(LI–9, LI-11, LI-12, LI-14 & LI-15)

DATE: 17.02.2017 **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: (5 Marks Each)

(a) Appropriateness of Going Concern Assumption: As per SA 570 on "going concern", when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor's judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.
To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources. **(2 Marks)**

In the instant case, TT ltd. has suffered continuous losses and having negative net worth also. Besides, its production head have also left the company resulting in steep fall in production. Thus there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.
Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion. **(2½ Marks)**

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion. **(½ Mark)**

(b) Disclosure of Related Party Transaction: As per definition given in the AS 18 "Related Party Disclosure" parties are considered to be related if at any time during the reporting period neo party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. **(1 Mark)**

Strong Ltd. is the holding company of Weak Ltd. as it holds more than 50% of the voting power of Weak Ltd. and thus should be treated as related parties as per AS - 18. **(1 Mark)**

According to AS-18, in the case of related party transactions, following facts should be disclosed:

(i) Related party relationship, name and nature of relationship.
(ii) If there is transaction between the related parties then descriptions of the nature of transaction, volume of the transaction outstanding at the Balance Sheet date etc.

(1 M)

Further, as per Section 188 of the Companies Act, 2013 also prescribes to take the permission of the Board of Directors by resolution at board meeting for such related party transactions.

(1 M)

In the instant case since there is related party transaction the contention of Managing Director of Strong Ltd. is not correct. The auditor is required to verify the compliance of section 188 of the Companies Act and insist to make proper disclosure as required by -18AS and if the management refuses, the auditor as per SA 550 "Related Parties", should express a qualified opinion. The auditor is also required to report under Clause (xiii) of Para 3 of CARO, 2016.

(1 Mark)

(c) Disclosure Requirements for Bank Balance: As per Part I of Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head "Cash and Cash Equivalents" in Current Assets as:
(i) Balances with Banks.
(ii) Earmarked balances with banks (for example, for unpaid dividend).
(iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.

(2 Marks)

The extract of the Schedule III, under Companies Act, 2013 regarding disclosure requirements is given below:

[General Instructions for Current Assets under Schedule III to the Companies Act, 2013]:
• Cash and cash equivalents: 1. Cash and cash equivalents shall be classified as: (a) Balances with banks; (b) Cheques, drafts on hand; (c) Cash on hand; (d) Others (specify nature). 2. Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated; 3. Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately; 4. Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated; 5. Bank deposits with more than 12 months maturity shall be disclosed separately.

(3 Marks)

(d) Non-provision of Trade Receivables on Account of Insolvency: According to AS 4, "Contingencies and Events Occurring after the Balance Sheet Date", any significant event occurring after the date Balance Sheet date but before the date of approval of financial statements by the Board requires adjustments to assets/liabilities as on the date of Balance Sheet in case additional evidence is available in respect of conditions existed on the date of the Balance Sheet. **(2 Marks)**

In this case, the trade receivables' balance has to be suitably adjusted since conditions existed on the date of the Balance Sheet in respect of which additional evidence has been provided by the insolvency of M/s Unreliable Traders. **(2 Marks)**

Thus, the auditor must ascertain that requirements of AS 4 have been followed. In case of non-observance of the same, the auditor should qualify the report. **(1 M)**

Answer 2: (2 Marks Each)

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

(i) **Incorrect:** The company shall place the matter relating to appointment of auditors for ratification by members at every AGM.

(ii) **Incorrect:** Before appointing an auditor, the written consent of the auditor to such appointment and a certificate from him that appointment shall be in accordance with the conditions as may be prescribed shall be obtained from the auditor.

(iii) **Incorrect:** Letter of weakness is a report issued by the auditor stating the weakness in the internal control mechanism. It also suggests measures by which the weakness in the system to be corrected and the control system be made better protected.

(iv) **Incorrect:** As per Section 143(1) of the Companies Act, 2013, every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company kept not only at the registered office of the company but also at any other place too.

(v) **Correct:** For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Scrutiny of Bank Reconciliation statement is one of the audit techniques commonly adopted by the auditors.

(vi) **Incorrect:** According to Section 142 of the Companies Act, 2013, the remuneration of subsequent auditors of a company shall be fixed in its general meeting or in such manner as may be determined therein.

(vii) **Correct:** As per Section 129(2) of the Companies Act, 2013, at every annual general meeting of a company, it shall be the duty of the Board of Directors of the company to lay before the company the financial statements for the financial year.

(viii) **Incorrect:** Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

(ix) **Incorrect:** Standards on Review Engagements (SREs*)* - to be applied in the review of historical financial information.

(x) **Incorrect:** Narrative Record is a complete and exhaustive description of the system as found in operation by the auditor. On the other hand, a Check List is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.

Answer 3:

(a) Government Expenditure Audit: Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds organization by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

(i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority. **(1½ M)**

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, organization such expenditure. **(1½ M)**

(iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made. **(1½ M)**

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, orin fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. **(1½ M)**

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organization, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness. **(2 M)**

(8 Marks)

(b)Special Steps Involved in Audit of a Cinema Hall: **(1 Mark for each valid point)**

(i) Verify-

(a) that entrance to the cinema hall is only through printed tickets;

(b) tickets are serially numbered and bound into books;

(c) that the number of tickets issues for each show and class are different;

(d) that for advance booking a separate series of tickets is issued and

(e) inventory of tickets is kept in proper custody.

(ii) If tickets are issued through computer- audit the system to ensure its reliability and authenticity of data generated by it.

(iii) System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.

(iv) Cash collected is deposited in banks partly on the same day and rest on the next day– depending upon the banking facility available.

(v) Verify that proper record is kept for free passes issued and the same are issued under proper authority.

(vi) Cross check the entertainment tax deposited.

(vii) Verify the income from advertisements and slides showed before the show.

(viii) Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.

(ix) Vouch recoveries of advertisement expenses etc from film distributors.

(x) Vouch payment of film hire with reference to agreement with distributor or producer.

(xi) Verify the basis of other incomes earned like restaurant, car and scooter parking and display windows etc.

(xii) Confirm that depreciation on machinery and furniture has been charged appropriate rates which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

(1 Mark for each valid point)

(8 Marks)

Answer 4:

(a) Power of Company to Buy Back its Own Securities: The Companies Act, 2013 under section 68(1) permits companies to buy back their own shares and other specified securities out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of the issue of any shares or other specified securities.

It may be noted that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

(1 Mark)

The other important provisions relating to the buyback are-

(i) Section 68(2) further states that no company shall purchase its own shares or other specified securities unless-

(a) the buy-back is authorised by its articles;

(b) a special resolution has been passed in general meeting of the company authorising the buy-back;

However, the above provisions do not apply where the buy back is 10% or less of the paid up equity capital + free reserves AND is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy back is upto 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of a special resolution of its members being passed at a general meeting of the company.

(1 Mark for each valid point)

(c) the buy-back is equal or less than 25% of the total paid-up capital and free reserves of the company:
It may be noted that in respect of the buy-back of equity shares in any financial year, the reference to 25% shall be construed with respect to its total paid up-equity capital in that financial year.

(d) the ratio of the debt owed by the company (both secured and unsecured) after such buy - back is not more than twice the total of its paid up capital and its free reserves:

However, the Central Government may prescribe a higher ratio of the debt to capital and free reserves than that specified under this clause for a class or classes of companies.

(e) all the shares or other specified securities for buy-back are fully paid-up;

(f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

(g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

It may be noted that no offer of buy back under this sub section shall be made within a period of 1 year reckoned from the date of closure of a previous offer of buy back if any. This means that there cannot be more than one buy back in one year.

(ii) Every buy-back shall be completed within 1 year from the date of passing the special resolution, or the resolution passed by the board of directors where the buy back is upto 10% of the paid up equity capital + free reserves.

(iii) The buy-back may be—
(a) from the existing shareholders or security holders on a proportionate basis; or
(b) from the open market; or
(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(iv) Where a company has passed a special resolution under clause b)(of Sub-section (2) or a resolution under item (ii) of the proviso thereto, buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any .
However, no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(v) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within 7 days of the last date of completion of buy-back.

(1 Mark for each valid point)

(vi) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of new shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of 6 months except by way of bonus issue or in the charged is of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.

(vii) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company shall be punishable with fine which shall not be less than Rs. 1 Lakh but which may extend to Rs. 3 lakh and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 3 years or with fine of not less than Rs. 1 lakh but which may extend to Rs. 3 lakh, or with both.

(viii) Section 69(1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.

(ix) The Capital Redemption Reserve Account may be applied by the company paying up unissued shares of the company to be issued to the members of the company as fully paid bonus shares.

(x) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

(xi) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within 30 days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(1 Mark for each valid point)

(8 Marks)

(b)

(i) Modification of Opinion: The auditor shall modify the opinion in the auditor's report when-

(a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(2 Marks)

(ii) Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements. **(2 Marks)**

(iii) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements. **(2 Marks)**

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

(a) 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

(b) 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. **(2 Marks)**

(8 Marks)

Answer 5: (4 Marks Each)

(a) Types of Companies Covered Under CARO, 2016: The Companies (Auditor's Report) Order, 2016 is an additional reporting requirement Order which has been issued by the Central Government in consultation with the Institute of Chartered Accountants of India under section 143(11) of the Companies Act, 2013. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013. **(½ Mark)**

However, the Order specifically exempts the following class of companies-

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;

(ii) an insurance company as defined under the Insurance Act, 1938; **(1 Mark)**

(iii) a company licensed to operate under section 8 of the Companies Act;
(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;
(v) a small company as defined under clause (85) of section 2 of the Companies Act; and **(1½ Marks)**
(vi) a private limited company with a paid up capital and reserves not more than Rs. 50 lakh an which does not have loan outstanding exceeding Rs.25 lakh from any bank of financial institution and does not have a turnover exceeding Rs. 5 crore at any point of time during the financial year. **(1 Mark)**

(b) Formation of Audit Committee: As per section 177 of the Companies Act, 2013 read with the Companies (Meeting of Board and its Powers) Rules, 2014, audit committee is to be formed by every listed companies and following classes of companies: **(½ Mark)**

(i) all public companies with a paid up capital of ten crore rupees or more,
(ii) all public companies having turnover of one hundred crore rupees or more,
(iii) all public companies having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more. **(3 Marks)**

Further, the auditor shall have the right to be heard in the meetings of the Audit Committee when it considers the Auditor's Report but shall not have the right to vote. **(½ M)**

(c) Indebtness to the Company: According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding Rs. 5,00,000 shall be disqualified to act as an auditor of such company and he should vacate his office of auditor when he incurs this disqualification subsequent to his appointment.
However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment. **(2 Marks)**

In the given case, Mr. Y was appointment as an auditor of PQR Ltd. for the year ended 31.03.2016 at the Annual General Meeting held on 16.08.2015. He repaid the loan amount fully to the company on 10.8.2015 i.e. before the date of his appointment.
Hence, the appointment of Mr. Y as an auditor is valid and the shareholder's complaint is not acceptable. **(2 Marks)**

(d) Responsibility of Joint Auditor: The principles governing to responsibilities of joint auditor are prescribed in SA 299, "Responsibility of Joint Auditor". As per SA 299, if joint auditors are appointed, they should divide the audit work among themselves by mutual discussion. The division of work would usually be in terms of audit of identifiable units or specified areas. Such division of work should be adequately documented and preferably communicated to the entity. **(1 Mark)**

It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issue such as appropriateness of using test checks, sampling or other audit techniques should be decided by each joint auditor individually in relation to his work. Thus, the responsibility will not be shared by the other auditor. Therefore, 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. **(1 Mark)**

Hence, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. However, all the joint auditors are jointly and severally responsible in respect of the audit work which is not divided among the joint auditors and is carried out by all of them, 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, 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, for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute and for ensuring that the audit report complies with the requirements of the relevant statute. **(2 Marks)**

Answer 6: (4 Marks Each)

(a) Trade Payables:

(i) Check the adequacy of cut off procedure to ensure that transaction of next period are not accounted and all transactions of year end are accounted.
(ii) Check posting in the bought ledger from books of prime entry.
(iii) Compare the balances in the schedule of trade payables with balances in bought ledger.
(iv) Compare the balances with the confirmation or statement of account received from trade payables.
(v) Pay special attention to long outstanding items and enquire about the reason thereof.
(vi) Verify subsequent payments and reversal entries in the bought ledger of year end entries.
(vii) See that trade payables are classified and shown in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.

(1 Mark for each valid point)

(b) Advances to Suppliers:

(i) Examine the bought ledgers to ascertain the debit balance of trade payables and trace the corresponding entry to the cash/bank book.
(ii) Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.
(iii) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.
(iv) Obtain/resort to direct confirmation procedure.
(v) Ensure proper classification in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.
(vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

(1 Mark for each valid point)

(c) Consignment Sales:

Ascertain that credit has been taken only for the profit on the goods sold through the consignee before the year end. No profit should be taken for the profit on goods remaining in the hands of the consignee.

Verify credits in the Consignment Account with the help of the Account Sales received from the consignee. The gross sale proceeds should be credited to the Consignment Account and debited to the consignee's account.

Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the Consignment Account and credited to the Consignee's A/c. The Account Sales also must be correspondingly checked.

Ensure that the inventory lying with the consignee at the end should be taken in the balance sheet at cost on a consistent basis and credited to the Consignment A/c to arrive at the result of the consignment transactions.

Obtain confirmation of the balance in the account of the consignee from the consignee.

Sometimes, the goods are consigned not at cost but at an inflated price. The auditor should see that the necessary adjustments to remove the loading are made at the end of the year.

Ensure that the goods consigned are not treated as ordinary sales. In cases it is so, the auditor should see that necessary adjustments are made at the year-end in respect of the unsold goods, commission and the expense incurred by consignee. The consignee should not be shown as a trade receivable for unsold goods and in valuation of inventory, these goods should be included in inventory at cost worked out on a consistent basis.

(1 Mark for each valid point)

(d) Royalties Received:

(i) Verify the relevant contract and ascertain the provisions relating to the conditions of royalty such as rate, mode of calculation and due date.

(ii) Check the periodical statement received in respect of books printed, sold and inventory lying at different locations.

(iii) Check the computation in the royalty statement and ensure that any deduction or adjustment made from the royalty due is as per agreement conditions.

(iv) Verify the provisions for the royalty to be received as at the end of the year.

(1 Mark for each valid point)

Answer 7: (4 Marks Each)

(a) Factors to be Considered While Designing Confirmation Request:

As per SA-505 "External Confirmations", the design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses. The following factors should be considered while designing a confirmation request:-

(½ Mark)

(i) The assertions being addressed.

(ii) Specific identified risks of material misstatement, including fraud risks.

(iii) The layout and presentation of the confirmation request.

(iv) Prior experience on the audit or similar engagements.

(v) The method of communication.

(vi) Management's authorisation to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.

(vii) The ability of the confirming party to provide the requested information.

(½ Mark each)

(b) Knowledge of Client's Business: An auditor can obtain this information from-

(i) Clients annual report to shareholders;
(ii) Minutes of shareholders/board of directors;
(iii) Internal financial management reports of current & previous year;
(iv) Previous year audit working papers;
(v) Discussion with client;
(vi) Clients policy and procedure manual;
(vii) Publications like trade journals, magazines, news papers; and
(viii) Visit to client's premises.

(½ Mark each)

(c) Relationship between Materiality and Audit Risk:

SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement. **(1 Mark)**

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances. **(3 Marks)**

(d) Inherent Limitations of Audit:

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from-

(i) The Nature of Financial Reporting: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. **(1 Mark)**

(ii) The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:
(1) There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information thats irrelevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
(2) Fraud may involve sophisticated and carefully organised schemes designed to conceal it. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
(3) An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(1 Mark)

(iii) Timeliness of Financial Reporting and the Balance between Benefit and Cost: The relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(1 Mark)

(iv) Other Matters that Affect the Limitations of an Audit: In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:
- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

(1 Mark)

(e) Disclosure of Accounting Policies:

The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected the by accounting policies followed in the preparation and presentation of the financial statements.
The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by some cases.
The purpose of AS 1 is to promote better understanding of financial statements by establishing through an accounting standard and the disclosure of significant

(2 Marks)

accounting policies and the manner in which such accounting policies are disclosed in the financial statements.
Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.
To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

(1 Mark)

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes which form part of financial statements.
Any change in accounting policy, which has a material effect, should be disclosed. The amount by which any item is in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies, which has not material effect on the financial statements for the current period, which is reasonably expected to have material effect in latter periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

(1 Mark)

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