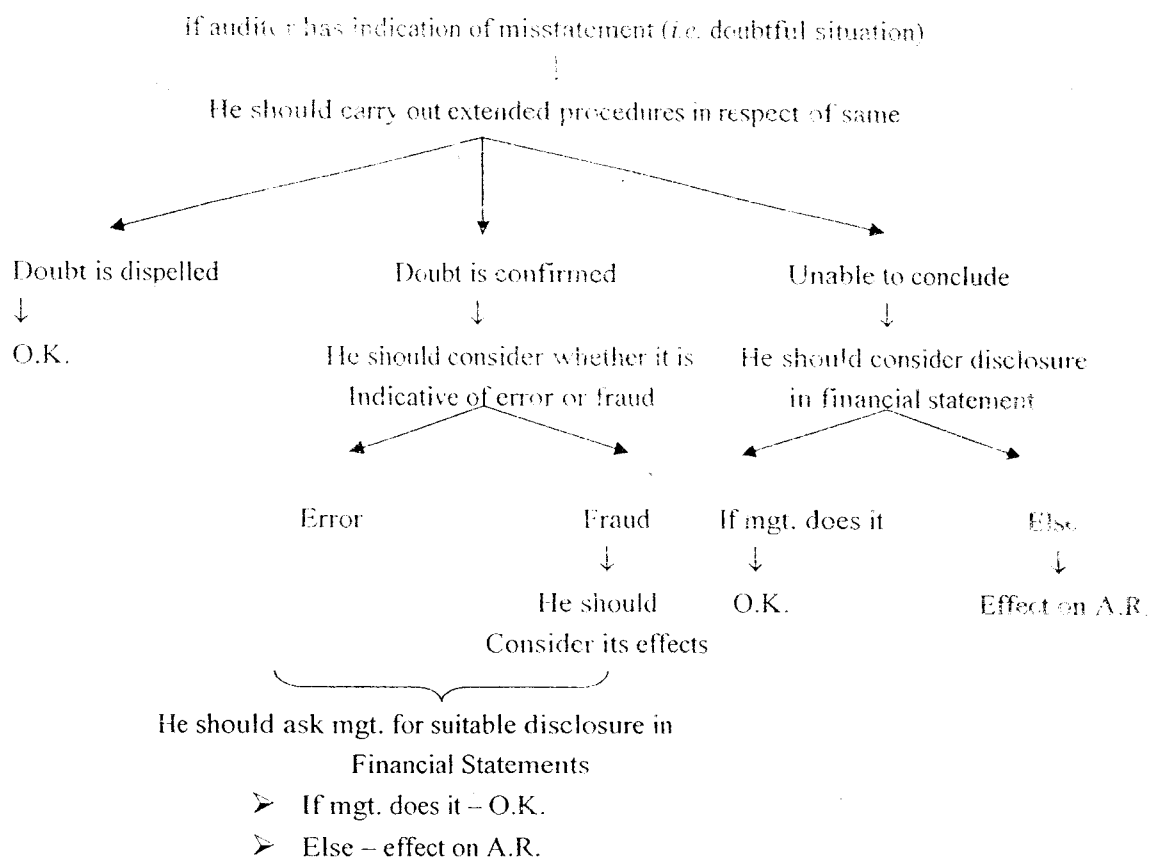
ID → Document
 → AU frauds
 → AU response

U → Unable
 → all factors
 to mgt

M → Mgt
 C → Commu-
 -cation
 D → Disruption

F → Fraud
 E → Error
 R → Responsibility
 I → Inherent
 Limitation

Error	<i>Nature</i>	Unintentional
	<i>By whom</i>	Same as *above
	<i>Example</i>	▪ Mathematical mistakes. ▪ Oversight of facts. ▪ Misapplication of Accounting Policies.
Responsibility	<i>On part of those Charged with Governance and Management</i>	▪ Prevention & detection of fraud & error is their responsibility. ▪ For this, management establishes suitable internal control system.
	<i>On part of Auditors</i>	▪ He must work in accordance with AAS. ▪ If there is indication of misstatement, he should extend his procedures to confirm/ dispel the doubt. ▪ He should maintain documentation. ▪ But he can't be held responsible for prevention of fraud & error. ▪ If auditor works in accordance with AAS, he can not be held responsible for non-detection of fraud or error.
Inherent limitations of audit due to which detection of all misstatements is not possible		▪ Test nature of Audit (<u>Sampling</u>). ▪ Professional <u>judgment</u> of Auditor. ▪ Persuasive nature of Audit <u>evidence</u> rather than conclusive. ▪ Limitations of <u>internal control system</u>. 1 C.
Discussion and inquiries	<i>With members of audit team</i>	Probability of Fraud and Error in financial statements.
	<i>With management</i>	Regarding accounting and internal control system.
	<i>With those charged with governance</i>	Regarding fraud by management.
Management representation letters that auditor should obtain MRL		(a) Management responsibility for accounting and I.C. system to prevent and detect & correct Fraud & Error. (b) Aggregate uncorrected misstatements are immaterial for financial information in opinion of management. (c) It has disclosed the auditor all facts regarding - ▪ Known frauds & ▪ Suspected frauds.



Documentation	1. Fraud risk factors. 2. His response to same.
Communication	1. <i>of fraud and error</i> ▪ At appropriate level. ▪ on Timely basis. ▪ If management is involved, consider communicating to those charged with governance. 2. <i>of weakness in I.C. system</i> ▪ If IC. fails to prevent/detect misstatement. ▪ Then, communicate this fact to management.
Auditor unable to complete the engagement	▪ He concludes that due to material misstatements, it is not possible for him to continue performing audit. ▪ Discuss all facts with management and those charged with governance. ▪ Consider withdrawal from engagement. ▪ Consider his responsibilities towards appointing authority. ▪ Consider his responsibilities towards regulatory authority. ▪ If he resigns due to misstatements, he should state the facts regarding these matters to incoming auditor.

1.13 SUMMARY OF DUTIES OF AUDITOR REGARDING FRAUD & ERROR AS PER AAS-4

1. The auditor should take into consideration the risk of material misstatement.
2. Get to know management as to any fraud or significant error.
3. If circumstances indicate the possible existence of fraud or error, the auditor should consider the effect of the suspected fraud or error on the financial information.
4. He should perform appropriate additional procedures.
5. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected.
6. In case auditor is unable to obtain evidence to confirm or dispel a doubt regarding fraud, the auditor should consider relevant laws and regulations and may obtain legal advice.
7. He should also communicate this situation to the management.
8. Where a significant fraud has occurred, the auditor should consider the necessity for a disclosure of the fraud in the financial statements and if adequate disclosure is not made, the necessity for a suitable disclosure in his audit report.

1.14 ACCOUNTING CONCEPT-DISCLOSURE OF ACCOUNTING POLICIES

Meaning Accounting policies	▪ It refers to specific accounting principles & methods of applying those principle, ▪ adopted by entity, ▪ In preparation & presentation of financial statements.
Why disclosure is needed	(a) There is no single list of Accounting policies that can be applicable in all situations. (b) Management chooses the appropriate accounting policy. (c) For e.g., depreciation can be charged as per written down value method or straight-line method. Same ways, different policies may be adopted for following:- ▪ Valuation of inventory <i>Inventory valuation</i> ▪ Treatment of expenditure during construction ▪ Valuation of fixed assets ▪ Conversion of foreign currency items ▪ Valuation of investments ▪ Treatment of research & development expenditure ▪ Treatment of contingent liability (d) The profit or loss can be significantly affected by adopting different accounting policies. (e) Thus disclosure of accounting policies followed, becomes necessary so that readers of financial statement can properly understand the view presented.
Requirement of Accounting standard regarding disclosure of accounting policies- AS-1	(a) All significant accounting policies adopted in financial statements should be disclosed; & (b) Disclosure should, usually, be made at one place; & (c) Disclosure should from part of financial statement; & (d) Any change in Accounting policies having material effect should be disclosed along with amount by which financial statement is affected by such change (if amount is ascertainable) If amount is not ascertainable, the fact should be stated; & (e) If any fundamental accounting assumption is not followed, the fact should be disclosed.

Method of depreciation
Treatment of Depreciated revenue exp.
Valuation of fixed assets
R&D

↳ Going Concern → that the firm will continue in the future & it has no present intention of winding up

↳ Accrual → Revenue exp are taken in A/c as incurred or accrued

↳ Consistency → All accounting policies are consistently applied from year to year

1.15 ACCOUNTING CONCEPT-FUNDAMENTAL ACCOUNTING ASSUMPTION

Meaning	• Certain fundamental accounting assumptions underlie the preparation & presentation of financial statements. • Their use is assumed.
Three fundamental accounting assumptions	(a) Going Concern: The enterprise is viewed as going concern, that is, continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of close down. (b) Consistency: It is assumed that accounting policies are consistent from one period to another period. (c) Accrual: Revenues and costs are accrued, that is, recognized as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the period to which they relate.
Disclosure requirement as per AS-1	(a) If all three fundamental Accounting assumptions are being followed in preparation & presentation of financial statements, specific disclosure is not needed. (b) However, if any fundamental accounting assumption is not followed the fact has to be disclosed in the financial statements. (c) Thus disclosure is needed only in case of non-compliance with the fundamental accounting assumption.

OBJECTIVE TYPE QUESTIONS

Comment alongwith reasons whether following are True or False.

- Financial statements include P&L accounting and Balance Sheet but not notes to accounts.**
FALSE ⇒ Financial statements mean whole set of accounts including P&L account, Balance sheet and disclosure *i.e.*, notes to accounts.
- Audit is independent examination of operations conducted by management.**
FALSE ⇒ Audit is independent examination of *financial statements* of an entity to express opinion thereon. It is thus examining financial information, not operations of entity.
- Auditor's opinion is on True & Fair view of financial statements.**
TRUE ⇒ For reporting on true & fair view, it is seen whether acceptable policies are consistently applied, regulations have been observed & appropriate disclosures have been made in financial statements.
- Auditor needs to be independent.**
TRUE ⇒ Independence means that judgement of a person is not subordinate to wishes of any person. Independent audit enhances credibility of financial statements of client.
- Audited financial statements help the lenders.**
TRUE ⇒ Lenders can rely on audited financial statements while making decision about credit worthiness of loan applicant & later on, they can judge recoverability of their funds.
- Auditor does not need communication skills, as he is concerned only with financial information.**
FALSE ⇒ During conduct of audit, he has to interact with various officers and staff of client & third parties, which requires good written & oral communication skills.

(7) Auditor must maintain confidentiality subject to certain exceptions.

TRUE ⇒ He (Auditor) should not disclose any confidential information relating to client. However, he can disclose if it is permitted by client or required by law.

(8) Auditor does not need knowledge of accounting.

FALSE ⇒ Auditor expresses opinion on financial statements. If he does not have expert knowledge on accounting, he cannot check whether financial statements prepared by entity's management are true & fair or not.

(9) Auditor should have knowledge of CIS. → COMPUTER INFORMATION SYSTEM.

TRUE ⇒ Now a days, most of the client maintain their accounts in computer information system. Thus, working knowledge on computer is required for auditors to conduct audit in an effective way.

(10) Audit doesn't require knowledge of business operations on part of auditor.

FALSE ⇒ In financial statements of client, result of various operations/ functions are shown. Unless auditor has knowledge about basic business operations, he can't judge their financial results in effective way.

(11) Documentation is required to be kept by auditor.

TRUE ⇒ He should document matters relating to the audit (maintain working papers). Working papers are maintained to demonstrate that the audit was carried out accordance with the basic principles.

(12) Auditor is responsible for prevention & detection of misstatements. Mgt

FALSE ⇒ Primary responsibility of prevention, detection & correction of fraud and error is that of management. Thus if auditor performs his work in accordance with basic principles governing an audit, he cannot be held liable for non-detection of misstatement in financial statements.

(13) Financial statements are responsibility of management.

TRUE ⇒ The management is responsible for maintaining an upto date and proper accounting of various transactions entered into during the course of the year.

(14) Sampling is a major inherent limitation of audit.

TRUE ⇒ Auditor uses sampling during performance of audit. It is not possible for him to conduct detailed checking due to time constraints and other practical problems. As he doesn't check each & every item, it is impossible for him to detect all fraud & errors.

(15) Disclosure of accounting policy, which is adopted in preparation of financial statements, is not required.

FALSE ⇒ The profit or loss can be significantly affected by adopting different accounting policies. Thus, disclosure of accounting policies followed becomes necessary so that readers of financial statements can properly understand the view presented.

(16) As per AS -1 disclosure of fundamental accounting assumptions is needed whether these are followed or not.

FALSE ⇒ If all three fundamental accounting assumptions are being followed in preparation & presentation of financial statements, specific disclosure is not needed. Thus, disclosure is needed only in case of non-compliance with the fundamental accounting assumption.

AS-1 → Basic Principles Governing an Audit [DISCO PAIR]

AS-2 → Objective and Scope of Audit

AS-4 → Auditor's Responsibility with regard to frauds and error

AS-11 Disclosure of Accounting Policies

Users of financial Statement → OMR, ECCIC (Key).

Inherent Limitation of audit

- Sampling
- Judgment of Auditor
- Internal Control System
- Nature of Evidence