

*Commercial's*

8<sup>th</sup>  
Edition  
2024

# Auditing & Ethics

## MADE EASY

for CA Inter (New Syllabus 2023)

**Applicable for May 2024 and onwards Examinations**

- ❖ Recent Amendments on Standards on Auditing & the Companies Act, 2013 (CARO) included;
- ❖ Student friendly
- ❖ It includes all the previous year exam questions and presentation of answers;
- ❖ Conceptual Understanding of the Standards with Detailed Examples
- ❖ Very simple Language to Understand
- ❖ Summary of the Standard on Auditing is presented in diagrams at the end of respective (each) standard; Wherever necessary, the concept is presented in diagrammatic form;

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## CHAPTER

# 1

# NATURE, OBJECTIVE AND SCOPE OF AUDIT

(VERY IMPORTANT CHAPTER)

I presume every student must have had basic idea about "Auditing" and without which he would not have joined CA course.

*Do you know:*

- What is the meaning of "Audit"?
- Who performs the Audit and what should be his qualifications?
- Why to perform audit?
- What are the primary objectives of audit?
- Whether the auditor is **responsible** to find out the frauds & errors in the entity?
- What are the advantages of audit?
- How to start and close the audit? (*Imagine you are in a company*)

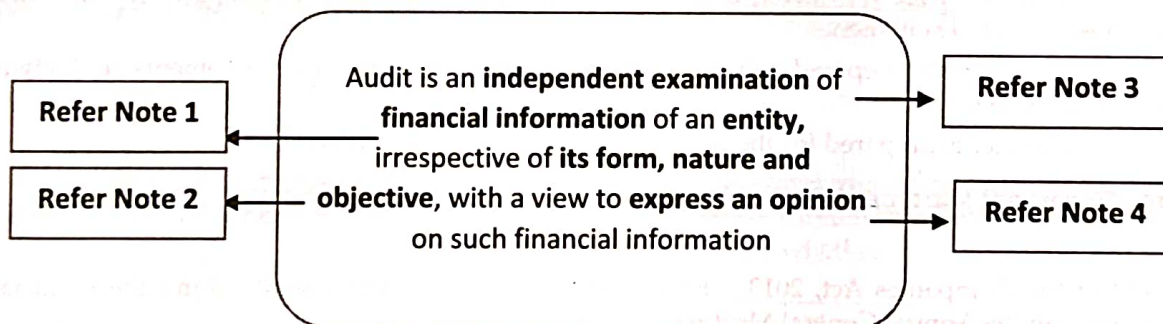
Think about these questions for some time. That will help you.

Generally, students do have some misconceptions on this subject. This chapter will help you to get an overall idea about the concept of "auditing". All the words are inter-linked, so you must read it with utmost concentration.

We suggest you to read this chapter at least **three times** very carefully so that your basics will be strong and you will be geared up to proceed to the next chapters.

### Q 1: What do you mean AUDIT?

*Answer*



*Read the definition at least three times*

Let us understand each and every word of the definition now.

### NOTE 1 - Financial Information

Let us understand completely about financial statements in this note.

(CA IPCC May 2017)

Financial information is often contained in financial statements.

Broadly speaking 'Financial statements' are a set of documents which include the following (along with the purpose of each statement).

Document Name		It Presents
1.	Balance sheet / Statement of affairs	The financial position of the entity as on a particular date (i.e., generally 31st March);
2.	Statement of Profit and Loss/Income Statement	The financial result of its operations during the period;
3.	Cash Flow Statement	The movement (in and out) of cash and cash equivalents during the period;
4.	Statement of Changes in Equity	The movement of Share capital and Reserves & Surplus during the period;
5.	Notes to Accounts	(a) The Significant accounting policies and procedures adopted in preparation and presentation of above financial statements; (b) Details of the items presented in the financial statements; Say in Balance sheet – you may find just PPE – 1,000 Crore. But in the notes – the entity explains what are included in PPE in detail.

Financial statements do NOT include the following statements:

1. Director's Report;
2. Statement by the Chairman;
3. Discussion and analysis by management.

#### Asked in Exam

Write short notes on general purpose Financial Statements.

(CA IPCC – Nov 2005)

#### Q 2: What do you mean by General purpose financial statements and Special purpose financial statements?

##### Answer

Financial statements which are used by varied users like creditors, lenders, government, shareholders are known as general purpose financial statements.

However, if financial statements are prepared only for a specific purpose, such financial statements are known as special purpose financial statements.

For example, financial statements prepared for the purpose of Bankers on Cash basis;

#### Q 3: Who prepares 'Financial statements? (Read carefully)

##### Answer

As per Section 129 of the Companies Act, 2013 – Every year, Board of Directors shall submit the financial statements to the members in the Annual General Meeting (AGM);

Governing body of the entity is responsible to prepare financial statements.

##### For Example

Form of Business Organization	Person responsible to prepare FS
Company	BOD
Partnership Firm	Partners
Trust	Trustees
Sole proprietorship	Proprietor

As you know governing body changes from entity to entity, hence from now onwards - Instead of naming them BOD, partners, trustees, etc. – We will use "Those Charged With Governance" or "TCWG" in its place.

'Charged' means – who is empowered to govern.

**Q 4: Why to audit "from the point of view of a company"?**

*Answer (read carefully – point by point)*

- ⇒ As you know – Members / Shareholders of the company are the real owners of the company;
- ⇒ As the members of the company cannot run the business together (especially listed companies), they appoint **Board of Directors**.
- ⇒ BOD is ultimately responsible to the members. BOD creates the hierarchy, establishes the controls and runs the business through the management;
- ⇒ BOD is responsible to prepare the financial statements. (Just imagine, how to ensure whether these Statements give true and fair view?)
- ⇒ To check and report on the financial statements, **members of the company appoint an auditor**. In the case of a company, it is a statutory requirement U/s 139 of the Companies Act, 2013 to appoint an auditor– hence, such auditor is called "**Statutory auditor**".

*I hope you understood it.*

**Q 5: Is there any difference between "TCWG" and "Management"?**

*Answer*

Let me explain from the point of view of a company;

Board of Directors are the TCWG in case of a company – They take **all the operating and financial decisions of the company** in the board meetings. BOD includes Managing director, Whole time directors (Executive directors) & Part time directors (non-Executive directors).

*Who executes the decisions taken in the Board?*

This execution work is performed by **Management**: i.e., one level below TCWG. Generally, management includes ALL Wholetime directors (executive directors) and others like Chief executive officer, Chief operating officer, etc.

Generally, in case of small companies – There won't be any difference between TCWG & Management as they do both the jobs, i.e., decision making as well as execution;

*I hope you understand this concept*

Practically, though TCWG is responsible to prepare financial statements, it is – management who prepares the financial statements under the guidance of TCWG.

**Q 6: Who are the stake holders of an entity and how are financials useful to them?**

*Answer*

The following table explains the usefulness from the point of view of different stakeholders:

Stake holders / Users	Purpose
Proprietor/Shareholders	To analyse performance, profitability and financial position of the entity and accordingly decide whether to hold / sell the shares (in case of shareholders).
Management	For day-to-day decision-making and performance evaluation;
Employees	To assess their growth prospects as well as bonus entitlement; And ESOPs if they are based on performance;
Lenders (Give money)	To determine the financial position of the company to decide whether to give loan or not? It also helps them to determine the ability of the entity to make the payments on debts by calculating debt service coverage ratio, interest coverage ratio, etc.
Suppliers (Provider goods/ services)	To determine the <b>credit worthiness</b> of the company in order to give credit
Customers	To know the general business viability before entering <b>into long-term</b> contracts and arrangements;
Government	To ensure <b>prompt collection of direct and indirect tax</b> revenues and to decide eligibility for any Government grants;

Stake holders / Users	Purpose
Prospective Investor	To assess the solvency and future prospects of the organization. Decides whether to buy the shares or not?

### Q 7: What are other Responsibilities of Management of the entity?

**Answer**

Besides preparation of financial statements, management's other responsibilities include:

- The maintenance of adequate accounting records and internal controls (will discuss this term in detail in next chapter).
- The selection and application of accounting policies and
- The safeguarding of the assets of the enterprise
- Compliance with applicable laws and regulations

### NOTE 2 – Entity irrespective of its form, nature and objective

As per the definition

Independent examination of financial information of an "entity".

It means **any entity – irrespective of its form** – means it can be a Company, Partnership firm, Limited Liability partnership (LLP), a Trust, a Society, etc.

**Irrespective of Nature of business** – it can be a manufacturer, service provider, software, real estate, etc.

**Irrespective of Objective** – means it can be a profit oriented OR Non-profit-oriented organisation.

### NOTE 3 – Independent Examination

The auditor should be **independent**.

### Q 8: What is the "Concept of Auditor's Independence"?

**Answer**

- ✓ There is **no definition** for independence;
- ✓ Independence is a **state of mind** in which one feels free & it is an attitude of mind.
- ✓ Audit objective is to express an opinion on financial information; Auditor should be in a position to express his opinion on the financial statements; Hence, independence is a prime requisite for the auditor;
- ✓ The judgment of the person is **NOT subject to the wishes or directions of another person** who might have engaged him and also **not subject to his own interest**;
- ✓ The Companies Act, 2013 – safeguards the auditor's independence with provisions like
  - Section 141(3) – Auditor should not hold any share in the company (*If the auditor has interest in the company, he cannot perform his duties independently*);
  - Section 141(3) – Auditor or his partners or his relative cannot be officers of the company;
  - Section 140(1) – Auditor cannot be removed by the company without prior permission from the Central Government and passing special resolution;
- ✓ ICAI issued a guidance note on Independence; as per the guidance note –
  - Auditor should be **independent and appear to be independent**; (*Just being independent is not sufficient and the users of financial statements should also feel that auditor is independent – Otherwise Auditor will lose public confidence*);
  - These laws may be relaxed or strengthened but the quality of independence should remain **unchanged**. (*It means even if there are loopholes in the law – auditor should ensure that he is independent*);
- ✓ Considering the above points, auditor should accept the work only when there are no threats to independence;

**Asked in Exam**

Discuss the concept of independence of an auditor.

(CA IPCC - May 2006)

**Asked in Exam**

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain.  
(CA Inter - May 2019)

**Concept capsule 1**

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain  
(CA Inter - May-2019)

**Suggested answer**

Independence" implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of the entity subject to the audit.

**(a) Independence of mind**

– the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

**(b) Independence in appearance**

– the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised." Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

**NOTE 4 – Objective of Audit**

Objectives of auditor in accordance with SA 200, are

1. To **obtain reasonable assurance** about whether the financial statements as a **whole are free from material misstatement**, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
2. To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

The following are derived from the above two points.

- (a) **Auditor's objective:** Obtain reasonable assurance that financial statements are free from material misstatement (fraud or error).
  - Reasonable assurance ≠ Absolute assurance; it is a high level but not a complete guarantee.
  - Audit conducted with professional competence, following Standards on Auditing (SAs).
  - Audit procedures, evidence, conclusions, and opinions formed to provide reasonable assurance.
- (b) **Misstatements:** Can occur due to fraud or error. Auditor seeks reasonable assurance regarding freedom from material misstatements.
  - Auditor assesses the effect of misstatements on financial statements as a whole.
- (c) **Purpose of obtaining reasonable assurance:** Allows the auditor to express an opinion on whether financial statements are prepared in accordance with a financial reporting framework (GAAP) (Explained in detail below).
- (d) **Reporting:** The auditor's opinion is reported and communicated through a written report as required by Standards on Auditing. (Further details to be covered in subsequent parts of the chapter.)

**Concept capsule 2**

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. In the above context, explain the guiding principles.

(RTP-Nov-2019) & (4 Marks - Nov 2020)

**Suggested answer**

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: –

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- In the case of audit, the key fundamental principles are **integrity, objectivity and professional skepticism**, which necessarily require the auditor to be independent.
- Before taking on any work, an auditor must **conscientiously consider whether it involves threats to his independence.**
- When such threats exist, the auditors should **either desist from the task or put in place safeguards** that eliminate them.
- If the auditor is **unable** to fully implement credible and adequate safeguards, then he must **not accept the work.**

**Q 9: What is the Audit opinion / Audit Report?****Answer**

- ⇒ Auditor expresses his **opinion in writing** – that is called as “**Audit report**”.
- ⇒ This opinion is expressed in a **prescribed format** as provided in SA 700 / SA 705 / SA 706, etc. or for tax audits, it is prescribed by the Income-tax Act, 1961- Form 3CD.

**Q 10: What is the “Concept of True and Fair view”?****Answer**

- ✓ True and fair view is NOT defined in either accounting or under the Companies Act, 2013;
- ✓ We should understand this based on general conclusions / judgements of the courts, etc

True means	Arithmetical accuracy, factual validity and completeness of the recording of the transaction and events; Complied with Financial reporting framework;
Fair means	Proper classification, summarization and disclosure as per regulatory requirements; No bias; presentation in FS shall reflect the economic substance rather than their legal form (Substance over form – as per AS-1)

Look into the following examples to get an idea

- ❖ Company constructed an additional floor with Rs. 40 Lacs and shown it as an expense in Profit and Loss in the same year;
- ❖ Company has incurred loss of Rs. 25 Lacs due to fire at godown and company has shown such losses under miscellaneous expenses in the Balance sheet;
- ❖ Secured loan received from State Bank of India amounting to Rs. 50 Lacs by giving the building as security but not disclosed appropriately in the financial statements;
- ❖ As there is loss in the CY, depreciation of Rs. 25 Lacs has not been provided.

All the above points do not give true and fair view and it misleads the users of financial statements;

True and fair is mentioned in some of the sections of the Companies Act, 2013

- ✓ Sec. 128 – Every company shall maintain proper books of account. Proper books of Account means preparing books of accounts by following Double entry system of accounting and Accrual basis;
- ✓ Sec 129 - All the matters of financial statements are to be disclosed in accordance with **Schedule III** of the Companies Act, i.e., the Balance Sheet and Profit and Loss account should be prepared in accordance with **Part I and Part II of Schedule III** respectively.



- ✓ Sec. 129 – Financial statements should comply with Accounting standards so as to provide true and fair view;
- ✓ True and Fair view is a **matter of judgment** and depends on facts and circumstances of each case. To ensure T&F view the Auditor has to ensure the following:
  - o The assets are **neither undervalued nor overvalued**;
  - o **No material asset OR liability is omitted**;
  - o The charge on assets (if any) is properly disclosed;
  - o All the matters of financial statements are disclosed in accordance with Schedule III of the Companies Act;
  - o Accounting principles are **consistently** followed (AS-1);
  - o All unusual or exceptional items are disclosed appropriately (AS-5)

**Asked in Exam**

Under what circumstances/conditions the financial statements are considered to present a "true and fair" state of affairs?  
(CA IPCC- Nov 2005)

What constitutes a 'true and fair' view, is the matter of an auditor's judgement in the particular circumstances of a case. In order to ensure 'true and fair' view, auditor has to review certain points. Mention any such 5 (five) points in brief.  
(CA Inter- May 2018)

**Q 11: Is there difference between 'Opinion' and 'Certificate'?***Answer*

- ⇒ **Opinion** means **one's point of view** towards any given fact; One person's opinion may vary with another person's opinion; it involves professional judgements / estimations/ assumptions, etc. In case of opinion, accuracy is not possible – Only fairness is possible;
- ⇒ **Certificate** means **establishing a given fact**. Certificate confirms the correctness / accuracy. It cannot be different for two persons and if certificate goes wrong – issuer of certificate is punishable. There is no involvement of professional judgement;
- ⇒ "Auditor usually issues opinion and does not certify financial health of an organization."

**Q 12: What is "Financial Reporting Framework" (FRF)?***(CA IPCC Nov 2017)**Answer*

In simple words – we can call it as Indian GAAP (Generally accepted accounting principles);

In general, Financial reporting framework includes the following:

- (a) Accounting standards / Ind AS;
- (b) Statutes, regulations like Schedule III of the Companies Act, 2013 and Ministry of Corporate Affairs (MCA) notifications;
- (c) Court decisions;
- (d) Professional and ethical obligations in relation to accounting matters (Guidance notes issued by ICAI);
- (e) General and industry practices widely recognised and prevalent; and
- (f) Accounting literature;

The financial reporting framework has to be adopted by management and TCWG for the preparation and presentation of the financial statements. The selected framework should be **acceptable in view of the nature of the entity and the objective** of the financial statements, or that is **required by law or regulation**.

**Q 13: What do you mean by the term "Misstatement"?**

*(You will read this word number of times in this book and throughout your audit life)*

*Answer*

Misstatement is the difference between (a) and (b) below:

- (a) The Amount, classification, presentation, or disclosure which is **reported in Financial Statements**; and
- (b) The Amount, classification, presentation, or disclosure **that is required to be presented as per the applicable Financial Reporting Framework**.

**Misstatements can arise from error or fraud.**

**For Example**

AS-2 "Inventory valuation" (Financial Reporting Framework) requires to follow either FIFO or weighed average method for valuation of inventory; and

If an entity applies LIFO, it would be a departure from what was expected to be followed, i.e., FRF. This will result in misstatements.

#### **Q 14: Fraud & Errors (Is it the duty of Auditor to detect & correct the frauds & errors?)**

1. **Fraud may be – 'Misappropriation of assets' and 'Fraudulent reporting'.**
2. Error is an **unintentional mistake**. Some of the errors are **self-revealing**, i.e., they are clearly identifiable.  
*For example:* Partial omission (Trial Balance will not tally). Wrong entries in bank account ledger (BRS will show up the error). Entering a transaction of Mr. X in Mr. Y Account. (When external parties statements are checked, that will not tally). Wrong Entry of Purchase of Furniture in Purchase account. (Physical verification of inventory will show up the difference).
3. Errors are – Error of omission, Error of commission, Error of Principle, Compensating error.
4. **The primary responsibility for the prevention & detection of fraud rests with Management & TCWG.** It is important that management place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence (punishment), which could persuade individuals not to commit fraud. (SA 200)
5. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of **professional skepticism** (*Explained later*) throughout the audit.
6. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures, he cannot be held responsible for the same. Management will only be held responsible in such cases.
7. The liability of the auditor for failure to detect fraud exists **only when such failure is clearly due to not exercising reasonable care and skill**. If the same cannot be proved, then auditor will not be held responsible.
8. **Detection & Correction of fraud & error is not the primary duty of the auditor.** But if auditor comes across instances of frauds & errors, then it is the part of his audit to suggest the corrective measures to avoid the repetition of such mistakes. (SA 200)
9. The auditor also has the responsibility to communicate the misstatement to the management on a timely basis & discuss it and rectify. If management fails to do so, then auditor shall mention the same in his report.

#### **Q 15: What are included in "the Scope of Audit"?**

Scope refers to range or reach of something. As you know, financial statements and accounting records are prepared by the management of the entity. If the same are verified by a qualified Chartered Accountant and express opinion on the same, it will give confidence to the users of financial statements that they can depend on the financial statements and take their economic decisions.

Let us understand what all included in the scope of Audit

##### **(1) Coverage of All Aspects of Entity:**

- Adequate organization of the audit to cover all relevant aspects of the entity related to the audited financial statements.

##### **(2) Reliability and Sufficiency of Financial Information:**

- Auditor's satisfaction that information in accounting records and source data is reliable and sufficient.
- Assessment through the study of accounting systems, internal controls, and appropriate tests, enquiries, and procedures.

##### **(3) Proper Disclosure of Financial Information:**

- Determination of whether relevant information is appropriately disclosed in financial statements.
- Compliance with applicable statutory requirements.

- Evaluation of judgments made by management, such as accounting policies (e.g., depreciation methods, inventory valuation).
- (4) **Evaluation of Accounting Policies:**
- Assessment of management's selection and consistent application of accounting policies. (**Remember:** We are questioning the policies selected, if auditor feels they are not suitable)
  - Ensuring **proper application** of chosen policies on a period-to-period basis. (Consistency)
- (5) **Understanding Historical Financial Information:**
- Financial statements based on historical financial information.
  - **Definition:** Information expressed in financial terms, derived from an entity's accounting system, about past economic events, conditions, or circumstances.
  - Examples include transactions like purchases and sales, reflecting past occurrences.

### Q 16: What are EXCLUDED from "the Scope of Audit"?

Audit is performed by a qualified Chartered Accountant. A CA is considered as Expert in the field of Accounting and Auditing.

(1) **Domain of Competence:**

Auditor not expected to perform duties outside their competence. Examples: Determining physical condition of sophisticated machinery or assessing suitability and life of civil structures (e.g., buildings). Specialized tasks require the expertise of qualified professionals like engineers.

(2) **Authentication of Documents:**

Auditor is not an expert in document authentication like we believe that the documents given by the client are real but not fake and we are not experts in deciding the authenticity of those documents.

(3) **Audit is not equal to Investigation:**

Not an official investigation into alleged wrongdoing. Lacks specific legal powers for actions like search or recording statements of witnesses on oath.

(4) **Investigation Characteristics:**

Critical examination of accounts for a specific purpose (e.g., suspected fraud). Takes on the character of an investigation when fraud is suspected.

#### Concept Capsule 3

Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

**Suggested answer**

An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.

#### Concept Capsule 4

Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean.

During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

**Suggested answer**

Proper disclosure of financial information is well within scope of audit.

**Concept Capsule 5**

A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?

**Suggested answer**

Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

**Q 17: What are the "Qualities of an Ideal Auditor"?****Answer**

These may be broadly classified into Professional/Technical Qualities and Personal Qualities.

**1. Professional/Technical Qualities**

- (a) He must be a CA in practice, i.e., he must be member of ICAI and he must hold a certificate of practice in India;
- (b) He must possess an exhaustive knowledge of accounting; He must have thorough understanding of all accounting principles and techniques;
- (c) He should possess thorough and in-depth knowledge of Auditing and Taxation laws;
- (d) He must have adequate knowledge of corporate laws and Mercantile laws – he must be going through many agreements in the profession;
- (e) He must have a reasonable knowledge of the concepts of financial management, Management accounting, Computers & systems, Economics;
- (f) He must have knowledge of the client's business;

**2. Personal Qualities:**

Auditor should have

- (a) Enquiring mind and analytical approach in his work, i.e., Professional skepticism;
- (b) Integrity (Honesty);
- (c) Good communication skills, both written and oral;
- (d) Be tactful (diplomatic) and practical in approach in dealings;
- (e) independence and must not compromise his independence for any material or social gain;
- (f) He should be clear and unambiguous in his reporting;
- (g) Confidentiality – i.e., he should not disclose the secrets/ details of his clients which are acquired during the course of audit unless it is required by the law & with the permission of the client;

**Asked in RTP**

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had summed up the overall view of what an auditor should be as regards the personal qualities. Explain stating also the qualities of Auditor. (RTP-May-2019)

**Q 18: Types of Audit****(1) Audit required under law:**

The organisations which require audit under law are the following:

Companies governed by the Companies Act; Banking companies; other statutory bodies required by their regulators or by specific Act.

**(2) Voluntary category**

Accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is **no basic legal requirement of audit**. Many of such enterprises as a matter of internal

rules require audit. Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc.

### Q 19: Who appoints the Auditor?

Generally, an auditor is appointed by owners or in some cases by constitutional or Government authorities in accordance with applicable laws and regulations.

In case of	Appointed by
Companies (Statutory Auditor)	Annual General Meeting (AGM) i.e. by Members
Government Companies	Comptroller and Auditor General of India (CAG), an independent constitutional authority
Firm	Partners of the Firm

There may be a situation in which auditor may be appointed by a Government authority in accordance with some law or regulation. For example, an auditor may be appointed under tax laws by a Government authority.

### Q 20: To whom the audit report is submitted?

Normally, the audit report is submitted to the authority who has appointed the auditor. In some cases, it may be different as agreed by the appointed authority.

### Q 21: What are the responsibilities of the Management?

(Remember these points – will be repeated number of places)

Answer

As discussed above, preparation and presentation of financial statements is the responsibility of the Management of the entity and it will be **supervised (oversight)** by TCWG.

**Remember:** Audit of financial statements does not relieve the management from their responsibilities;

Responsibilities of Management include:

- Preparation and presentation of financial statements; (*already discussed above*)
- Maintenance of **adequate accounting records**;
- Establishment of **good internal control systems** and ensuring its effectiveness throughout the period;
- Compliance of laws and regulations**;
- Selection and application of appropriate accounting policies;
- Safeguarding** of the assets of the enterprise; and
- Prevention and detection of frauds and errors.**

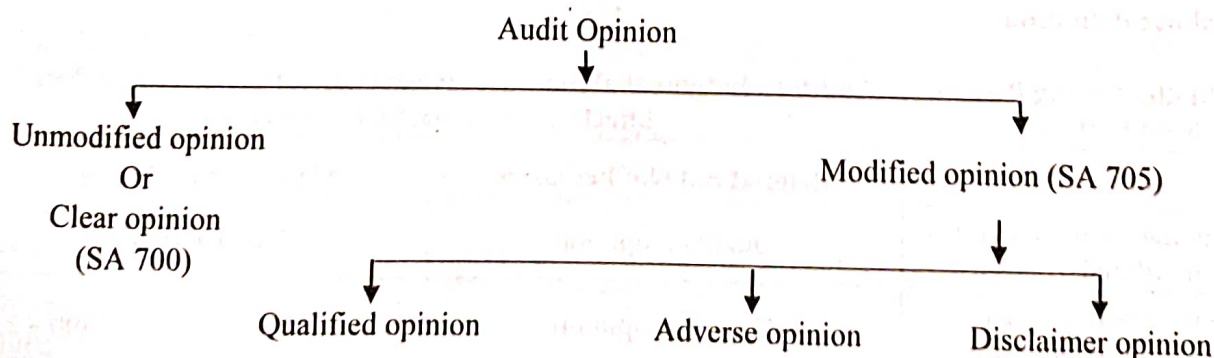
### Q 22: What are the types of Audit Reports?

(We will have a detailed discussion on this topic in SA 700, SA 705, etc. this is for basic understanding)

Answer

Audit opinions are broadly of two types, i.e., Unmodified and Modified. Modified opinion is further classified into three, i.e., Qualified, Adverse and Disclaimer.

Auditor may form and express ANY ONE of the following opinions in his report:



**(1) Unmodified opinion**

Where an auditor gives an opinion on the various matters **without any reservations / qualifications / material misstatements**, it is termed as an unqualified opinion. It means, financial statements give true and fair view in all material respects, comply with financial reporting framework and free from material misstatements either from fraud or errors.

These words will be presented in the unmodified opinion:

*"in our opinion and the best of our information and according to the explanations given to us, the Balance Sheet and the Statement of Profit and Loss give a true and fair view of the state of affairs and working results".*

**(2) Modified Opinion****(a) Qualified opinion**

All items in the financial statements are fine **except one or few misstatements** which are material which **cannot be ignored**. It means auditor feels that "he should bring these items to the attention of the stakeholders"

BUT remember, the effect of these items is **NOT pervasive** (i.e., Not effecting the financial statements as a whole, i.e., confined to a specific area)). In simple words, **misstatements are material but not pervasive**.

For example, the wordings in the audit report would be

*"Subject to the qualifications, we report that the Balance Sheet shows a true and fair view".*

**(b) Adverse (or negative) Opinion**

The auditor shall express an adverse opinion when the auditor

- Has **OBTAINED sufficient appropriate audit evidence** regarding misstatement; and
- Concludes that misstatements, individually or in the aggregate, are **BOTH MATERIAL AND PERVASIVE** to the financial statements. Consider below examples
  - o Going concern assumption does not hold good with the entity but it is valuing assets at historical cost instead of at Net realisable value;
  - o The entity did not consolidate one of its subsidiaries as per AS-21;

In these two cases, the misstatement is not confined to one area of financial statements – hence qualification is not sufficient. It is pervasive that means it effects the financial statements as a whole.

Indirectly, the **financial statements as a whole are not reliable and doesn't provide true and fair view;**

**(c) Disclaimer of opinion**

The auditor shall disclaim an opinion when the auditor is

- **UNABLE TO OBTAIN** sufficient appropriate audit evidence based on which he should be able to express the opinion; and
- Concluded that the possible effects of such undetected misstatements, could be **BOTH MATERIAL AND PERVASIVE** on the financial statement.

An example of wording of a disclaimer of opinion:

*"We have been unable to verify the existence and value of the fixed assets of the company. Hence, we are unable to state whether the Balance Sheet shows a true and fair view".*

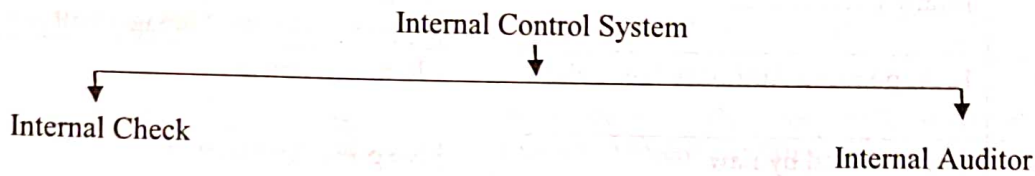
**Read the above definitions twice – required throughout your audit life**

**Summary of above definitions**

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

**Q 23: What is Internal Control System (ICS)? And Explain****Answer**

- ⇒ As you learnt as part of "Management responsibilities" – ICS refers to Internal rules and procedures established by the management for smooth running of the business.
  - ⇒ Management establishes ICS and monitors the same frequently.
  - ⇒ Through a strong ICS – it can avoid errors and frauds that otherwise take place in the company;
- For understanding purpose, we can classify ICS into two parts, i.e., Internal check and Internal auditor.



**Internal Check:** (This is discussed in detail later in SAs)

"Work of checking day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud".

Thus, internal check covers two things:

- (a) Work of one person is checked automatically by another person; and
- (b) No single person is allowed to carry out transaction from origin to its end.

Internal check is a part of the **overall internal control system** and operates as a **built-in device** as far as the staff organisation and job allocation aspects of the control system are concerned.

Simple example to understand:

If you go to a bank for taking a Demand draft – observe there. One person collects money and filled form. Another person ensures that money is received and gets the approval of senior online. Later DD is printed and takes to higher official signature. Now, you will receive the DD after signing on a book.

In the above case, each step of one person is verified by another person.

**Internal auditor**

- ✓ Monitoring of the ICS is the duty of the management.
- ✓ Management takes the help by appointing an Internal auditor.
- ✓ Internal auditor is a professional (he need not be a Qualified Chartered accountant) who visits offices and checks almost 100% of transactions.
- ✓ Internal auditor's scope & remuneration is determined by the management. Scope can be reduced or increased based on understanding. But in case of statutory auditor, Scope of audit is determined by the law and management cannot reduce this scope but they can increase if it is permitted by the law;

**Q 24: What are the differences between statutory auditor and Internal auditor?****Answer**

On the basis of function, auditors can be classified into two categories, external auditors and internal auditors

	External/Statutory Auditor	Internal Auditor
<b>Appointment</b>	Appointed by owners of the organization	Appointed by Management, Generally Directors
<b>Scope</b>	Determined by the statute, Official Pronouncements of ICAI and Engagement Letter (appointment letter)	Determined by the management
<b>Qualification</b>	A Qualified Chartered Accountant in practice / Chartered Accountant's firm.	Internal auditor need not be a Qualified Chartered Accountant.