

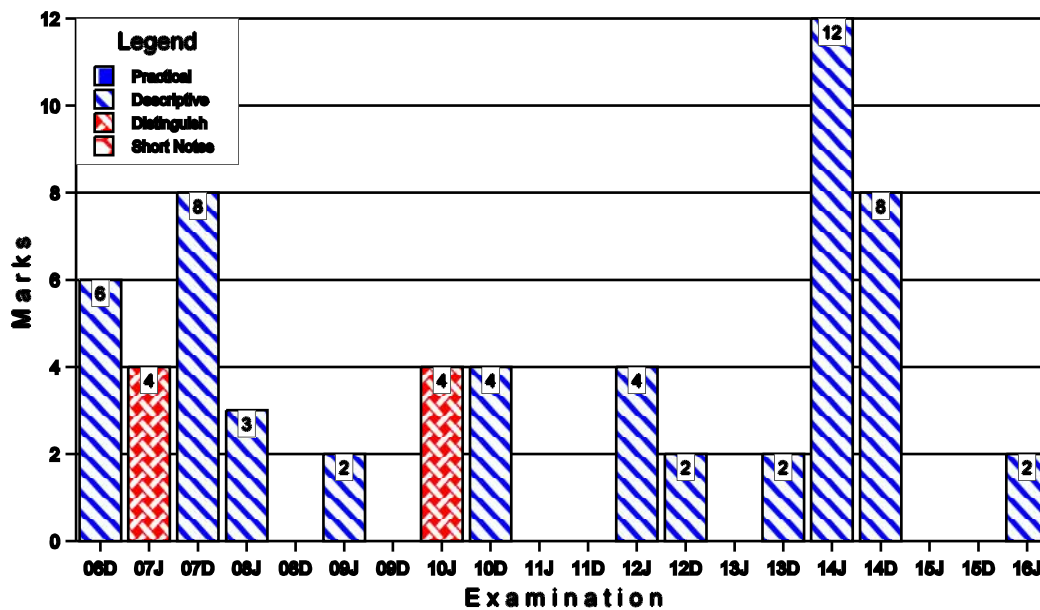
# 10

## Auditing Concepts

### This Chapter Includes

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| <ul style="list-style-type: none"> <li>● Auditing: Evolution</li> <li>● Nature</li> <li>● Scope</li> <li>● Aspects to be covered</li> <li>● Objectives</li> <li>● Basic Principles</li> <li>● Significance</li> <li>● Advantages</li> <li>● Inherent Limitations</li> <li>● Types of Audit</li> <li>● Book Keeping</li> </ul> | <ul style="list-style-type: none"> <li>● Accounting</li> <li>● Investigation</li> <li>● External &amp; Internal Audit</li> <li>● Auditor</li> <li>● Auditor's Engagement</li> <li>● Audit Evidence</li> <li>● Concept of True &amp; Fair</li> <li>● Materiality</li> <li>● Auditor's Independence</li> <li>● Disclosure of Accounting Policies.</li> </ul> |
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### Marks of Short Notes, Distinguish Between, Descriptive & Practical Questions



Questions of December - 2007 are from CMA Stage I and from December-2008 onwards are from CMA Gr. II New Course.

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DISTINGUISH BETWEEN

**2007 - June [8]** (b) Distinguish between:

(i) Audit and Investigation

(4 marks)

**Answer :**

**Audit and Investigation distinguished**

1. **Legal binding:** Audit of annual financial statements of a company is compulsory under the Companies Act, 2013. However, Investigation is not compulsory under the Companies Act, 2013 but voluntary depending upon necessity.
2. **Object in view:** Audit is conducted to ascertain whether the financial statements show a true and fair view. Investigation is conducted with a particular object in view, viz to know financial position, earning capacity, prove fraud, invest capital, etc.
3. **Period covered:** Audit is conducted on annual basis. Investigation may be conducted for several years at a time, say three years.
4. **Parties for whom conducted:** Audit is conducted on behalf of shareholders (or proprietor, or partners). Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc.
5. **Documents:** Audit is not carried out of audited financial statements. Investigation may be conducted even though the accounts have been audited.
6. **Extent of work:** Audit is normally conducted on test verification basis. Investigation is a thorough examination of books of accounts.
7. **Report:** Audit report of a company is addressed to shareholders (or proprietors or partners). Investigation report is addressed to the party on whose instruction investigation was conducted.
8. **Person performing work:** Audit is to be conducted by a person having prescribed qualification i.e. Chartered Accountant, Cost Accountant. No statutory qualification is prescribed for Investigation. It may be undertaken by any one.

**2010 - June [6]** (a) Find out the difference between US-GAAP and India-GAAP in respect of R & D. (4 marks)

**Answer :**

Indian GAAP allows the R and D expenditure to be capitalised under certain conditions like technical feasibility, resource availability etc.

In the US GAAP R and D costs are treated as expenses. If the Plant & machinery has future use, it can be capitalised.

### DESCRIPTIVE QUESTIONS

**2006 - Dec [8]** (a) Explain how disclosure of accounting policies improve the presentation of financial statements. (6 marks)

**Answer :**

- This standard deals with the disclosure of significant accounting policies followed in the preparation and presentation of financial statements.
- The purpose of this standard is to promote better understanding of financial statements by establishing the disclosure of significant accounting policies in the financial statements and the manner of doing so.
- Compliance with this standard should go a long way in facilitating a more meaningful comparison between financial statements of different enterprises.
- The views presented in the statements of an enterprise of its state of affairs and of the profit or loss account can be significantly affected as the accounting policies followed vary from enterprise to enterprise.
- All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
- The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.
- Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed.

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- In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements 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 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. The primary consideration is that the financial statements should give a true and fair view of the firm's income and financial position.

**2007 - Dec [6]** (a) Is the disclosure of accounting policies, mandatory for companies? What should the Auditor do in this regard ? (8 marks)

**Answer :**

*Please refer 2006 - Dec [8] (a) on page no. 403*

**2008 - June [4]** (b) List three examples of situations in which the techniques of observation can be employed by external auditor. (3 marks)

**Answer :**

This Standard is quite detailed in terms of audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This SA also deals with the requirements of obtaining sufficient appropriate audit evidence, how information to be used as audit evidence, how to select items for testing to obtain audit evidence and procedures in case of inconsistency in, or doubts over reliability of, audit evidence.

The following are three situations where the auditor can employ the technique of observation for gathering information and evidence for the purpose of the audit:

- Physical observation of payments being made and incomes being received in the cash department;

- Physical counting and examination of various countable items of balance sheet e.g. Inventory stocks etc.
- Physical verification of fixed assets as arranged by the management.

**2009 - June [5] {C}** Comment on the following statements based on legal provisions:

(e) Auditor's primary responsibility is to detect errors and frauds.

(2 marks)

**Answer :**

**False:** auditor's primary responsibility as per AAS-2 is to express an opinion on financial statements.

**2010 - Dec [7]** (b) Explain the factors which act as guiding measures to the concept of materiality. (4 marks)

**Answer :**

**(b) The main factors to be considered for determining materiality of an item are:**

- Individually:** It may be determined individually. e.g., a payment of ₹ 1,000 may be material in a small business, but even ₹ 1 lac could be immaterial for a big business entity.
- 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.
- Legal Considerations:** It depends on the statutory or legal considerations. e.g., where the terms of appointment of a whole time director are not according to law, the remuneration paid to him is a material item even if the financial implication is not much.
- 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.
- 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.

- (vi) **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.
- (vii) **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.

**2012 - June [5] {C}** Comment on the following statements based on legal provisions:

- (a) Development of the audit evidence is the basic to the understanding of the audit process.
- (f) Test checks may be applied to all transactions.

(2 marks each)

**Answer :**

- (a) **True:** The development of audit evidence is fundamental to understand the audit process. It is the evidence which gives information about the state of affairs of the company. Evidence helps the auditor to decide what is to be audited and how much is to be audited. Evidences are collected through various audit techniques from various sources.

**Answer:**

- (f) **False:** Only some transactions are subject to Test Check. Cash/Bank Book and Pass Book should be thoroughly checked.

**2012 - Dec [6]** (f) Risk of non-detection of error is less than the risk of non-detection of fraud—Comment. (2 marks)

**Answer :**

Fraud is more difficult to detect than error. Fraud may be divided broadly into two classed:

- (a) Defalcation, involving either misappropriation of money or goods.
- (b) The fraudulent manipulation of accounts not involving defalcation.

This is so since fraud generally involves complicated, ticklish and carefully organized/perpetrated schemes to concede the same from the eyes of the

Auditor and/or the management, such as forgery, intentional failure of records, transaction, cooking up the vouchers for expenses etc.

**2013 - Dec [5] {C}** Answer the following:

(a) What do you understand by audit evidence? (2 marks)

**Answer:**

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truthfulness and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

Audit evidence may be defined as the 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.

**2014 - June [6]** (a) (ii) Discuss in brief, the principles, which are useful in assessing the reliability of audit evidence. (4 marks)

**Answer:**

**Useful principles for assessing the reliability of audit evidence:**

Audit evidence refers to any information, verbal or written, obtained by the auditor on which he bases his opinion on financial statements.

The reliability of audit evidence depends on its source-internal or external and on its nature-visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence.

(a) External evidence (e.g. confirmation received from third party) is usually more reliable than internal evidence.

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- (b) Internal evidence is more reliable when related internal control is satisfactory.
- (c) Evidence in the form of documents and written representations is usually more reliable than oral representations.
- (d) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

**2014 - June [7]** (a) (i) Bring out in a tabular form, the relationship between accounting and auditing. (4 marks)

(ii) State the aspects to be seen by an auditor to ensure that the statements audited project a true and fair view. (4 marks)

**Answer:**

- (i) The relationship between accounting and auditing has been explained by Kell and Ziegler in "Modern Auditing" as follows:

Accounting	Auditing
(i) Analyze events and transactions.	Review client's internal control system.
(ii) Record and summarize data in accounting records.	Obtain and evaluate evidence on statement assertions.
(iii) Make financial statement assertions.	Determine fairness of statements in conformity with recognized accounting principles.
(iv) Prepare financial statements as per recognized accounting principles.	Prepare audit report on finding.
(v) Distribute Financial statements and Auditor's report to shareholders.	Deliver audit report to client.

- (ii) (i) That the assets are neither undervalued or overvalued, according to the applicable accounting principles;
- (ii) No material asset is omitted
  - (iii) The charges, if any, on assets are disclosed;
  - (iv) Material liability should not be omitted;



- (v) 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;
- (vi) All unusual, exception or non-recurring items have been disclosed separately.

**2014 - Dec [4]** Answer the questions:

(a) Comment on the following:

- (i) The concept of true and fair is a fundamental concept in Auditing. (4 marks)

(c) (iv) What is meant by Computer Assisted Audit Technique (CAAT)? Name any three CAATs available to the auditor. (4 marks)

**Answer:**

- (a) (i)** The main object of audit is to find out whether the financial statements prepared by a company show the true and fair view of the financial state of affairs of a company and if not then in what respect they are not showing. The accounts are said to be true and fair if:
1. The books of account have recorded all the business transactions correctly.
  2. The books of account have been prepared according to the accepted principles of accountancy and have followed accounting standards issued by different regulatory bodies.
  3. There are no errors and frauds present in the books of account.
  4. The financial statements that have been prepared by the company are in conformity with the books of accounts and all mandatory provisions of Companies Act.
  5. The profit and loss shown in the profit and loss account shows the true and fair results of entity's operations and the value of assets and liabilities appearing in the balance sheet is shows the correct financial picture.
  6. The books of accounts must disclose all material facts regarding revenue, expenses, assets and liabilities.

**Answer:**

**(c) (iv) Computer Assisted Audit Technique (CAAT)**

- Computer assisted audit technique uses computer to process the information, required for audit, stored in the auditee's information system.
- This technique is used for testing general controls and application controls and also for substantive procedures.
- This technique is also helpful in getting data from auditee's record as well as for analytical procedures.
- The auditor must have expertise and experience in executing and using the results of the Computer Assisted Audit Technique. Before applying this technique auditor should get reasonable assurance of its integrity, reliability, usefulness and security through appropriate planning, designing, processing and review of documentation.
- He should see that this technique is properly controlled.
- Auditor should maintain sufficient documents describing the application of the technique and regarding planning, execution, inputs, processing, output, source code, technical information about the auditee's accounting system, audit evidence and suggestions, if any, for use of the technique in future etc.
- Auditor should make necessary arrangements for data files to minimize the effect on auditee's routine activities.

Different Computer Assisted Audit Techniques available are as under.

- (a) Test data
- (b) Integrated Test Facility
- (c) Audit Software
- (d) Audit Automation
- (e) Core Image Comparison
- (f) Data Base Analysis
- (g) Embedded Code
- (h) Log Analyzers
- (i) Mapping
- (j) Modeling

- (k) Online Testing
- (l) Program Code Analysis
- (m) Program Library Analyzers
- (n) Snapshots
- (o) Source Comparison
- (p) Tracing

**2016 - June [3]** Answer the question:

(c) What do you understand by Audit Evidence? (2 marks)

<b>Repeatedly Asked Questions</b>		
No.	Question	Frequency
1	What do you understand by Audit Evidence? 13 - Dec [5] (a), 16 - June [3] (c)	2 Times

<b>Table Showing Marks of Compulsory Questions</b>										
Year	11 D	12 J	12 D	13 J	13 D	14 J	14 D	15 J	15 D	16 J
Descriptive		4			2					
Total		4			2					