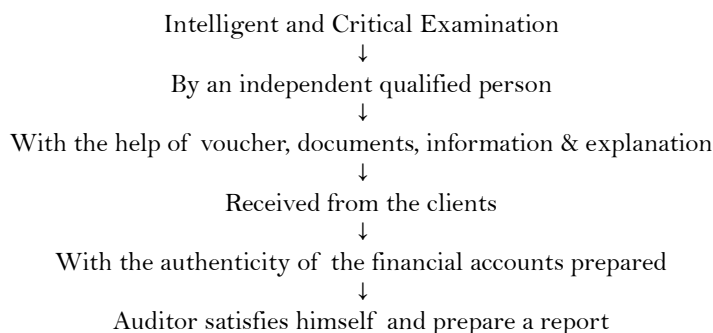


Auditing Concepts

Definition of Audit

Ans: The term “audit” has been derived from the Latin words “audire” which means to listen.

- **ICAI defines Auditing as:** A systematic and independent examination of data, statement, records, operation and performances of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the proposition before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report.
- **According to SA 200 as:** “Basic Principles Governing an Audit.” An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon.



What does the auditor mention in his report?

Ans: The auditor reports that :-

- The Balance Sheet exhibits a true and fair view of the state of affairs of the concern.
- The profit and loss account reveals the true and fair view of the profit or loss for the financial period.
- The accounts have been prepared in conformity with the concerned law.
- If he is not satisfied then reports in what respect he is not satisfied.
- The Auditor shall State that :-

To the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Scope of Auditing

Ans: As per SA-200A :-

- The scope of an audit of financial statements will be determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and pronouncement of the Institute of Chartered Accountants of India.
- The auditor is not supposed to perform the duties which are beyond the scope of his competence. However he is expected to exercise due diligence and professional care in his work as expected of him. Accounting is concerned with the recording of the transaction and preparation of statements of account but auditing involves a detailed and critical examination of accounts prepared by others. In fact, auditing begins where accounting ends.

Distinction Between Auditing and Accounting. [Imp]

Ans:

<u>Accounting</u>	<u>Auditing</u>
• Analyze events and transactions	• Review client's internal control system
• Record and summarize data in accounting records	• Obtain and evaluate evidence on statement assertions

Auditing Concepts

• Make financial statement assertions	• Determine fairness of statements in conformity with recognized accounting principles
• Prepare financial statements as per recognised accounting principles	• Prepare audit report on finding
• Distribute Financial statement and Auditor's report to shareholders	• Deliver audit report to client

Qualities of Auditor

Ans: The person conducting the audit is known as the auditor.

- Sound knowledge of various disciplines associated with the audit,
- An auditor must possess the integrity and be objective and independent in his approach to the audit work.
- The auditor must have the knowledge of the general principles of the Law governing the auditee enterprise.
- An auditor should also have an understanding of the special features which are peculiar to a particular business. SA 300 (Revised) and SA 310 issued by ICAI lay down principles in this regard.
- Though technical knowledge is necessary to conduct an audit, only those persons whose technical knowledge is backed by basic human qualities can prove to be successful auditors.
- An auditor must be honest, that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true.

Audit and Investigation [Imp]

Ans:

<u>Accounting</u>	<u>Investigation</u>
• Auditing is an independent and systematic examination of the evidence underlying the accounting or other data in accordance with the generally accepted auditing practices to ascertain the true and fair view of the financial statements of an enterprise.	• An investigation may be defined as an examination of accounts and records with a view to ascertain any fact for some special purpose which varies from assignment to assignment.
• The audit has a wide scope. In statutory audit, the scope is determined by the relevant law and in case of a private audit by a client.	• The scope of investigations, on the other hand, is limited as regards the period or areas to be covered.
• In audit, the accounts and records are verified as to their truth and fairness.	• Investigation is for special purpose
• The audit is conducted in accordance with the generally accepted auditing procedure	• Investigations involve an extended auditing procedure

Aspects to be covered in Audit [Imp]

Ans: The principal aspects to be covered in an audit concerning the final statements of accounts are as follows:

- Accounting and Internal Control System
- Examination of books, records etc.
- Compliance with the Generally Accepted Accounting Standards and Applicable Statutory Regulations
- Reporting

Auditing Concepts

Objectives of Auditing

Ans: An audit is conducted with two main objectives :

- **Primary Objective:** The main objective of an audit is to determine whether the financial statements presents a "true & fair view" of the financial position and financial performance of a business during the period.
- **Secondary Objective:** The auditor is also responsible for detecting frauds and errors in the books of accounts and financial records of the client's business. If the auditor suspects the presence of material misstatements or defalcations in the records of the business, he is expected to look into the matter with greater detail by applying various audit procedures to satisfy himself about their existence or in existence. He is also to report on the existence of such misstatement and their magnitude through his audit report.

Basic Principles Governing an Audit (PICASA²) [Imp]

Ans: SA 200 issued by ICAI gives the following basic principles that govern the auditor's responsibilities.

- **Planning:-** The auditor should obtain the knowledge about client's business to determine the nature, timing and the extent of the audit procedures.
- **Integrity, objectivity and independence:-** The auditor should be straight-forward, honest, sincere and free from any influence on his audit work.
- **Confidentiality:-** He should not disclose the client's information to anybody without the client's permission or under any regulatory requirement.
- **Accounting system and internal controls:-** An understanding of the accounting system and the related internal controls help in determining the nature, timing and extent of other audit procedures.
- **Skills and competence:-** The audit should be performed and audit report be prepared by adequately trained, experienced and competent person.
- **Accounting system and internal controls:-** An understanding of the accounting system and the related internal controls help in determining the nature, timing and extent of other audit procedures.
- **Audit conclusions and reporting:-** On the basis of conclusions drawn from the audit evidence obtained the auditor should give unqualified report or qualified report or adverse report or the disclaimer report.

Significance of Audit

Ans:

From Legal Point of View

1. **Filing of income tax return:-** Income Tax authorities generally accept the profit and loss account that has been prepared by a qualified auditor and they do not go into details of the accounts.
2. **Borrowing of money from external sources:-** Money can be borrowed easily on the basis of audited balance sheet from the external sources. Most of the financial institution sanctions various loans on the basis of audited financial statements.
3. **Statement of insurance claim:-** in case of flood, fire, other natural calamities and the like unexpected happenings the insurance company may settle the claim for loss or damages on the basis of audited accounts of the previous year.
4. **Sales tax payments:-** The audited books of accounts may generally be accepted by the sales tax authorities.
5. **Action against bankruptcy:-** The audited accounts serve as a basis to determine action in bankruptcy and insolvency cases.

From Internal Control Point of View

1. **Quick discovery of errors and frauds:-** Errors and frauds are located at an early date, so that in future no attempt is made to commit such frauds as one is rather careful not to commit an error or a fraud as the accounts are subject to regular audit.
2. **Moral check on the employees:-** The auditing of the accounts keeps the accounts clerks and the accountants regular and vigilant as they know that the auditor would complain against them if the accounts are not prepared upto date or if there is any irregularity.
3. **Advice to the management:-** It may happen that the management may consult the auditor and seek advice on certain technical points although it is not the duty of the auditor to give advice.

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4. **Uniformity in accounts:-** If the accounts have been prepared on an uniform basis, accounts of one year can be compared with other years and if there is any discrepancy, the cause may be enquired into.

- **From External Affairs Point of View**

1. **Settlement of accounts:-** The audited accounts would facilitate the settlement of accounts of a deceased partner.
2. **Valuation of assets and goodwill:-** If the business is to be sold as a going concern basis, there may not be much difficulty regarding the valuation of assets and goodwill as the accounts have already been audited by an independent person.
3. **Future trend of the business:-** From the audited books of accounts, the future trend of the business can be assessed easily with certainty.

- **Advantages of Audit**

Ans:

1. Stakeholders can use to protect their interests in the enterprise.
2. It serves as a moral check on the employees from committing defalcations or embezzlement.
3. The employees of the organization remain alert as regards the updating of books of accounts and other records.
4. Audited accounts are considered more reliable by different cadres of Government.
5. Audited accounts are taken to be more reliable and useful during corporate restructuring exercises, valuations etc.
6. Banks, Financial Institutions and Government require audited accounts before granting any financial assistance to the enterprise.
7. Audited accounts are taken to be more helpful in the settlement of accounts between the partners and thus avoiding any dispute among them.

- **Inherent Limitations of an Audit [Imp]**

Ans:

- An audit does not guarantee that all the material misstatements will be detected because of the following inherent limitations of audit:
 1. Test nature of the audit;
 2. The audit evidence available to the auditor is persuasive rather than conclusive in nature;
 3. Inherent limitations of internal control.
- Professional skepticism:- Professional skepticism means an approach that would ensure that if something is wrong it is detected. This behavior of auditor helps him in identifying and evaluating
 1. Matters that increase the risk of material misstatements resulting from fraud or error,
 2. Circumstances that make the auditor to suspect material misstatements,
 3. The question of management's representations reliability. The auditor is entitled to accept the records and documents as genuine unless there is some evidence to the contrary.

- **Types of Audit**

Ans: Audits can be of various types. They can be classified on the basis of independence or interference of the client, and also on the basis of function performed.

- Depending on independence and interference of the client
 1. **Statutory Special Audit** by auditors appointed by the Government to report to the respective government authorities on specific issues. This has the least interference of the client.
 2. **Statutory Audit, or Cost Audit, or Tax Audit** by independent auditors appointed by the Company, or Board of Directors, or the client. This has high degree of independence.
 3. **Internal Audit** by an auditor, who may or may not be an independent auditor, appointed by the management depending on the nature and scope defined and mutually decided in the terms of engagement.

Auditing Concepts

- Depending on functional classification
1. **Statutory Audit of a Company or a LLP**
 2. **Statutory Cost Audit**

Define Tests of control or Compliance procedures

Ans: Tests of control are those activities performed by the auditor during the control testing stage that gather evidence as to the operational effectiveness of internal control procedures upon which the auditor has planned reliance.

Define Substantive procedures

Ans: Substantive procedures (or substantive tests) are those activities which are performed by the auditor during the substantive testing stage of the audit that gather evidence as to the completeness, validity and/ or accuracy of account balances and underlying classes of transactions.

Audit Evidence [Imp]

Ans: While auditing, the auditor come across various assertions of the management. The auditor has to evaluate these assertions so that he would be able to express his opinion on the financial statements. This evaluation can be made in the light of some facts and reasons. These facts and reasons are called "Audit Evidence".

• **Methods to Obtain Audit Evidence**

1. **Inspection :-** It consists of examining records, documents, or tangible assets.
2. **Observation :-** It consists of witnessing a process or procedure being performed by others.
3. **Inquiry :-** Inquiry consists of seeking appropriate information from a knowledgeable person inside or outside the entity.
4. **Confirmation :-** Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records.
5. **Computation :-** It consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.
6. **Analytical Review :-** It consists of studying significant ratios and trends and investigating unusual fluctuations and items.

Materiality in Planning and Performing an Audit (SA 320)

Ans: The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

• **The main factors to be considered for determining materiality of an item are:**

1. **Individually:** It may be determined individually. E.g., a payment of 1000 may be material in a small business, but even Rs. 1 lac could be immaterial for a big business entity.
2. **Aggregate:** It may be determined in aggregate. E.g., total income from investment in mutual funds could be more material than looking into each individual investment.
3. **Legal Considerations:** It depends on the statutory or legal considerations. E.g., the remuneration paid to him is a material item even if the financial implication is not much.
4. **Legal Definition:** It may be defined or described in law itself. E.g., Schedule III requires separate disclosure of items of all expenses exceeding 1% of turnover or to write off capital assets purchased for less than 5000.
5. **Relative overall impact:** It may depend on the relative degree of relevance to the overall accounts or the group, or class of transactions to which it pertains. E.g., short recoveries from debtors.
6. **Qualitative:** It may be qualitative and not often reckoned with respect to quantitative details alone. E.g., improper disclosure of an accounting policy in the Notes to the Annual Financial Statements may affect economic decisions.
7. **Insignificant quantity but special context:** It maybe of an insignificant quantity otherwise, but material in special circumstances. E.g., rounding off to the nearest rupee the fraction of 0.666 as 0.67 in computer software. It may be material in future due to cumulative effect even if insignificant now.

Auditing Concepts

Concept of True and Fair

Ans: The phrase “true and fair” in 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 verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted.

- To ensure true and fair view, an auditor has to see the following:
 1. That the assets are neither undervalued or overvalued, according to the applicable accounting principles;
 2. No material asset is omitted
 3. The charge, if any, on assets are disclosed;
 4. Material liability should not be omitted;
 5. The profit and loss account discloses all the matters required to be disclosed by Part II of Schedule III and the balance sheet has been prepared in accordance with part I of Schedule III;
 6. All unusual, exception or non- recurring items have been disclosed separately.

Define Auditor’s independence

Ans: By the term “auditor’s independence” we mean that the judgment of the auditor is not subordinated to the wishes or directions of any person who might have engaged him or to his own self-interest. Independence is an attitude of mind. However not only should a professional accountant maintain independence but he should also appear to be independent to all reasonable persons. Thus independence must be real, present and evident.

• Advantages of Independent Auditors

1. The society being able to get an informed, objective and unbiased opinion on the financial statements of an organization which is used in making significant economic decisions by interested segments of the society, i.e. shareholders, creditors, bankers, financial institutions etc.
2. It is to be noted that only the auditor is in a position to examine the accounts and transactions of an organization with a view to form an opinion. His report is therefore, the only real safeguard available to various parties interested in the financial affairs of the organization.

Disclosure of Accounting policies

Ans: 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 the financial statements.

• Fundamental Accounting Assumptions

1. **Going Concern :-** It means that the enterprise has an intention to carry on its operations for the foreseeable future. There is no intention on the part of the enterprise to discontinue the business nor has any need arisen as to the liquidation of the organization. It is because of this fundamental assumption that depreciation etc. is provided in the books of accounts.
 2. **Consistency -** Accounting policies are followed on consistent basis from one period to another.
 3. **Accrual -** Revenues and cost are accrued, i.e., they are recognized when they are earned or incurred. Actual receipt or payment is not necessary. In other words, the accounts are maintained on ‘mercantile system’ only.
- **The accounting policies are selected on the basis of following factors:**
1. **Prudence :-** It states to ‘provide for all losses and anticipate no profits.’ At the time of preparation of financial statements the preparer may face various uncertainties, for example, as to recoverability of receivables, warranty claims etc. Thus, estimates are made for uncertainties and provided for in the books of accounts. For example, provision for bad and doubtful debts.
 2. **Substance over Form :-** The transaction should be accounted for in accordance with its actual happening and the economic reliability. The legal form is not relevant.
 3. **Materiality :-** Financial statements should disclose all the items and facts which are sufficient enough to influence the decisions of the user of the financial statements.