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BASIC CONCEPTS IN AUDITING

Question 1

State with reasons (in short) whether the following statement is true or false.

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. *(2 Marks) (May 2007)*

Answer

False: According to the Guidance Note issued by the ICAI on "Independence of Auditors", "Independence implies that the judgment 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." In this case of Renting of building to the client does not affect the independence.

Question 2

State with reasons (in short) whether the following statement is true or false.

One of the techniques used for gathering evidence is substantial review.

(2 Marks) (Nov 2007)

Answer

False: One of the techniques used for obtaining evidence is analytical review procedure which consists of studying significant ratios and trends. (SA 500 "Audit Evidence")

Question 3

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

(5 Marks) (Nov 2007)

Answer

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

(i) Method of depreciation, depletion and amortization-Straight Line Method, Written Down Value method.

(ii) Treatment of expenditure during construction i.e. write off, capitalization, deferment.

(iii) Conversion or translation of foreign currency items-average rate, actual, TT buying rate etc.

(iv) Valuation of inventories – FIFO, LIFO, weighted average etc.

(v) Treatment of goodwill – write off, retain.

(vi) Valuation of investment –at cost, market or net realizable value etc.

(vii) Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.

(viii) Recognition of profit on long term contracts –year to year, % completion etc.

(ix) Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.

(x) Treatment of contingent liabilities.

Question 4

State with reasons (in short) whether the following statement is true or false.

Compliance procedures are tests designed to obtain audit evidence as to completeness, accuracy and validity of the data produced by accounting system. (2 marks) (May 2008)

Answer

False: Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Here auditor is concerned with assertions that the control exists and is operating effectively.

Question 5

What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure? (6 Marks) (May 2008)

Answer

In obtaining audit evidence from substantive procedures, the auditor 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 6

Write short note on Reliability of audit evidence. *(5 Marks) (May 2008)*

Answer

Reliability of audit evidence: The reliability of audit evidence is influenced by 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 generalization is useful in assessing the reliability of audit evidences.

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

(ii) Internal evidence is more reliable when related internal control is satisfactory.

(iii) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.

(iv) Evidence in the form of documents and written representations is more reliable than oral representation.

Question 7

Distinguish between Internal evidence and External evidence. *(6 Marks) (Nov 2008)*

Answer

Types of Audit Evidence: There are two types of Audit evidence:

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 8

State with reason (in short) whether the following statement is True or False.

The principle of confidentiality precludes auditor to disclose the information about the client to a third party at all circumstances without any exception. (2 Marks)(June 2009)

Answer

False: The principle of confidentiality is one of the basic principles of auditing. Auditor is generally not expected to divulge the information of his client to others. But it is not the case always. He can disclose the information to others if (a) permitted by his client and (b) if he has to disclose it as per any statutory obligation dictated by any law.

Question 9

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. (10 Marks)(June 2009)

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.