(LI–9, LI-11, LI-12, LI-14 & LI-15)

DATE: 05.04.2017 **MAXIMUM MARKS: 100** **TIMING: 3 Hours**

AUDITING

Q. No. 1 is compulsory.
Wherever necessary suitable assumptions should be made by the candidates.
Working notes should form part of the answer.
Candidates are also required to answer any five questions from the remaining six questions.

Answer 1:

(a) Factors that may affect the Identification of an Appropriate Benchmark in Determining Materiality: As per SA 320 "Materiality in Planning and Performing an Audit", determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following- **½M**

(i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses); **1M**

(ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets); **1M**

(iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates; **1M**

(iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and **1M**

(v) The relative volatility of the benchmark. **½M**

(b) Assertions used by Auditor to Consider Potential Misstatements about Account Balances at the Period End: According to SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the assertions used by the auditor to consider the different types of potential misstatements that may occur about account balances at the period end are- **1M**

(i) Existence—assets, liabilities, and equity interests exist. **1M**

(ii) Rights and obligations—the entity holds or controls the rights to assets and liabilities are the obligations of the entity. **1M**

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded. **1M**

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded. **1M**

(c) New Audit Engagement Letter: As per SA 210, "Agreeing the Terms of Audit Engagements", on recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. **1M**

It is not necessary to issue audit engagement letter each year for repetitive audit. It is enough if the same had been issued at the time of taking initial engagement. Therefore, Mr. P is right in his approach. **1M**

However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.
(ii) Any revised or special terms of the audit engagement.
(iii) A recent change of senior management.
(iv) A significant change in ownership.
(v) A significant change in nature or size of the entity's business.
(vi) A change in legal or regulatory requirements.
(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
(viii) A change in other reporting requirements.

(½ Mark for each valid point content wise)

(d) Aspects to be covered in Audit: The principal aspects to be covered in an audit concerning financial statement of account are the following-

(i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account. **1M**
(ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
(iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
(iv) Verification of the authenticity and validity of transactions entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
(v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
(vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
(vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
(viii) Verification of the liabilities stated in the balance sheet.
(ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
(x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
(xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organization.

(½ Mark for each valid point content wise)

Answer 2: (8×2 = 16 Marks)

(i) **Incorrect:** As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if his relative is holding any security of or interest in the company of face value exceeding Rs. 1 lakh.

Therefore, AB & Co. shall be disqualified for being appointed as an auditor of XYZ Ltd. as Mr. C, the relative of Mr. B who is a partner in AB & Co., is holding securities in XYZ Ltd. having face value of Rs. 2 lakh.

(ii) **Incorrect:** Working papers are the property of the auditor and he is entitled to retain them. He may, at his discretion, make portions of or extracts from his working papers available to clients.

(iii) **Incorrect:** The provisions of Companies Act, 2013 grant rights to the auditor to access books of account and vouchers of the company. He is also entitled to require information and explanations from the company. Therefore, he has a statutory right to inspect the minute book.

(iv) **Incorrect:** If an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

(v) **Incorrect:** According to section 139 of the Companies Act, 2013, the provisions related to rotation of auditor are applicable to all private limited companies having paid up share capital of Rs. 20 crore or more; and all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of Rs. 50 crore or more.

Although company A is a private limited company yet it is having public borrowings from nationalized bank of Rs. 50 crores, therefore it would be governed by provisions of rotation of auditor.

(vi) **Incorrect:** The auditor should study the Memorandum of Association to check the objective of the company to be carried on, amount of authorized share capital etc. and Articles of Association to check the internal rules, regulations and ensuring the validity of transactions relating to accounts of the company.

To see the validity of appointment, the auditor should ensure the compliance of the provisions of section 139, 140 and 141 of the Companies Act, 2013.

Alternative reasoning: The auditor should study the appointment letter & the prescribed form submitted to the Registrar of the Companies to see the validity of his appointment.

(vii) **Incorrect:** Teeming and Lading is one of the techniques of suppressing cash receipts and not of inflating cash payments. Money received from one customer is misappropriated and the account is adjusted with the subsequent receipt from another customer and so on.

(viii) **Incorrect:** As per section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a government company, shall be appointed by the Board of directors within 30 days from the date of registration of the company.

Therefore, the appointment of first auditor made by the managing director of A Ltd. is in violation of the provisions of the Companies Act, 2013.

(1 Mark for True/False & 1 Mark for reason)

(ix) Incorrect: As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if he is holding any security of or interest in the company.
As the chartered accountant is holding securities of S Ltd. having face value of Rs. 950, he is not eligible for appointment as an auditor of S Ltd.

(x) Incorrect: A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.
It may be noted that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.
Thus, Mr. N is disqualified to be appointed as an auditor of Indian Companies.

Answer 3:

(a) Refund of General Insurance Premium Paid: The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds-

(i) Ascertain the reasons for refund of insurance premium.
(ii) Examine insurance policy or cover note to find out the amount of premium.
(iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.
(iv) Scrutinise correspondence between the insurance company and the client.
(v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

(1 Mark for each Exact/specific point ¼ Mark for general point, No marks for irrelevant point)

(b) Payment of Taxes:

(i) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
(ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
(iii) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.
(iv) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
(v) The assessee can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made.
(vi) It is not necessary for the assessee to make payment of taxes from his own account in an authorized bank. While vouching such E-Payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No./TAN No. etc.

(1 Mark for each Exact/specific point ¼ Mark for general point, No marks for irrelevant point)

(c) Sale Proceeds of Junk Material:

(i) Review the internal control on junk materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.

(ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk materials.

(iii) Review the production and cost records for the determination of the extent of junk materials that may arise in a given period.

(iv) Compare the income from the sale of junk materials with the corresponding figures of the preceding three years.

(v) Check the rates at which different types of junk materials have been sold and compare the same with the rates that prevailed in the preceding year.

(vi) See that all junk materials sold have been billed and check the calculations on the invoices.

(vii) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.

(viii) Make an overall assessment of the value of the realisation from the sale of junk materials as to its reasonableness. Ensure that proper accounting has been done for it.

(1 Mark for each Exact/specific point ¼ Mark for general point, No marks for irrelevant point)

(d) Intangible Assets: The auditor should verify the following points in this regard-

(i) An intangible asset should be measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.

(ii) If an item covered does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

(iii) Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a license or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

(iv) In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant.

(v) As per AS-26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

(vi) Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

(1 Mark for each Exact/specific point ¼ Mark for general point, No marks for irrelevant point)

Answer 4:

(a) Points/Areas in which all the Joint Auditors are Jointly and Severally Responsible: As per SA 299 "Responsibility of Joint Auditors", in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the **1M**

work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(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.
(v) for ensuring that the audit report complies with the requirements of the relevant statute. **(½ Marks each)**
(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. **1M**
(vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors. **½M**
(viii) each joint auditor is entitled to assume 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. **1M**

(b) Audit Evidence: According to <u>SA 500 "Audit Evidence"</u>, audit procedures to gather more audit evidence would include - **½M**

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. **1M**

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 personnel, or of the performance of control activities. **½M**

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. **1M**

Recalculation: Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically. **½M**

Re-performance: Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control. **½M**

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. **1M**

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. **1M**

(c) Recognition Principles of Contingent Liability:

An enterprise should not recognize the contingent liability but it should be disclosed in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. **½M**

In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the obligation that is expected to be met by other parties is treated as contingent liability. **½M**

Contingent liabilities are continuously assessed and if it becomes probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognized. **½M**

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. **½M**

An enterprise should disclose for each class of contingent liability at the balance sheet date:

- A brief description of the nature of the contingent liability, where practicable.
- An estimate of the amount as per measurement principle.
- Indication of the uncertainty relating to outflow.
- The possibility of any reimbursement.

1½M

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated. **½M**

Answer 5:

(a) Removal of Auditor Before Expiry of Term: According to section 140 of the Companies Act, 2013, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Companies (Audit and Auditors) Rules, 2014 - **2M**

(i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with prescribed fees. **1M**

(ii) The application shall be made to the Central Government within thirty days of the resolution passed by the Board. **1M**

(iii) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution. **1M**

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard. **1M**

(b) Factors which decreases the Gross Profit: Factors which may be responsible for decrease in gross profit are-

(i) Over valuation of the opening inventory or undervaluation of closing inventory either due to mistakes made in taking inventory or in its valuation.

(ii) Alteration of the basis of valuation of inventory, e.g., closing inventory having been valued at cost, which is below the market price, when the opening inventory was valued at market price above cost.

(iii) Inclusion in the year of the amount of goods purchased in the previous year, that were received and taken in the same year.

(iv) Reversal of the fictitious sale entries recorded in the previous year to boost up profit.

(v) Entry of sales returns twice or failure to account for purchase returns when the goods in question have been sent back.

(vi) Excessive provisions have been made for wages or direct expenses.

(vii) Failure to include in closing inventory goods sent out for sale on approval or on a consignment basis.

(viii) Omission to adjust the value of unused inventory of consumables stores, such as fuel and packing material or inclusion in Trading Account expenses which should have been included in the Profit in the Loss Account.

(ix) Failure to take credit for the amount of an insurance claim in respect of a consignment of goods lost in transit or destroyed by fire.

(x) Failure to account for goods sold or destroyed or given away as samples.

(½ Mark for each valid point)

(c) Precautions to be taken to Avoid Disadvantages of a Continuous Audit: The disadvantages of a continuous audit can be avoided if the following precautions are taken -

(i) During the course of each visit, work should be completed upto a definite stage so as to avoid loose ends.

(ii) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.

(iii) The visits should be at irregular intervals of time so that the client's staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.

(iv) The nominal accounts should be checked only at the time of final closing.

(v) The client's staff should be instructed not to alter or correct audited figures. The auditor should also device a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client's staff.

(½ Mark for each valid point)

Answer 6:

(a) Form, Contents and Extent of Audit Documentation: Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. **½M**

According to SA 230 "Audit Documentation", the form, content and extent of working papers depend on factors such as:

(i) The size and complexity of the entity.

(ii) The nature of the audit procedures to be performed.

(iii) The identified risks of material misstatement.

(½ Mark each)

(iv) The significance of the audit evidence obtained.
(v) The nature and extent of exceptions identified.
(vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
(vii) The audit methodology and tools used.

(½ Mark each)

(b) Tests of Control: Tests of control are performed to obtain audit evidence about the effectiveness of the -
(i) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
(ii) operation of the internal controls throughout the period.
Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk. **1M**

Tests of control may include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised. **1M**
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it. **1M**
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity. **1M**
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls. **1M**

(c) Engagement Standards: The following standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards-
(i) Standards on Auditing (SAs), to be applied in the audit of historical financial information.
(ii) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.
(iii) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.
(iv) Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

(1 Mark for each)

(d) Factors to be considered for Determining Materiality:
(i) Item of materiality may be determined individually or in aggregate.
(ii) The materiality depends on the regulatory or legal considerations.
(iii) Materiality is not often reckoned with respect to quantitative details only. It has qualitative dimensions as well.

(½ Mark for each)

(iv) Even insignificant items in terms of quality may be material in special circumstances.
(v) Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule III requires disclosure of items of expenditures which are in excess of one percent of the revenue from operations or Rs. 1,00,000, whichever is higher.
(vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

(½ Mark for each)

Answer 7 :

(a) Remuneration Paid to Directors: The following points must be considered regarding the directors' remuneration in case of a public company–

(i) **Examine the Entitlement:** The directors are not automatically entitled to remuneration. It is paid either according to the terms of articles of association or in accordance with a resolution of the general meeting.

(1½ Marks)

(ii) **Examine Adherence to Legal Provisions:** The auditor should examine adherence to relevant sections of the Act such as –
(1) Section which deals with manner of payment of managerial remuneration.
(2) Section which deals with payment of sitting fees.
(3) Section which has prescribed the overall limit to managerial remuneration.
(4) Schedule V to the Act that has laid down conditions for payment of remuneration for companies having no profits or inadequate profits and companies having negative effective capital.
(5) Proviso to section which provides for increase in remuneration with the approval of the Central Government.

(½ Mark each)

(b) Payment for Acquisition of Assets: The following points must be considered regarding payment for acquisition of assets–

(i) The purchase of an asset must be duly supported by the receipt for the amount paid.
(ii) In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore essential for an auditor to see that property has been registered in the purchaser's name as required by the relevant regulations and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.
(iii) In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards existence, value and title of the assets acquired.
(iv) It must also be verified that the assets were purchased only by a person who had the authority to do so. Companies Act, 2013 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset.
(v) If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired.

(½ Marks for each point + ½ Mark for any extra point)

(vi) In the case of an asset constructed or manufactured by the client himself, e.g., where a building has been constructed or a plant or machinery manufactured by the concern with its labour and materials, it must be verified that the cost of labour, materials and other direct expenses incurred has been charged as cost of the asset on a proper allocation of the total expenditure debited under these heads.

(vii) It must also be seen that neither expenses on repairs and maintenance have been capitalised nor the cost of additions to assets charged off as revenue expenses.

(c) Qualified Opinion: The auditor shall express a qualified opinion when -

(i) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or **2M**

(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive. **2M**

(d) Fraudulent Financial Reporting: Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. **1½M**

In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing. **½M**

Fraudulent financial reporting may be accomplished by the following:

(i) Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared. **½M**

(ii) Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information. **½M**

(iii) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure. **½M**

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. **½M**

(e) Surprise Checks: Surprise checks are a part of normal audit procedures. An element of surprise can significantly improve the audit effectiveness. Wherever practical, an element of surprise should be incorporated in the audit procedures. **1M**

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client's office for audit and selection of areas of audit. **1M**

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client's staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management's attention, so that corrective action can be taken at the earliest. Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit. **2M**

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