

Basic concepts in auditing Notes

1. Importance of having the accounts audited by the professional auditor:-

- *The society is able to get an informed, objective and forthright opinion on the financial statements which are useful in making significant economic decisions.*
- *Shareholders of the company are assured that funds invested by them are safe and they are being used for only for that purpose for which there were raised and collected.*
- *Management uses it for decision making purpose.*
- *Lenders and creditors examine to it for safety their money.*
- *Investors review the information for making investment decisions.*
- *Workers are assured that reasonable share of the income earned by the organization has been paid to them as bonus.*
- *In company, shareholders have no direct control on day to day administration of the company so the report of auditor is only safeguard available to them.*

2. As per AS 1, Accounting policies refer to the accounting principles and the method of applying those principles adopting by an enterprise in the preparation and presentation of the financial statements. The choice of the accounting policies is responsibility of the management. Three fundamental accounting assumptions are (i) Going Concern (ii) Consistency (iii) Accrual.

3. Audit evidence is the information used by an auditor in arriving at conclusions on which the auditor's opinion is based.

4. Different types of audit procedures:-

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- *Inspection: It involve examining records or documents, whether internal or external or in paper form or in electric form. It provide audit evidence of varying degree of reliability, depending on their source and nature.*
 - *Observation: It includes looking the procedures which is performed by the others. It provide evidence about the performance of any procedure and process.*
 - *External Confirmation: It represent audit evidence obtain by the auditor as a direct written response to the auditor from third party In paper form or electric or any other medium.*
 - *Recalculations: It includes checking the mathematical accuracy of the documents. It may done either manually or electronically.*
 - *Reperformance: It involve the auditor independent execution of procedures that were originally performed as part of internal control.*
 - *Analytical Procedure: It include evaluation of financial information made by study of relationship of both financial or non financial data.*
 - *Inquiry: It includes seeking information of knowledgeable persons both financial and non financial within the entity or outside the entity. In respect of some matters the auditor may consider it necessary to obtain written representation from management and where appropriate from those that charge with governance.*
5. As per SA 500, Reliability of audit evidence is depend upon its source and its nature, and the circumstances under which it is obtained. Audit evidences are more reliable when (i) it is obtain from independent source outside the entity. (ii) it is generated within the entity only where internal control system is effective. (iii) it is obtained directly by the auditor. (iv) it

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is in documentary form rather than obtained orally. (v) it is obtained as original rather than just zerox copies or photo copies.

6. Audit working papers are records for the auditor in respect of audit carried out by him. The audit working papers are useful in (i) the planning and the performance of the audit (ii) in supervision and review of audit work (iii) to provide evidence that audit work is performed (iv) and evidence in the court of law when charge of negligence is brought against the auditor. Working papers are retained long enough, for a time sufficient to meet the need of practice. The retention period is not less than seven years from the date of the auditor's report.
7. As per AS 1, For better understanding of financial statement accounting policies the disclosure of it is important. It provide more meaningful comparison between financial statements of different enterprises. It would be helpful to reader of financial statements if they are disclosed ay one place. Any change in the accounting policy is also disclosed in the financial statements.
8. The Concept of true and fair signifies that the auditor is required to express his opinion as to whether financial statements are truly and fairly represented. For that purpose the auditor required to verifying all assets and liabilities, incomes and expenses which are in accordance with accounting policies and no material items has been omitted. It may be noted that where the financial statements of the company do not comply with accounting standards then the company should disclose the deviation and the reason behind such deviation.
9. The following conditions are may create doubt about continuity of going concern:

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- *Net current Liability Position*
 - *Withdrawal of financial support by the trade payable*
 - *Negative operating cash flows*
 - *Adverse key financial ratios*
 - *Significant deterioration in the value of fixed assets*
 - *Arrears or discontinuation of dividend*
 - *Inability to pay trade payable on due date*
 - *Change from credit to cash on delivery transactions from suppliers*
 - *Inability to obtain finance*
 - *Management intention to liquidate the entity*
 - *Loss of key management without replacement*
 - *Loss of major market, key customers*
 - *Labour difficulties*
 - *Shortage of important supplies*
 - *Emergence of successful competitor*
 - *Non compliance of statutory requirements*
 - *Pending legal proceedings against the company*
 - *Change in law or regulations or government policy*
10. As per SA 540, Accounting estimates means approximation of monetary amount in the absence of precise means of measurement. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. For some accounting estimates there may be relatively high estimation E.g (i) Accounting estimation relating to the outcome of the litigation (ii) Allowance for doubtful accounts (iii) inventory obsolescence (iv) depreciation method or asset useful life (v) Provision against any investments (v) outcome of long term contracts.

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11. Independence is the keystone upon which the respect and dignity of profession is based. It implies that a judgement of a person is not subordinated to the wishes of another person who might have engaged him or to his own self interest. Independence is a condition of mind and personal character. In the context of the auditors, his independence is necessary for expressing unbiased opinion on the financial statements. The users will rely on the opinion only when he is convinced about his independence. The chartered accountant is not known personally to the third parties who relies on opinion given by him.
12. As per SA 520, Analytical Procedures means evaluations of financial information through analysis of relationship among both financial and non financial data. It includes consideration of comparisons of the entity's financial information and also consideration of relationship.
13. As per SA 200, Misstatements including omissions are considered as material, if they individually or in aggregate could influence the economic decisions of the readers. Judgements regarding materiality is depend upon the circumstances and also affected by the size or nature of the auditor or both. The concept of materiality is applied by the auditor both in planning and performing the audit.
14. As per SA 505, External Confirmation is direct written response obtained by the auditor from third party in paper form or by electronic or in other medium. The external confirmation may be useful in (i) Bank balance and other information from bankers. (ii) Account receivable balance (iii) Inventory held by the third party (iv) Account Payable balances.
15. Areas in which Different accounting policies may be useful:
 - *Method of Depreciation, depletion and amortization :- Straight line method or written down value method*

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- *Valuation of Inventory :- FIFO, LIFO, Weighted average*
 - *Treatment of Goodwill :- Written Off or Retain*
 - *Valuation Of Investments :- At cost, market or net realizable value*
 - *Treatment of retirement benefits :- Actuarial, Insurance Policy Etc.*
 - *Valuation of Fixed Assets :- Historical Cost, Revaluation price, etc.*
16. Matters need to be consider while obtaining evidence from substantive procedure:-
- *Existence – that an asset or liability is existed at a given date*
 - *Rights and obligations – that an asset is right of the entity and liability is the obligation at a given period.*
 - *Occurrence – that a transaction or event took place which pertain to the entity*
 - *Completeness – that there are no unrecorded assets, liabilities or transactions*
 - *Valuation – that an asset or liability is recorded at an appropriate value*
 - *Measurement – that a transaction is recorded in proper amount and revenue or expense are allocated to proper period.*
 - *Presentation & Disclosure – that an item is disclosed, classified and described in accordance with recognize accounting policies and statutory requirements.*
17. Evidences which are generated within the organization are called Internal Evidences. E.G Sales Invoices, Inspection reports, copies of cash memo, debit or credit memo etc. External Evidences are the evidences which originate outside the client's organization. E.G Purchase Invoices, supplier challans etc.
18. As per SA 299, Where the joint auditors are appointed they should divide the audit work. Certain areas of audit work which is not divided for which

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all joint auditors are responsible. Where the performing the audit work, a joint auditor comes to know some important matters which is very useful to other joint auditor then he should communicate the same to other joint auditor. In respect of work divided, each joint auditor is responsible only for the work allocated to him. But in the following circumstances all joint auditors are jointly responsible :

- *In respect of audit work which is not divided*
- *In respect of decisions which are taken by all joint auditors*
- *In examining that the disclosure requirements are fulfilled by the enterprise*
- *For ensuring that audit report is complying all the requirements of the relevant statute*
- *The responsibility of obtaining information and explanation from the management*
- *It is necessary that each joint auditor is examine the audit work performed by the other*

19. As per SA 500, Sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of quantity. Appropriateness is the measure of quality. How much of audit evidences are required to be generated is depend upon the risk of assessment regarding material misstatement. The quality of audit evidence is depend upon the source, nature and the circumstances under which it is obtained. Following are the various factors which may be useful for the auditor to decide about sufficient and appropriate audit evidences (i) Degree of risk of misstatements (ii) The materiality of the item (iii) The result of auditing

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procedures (iv) The experience obtain from the previous audit (v)
The type of information available (v) The trend indicated by the
accounting ratios and analysis.

20. Auditors could not give clean report on the basis of zerox copies.

If all documents are to be taking by the income tax authority then
auditor require true copies of certified by the income tax
department. If the auditor is fully satisfied then only he given a
clean report otherwise give disclaimer of opinion.

21. Inquiry is one of the audit procedure performed by the auditor. It
includes obtaining information from knowledgeable persons both
financial and non financial from within the entity and outside the
entity. It includes formal written enquires and informal oral
enquires. Evaluating responses is an integral part of an enquiry.
Responses might provide different information which is not
obtained earlier by the auditor. In some cases response provide a
basis for the auditor to perform additional auditing procedures. In
respect of some matters auditors are required to obtain written
representations from the management and when needed from
those with charge with governance to confirm the oral enquires.

**The above notes may be useful to students at the time of revision.
So it is request to all of you to first read your modules and
practise manuals and then the above notes. The dark mark
paragraphs are important. I hope that you like above notes and it**

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will be very useful at last minute rust in exam. All the best for your exams.

Thank You.