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: 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. For purposes of the SAs:

(i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.

(ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

Types of Audit Evidence

- Depending upon nature
  - Visual
  - Documentary

- Depending upon source
  - Oral
  - Internal
  - External
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.

**Question 2**

*Write short notes on the following:*

(a) *Preliminary Expenses*
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(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.

As per the Revised Schedule VI, the unamortised preliminary expenses should be disclosed in the balance sheet under the heading "Other Non-Current Assets/Current assets" (depending on the remaining period of amortisation.

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**: As per SA 500 “Audit evidence” 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.

(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
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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.

**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.

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".*
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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


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.

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 6

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 foregoings.

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 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 goods 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 7

*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 SA 220.
➢ 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.

Retention of working papers: Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Question 8

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

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 9

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 10

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" In some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity. However, the auditor should consider the risk that the going concern assumption may no longer be appropriate. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of
one or more of the items always signify that a material uncertainty exists.

**Financial**

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

**Operating**

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

**Other**

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management’s plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional...
capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

The risk assessment procedures required by paragraph 10 help the auditor to determine whether management’s use of the going concern assumption is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management’s plans and resolution of any identified going concern issues.

**Question 11**

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

**Answer**

According to the SA 540, “Auditing 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. 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.
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- 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 12

Write short note on Auditor’s Independence.

Answer

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:

(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 13

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’**: As per SA 520 the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor’s choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures include the consideration of comparisons of the entity’s financial information with, for example: comparable information for prior periods, anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation and similar industry information, such as a comparison of the entity’s ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example: among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages and between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Analytical procedures are used for the following purposes:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity.

(ii) **Concept of Materiality**: Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:
• Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

• Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

• Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

1. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference.

2. The auditor’s determination of materiality is a matter of professional judgment, and is affected by the auditor’s perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

   (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

   (b) Understand that financial statements are prepared, presented and audited to levels of materiality;

   (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

   (d) Make reasonable economic decisions on the basis of the information in the financial statements.

3. 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 and in forming the opinion in the auditor’s report.

Question 14

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

**Answer**

*External confirmation:* As per SA 505 “External Confirmations” Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or
by electronic or other medium.

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.

**Question 15**

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

**Answer**

Areas in which different accounting policies may be encountered are:-

- Valuation of inventories – FIFO, LIFO, weighted average etc.
- Treatment of goodwill – write off, retain.
- Valuation of investment –at cost, market or net realizable value etc.
- Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.
- Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.

Note: (The above list is not exhaustive. There may be other examples as well.)

**Question 16**

*What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure?*

**Answer**

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

(i) Existence - that an assets or liability exists at a given date.
(ii) Rights and obligations - that an asset is a right of the entity and a liability is an obligation at a given date.
(iii) Occurrence - that a transaction or event took place which pertains to the entity.
(iv)Completeness - that there are no unrecorded assets, liabilities or transaction.
(v) Valuation - that an asset or liability is recorded at an appropriate carrying value.
(vi) Measurement - that a transaction is recorded in the proper amount and revenue or expenses are allocated to proper period.

(vii) Presentation & disclosure - that an item is disclosed, classified and described in accordance with recognized accounting policies, practices and statutory requirements.

**Question 17**

*Distinguish between Internal evidence and External evidence.*

**Answer**

**Internal evidence and external evidence:** Evidence which originates within the organization being audited is internal evidence. Example – sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization; for example, purchase invoice, supplier's challan and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g., an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

**Question 18**

*In auditing, the auditor checks the specific assertions of the items appearing in the financial statements and opines about the overall assertions they signify. Explain specific assertions and overall assertions in this context.*

**Answer**

Auditor checks specific assertions that the items of financial statements portray and also gives his opinion in the form of overall assertion in respect of financial statements taken as a whole.

The specific assertions are –

(a) Existence – That the asset or liability exists at a given date.
(b) Rights and obligations – The asset is a right of the entity and the liability is an obligation of the entity at a given date.

(c) Occurrence – That a transaction or event has occurred which pertains to the entity

(d) Completeness – There are no unrecorded asset/liabilities or transactions

(e) Valuation – An asset or liability is recorded in the proper amount and recorded at appropriate carrying value.

(f) Measurement – A transaction is recorded in the proper amount and revenue or expenses is allocated to proper period.

(g) Presentation – An item is disclosed, classified and described in accordance with accounting policies and legal requirements.

The overall assertions opined by the auditor about the financial statements are:

(a) The profit and loss account give a true and fair view of the results – profit or loss for the period ended on the last date of the accounting period.

(b) The balance sheet gives a true and fair view of the status or financial position of the entity as on the last date of the accounting period.

**Question 19**

'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.'

*Justify this statement in the light of responsibilities of Joint Auditors under SA 299.*

**Answer**

**Responsibility of Joint Auditors:** SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 1956. Main features of the said SA are discussed below:

- **Division of Work:** Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.

- **Coordination:** Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work.
performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(v) for ensuring that the audit report complies with the requirements of the relevant statute.

(vi) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(viii) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

**Question 20**

*Write short notes on the following:*

(a) **Substantive Procedures**

(b) **Audit Working Papers.**

**Answer**

(a) **Substantive Procedures:** These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions

(i) The asset or a liability should exist at a given date.

(ii) The asset should be owned by the entity and the liability is an obligation of the entity at a given date.
(iii) There should not be any unrecorded assets, liabilities or transactions.
(iv) Assets or liabilities should be recorded at appropriate carrying values.
(v) Transaction or event that took place should pertain to the entity during the relevant period.
(vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period.
(vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

(b) Audit Working Papers: The audit working papers constitute the link between the auditor’s report and the client’s records. SA 230 (revised) on “Audit Documentation” states that Audit Working papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The object of Audit working papers is to provide:

(i) Evidence of the auditor’s basis for a conclusion about the achievement of the overall objective of the auditor; and
(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides above, 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 SA 220.
- 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.

Working papers should contain audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The auditor shall assemble the audit working papers in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor’s report. The retention period for audit working papers ordinarily is no shorter than ten years from the date of the auditor’s report, or, if later, the date of the group auditor’s report. Unless otherwise specified by law or regulation, audit working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients.

Question 21

What do you mean by the term ‘Sufficient Appropriate Audit Evidence’? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence.
Meaning of sufficient appropriate audit evidence: The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

SA 500 on ‘Audit Evidence’ further expounds this concept. According to it, 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.

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgment. Further, SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

In general the various factors which may influence the auditor’s judgment as to what is sufficient and appropriate audit evidence are as under:

(i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.

(ii) The materiality of the item.

(iii) The experience gained during previous audits.

(iv) The results of auditing procedures, including fraud and errors which may have been found.

(v) The type of information available.

(vi) The trend indicated by accounting ratios and analysis.
EXERCISES

1 State with reasons your views on the following:

(a) An assistant of X & Co. Chartered Accountants detected an error of ₹ 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.

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

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.