Roll No……..

Total No. of Questions – 7 www.pace2race.com

Time Allowed – 3 Hours Maximum Marks – 100

**Ans-PEE-Audit-1**

Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi medium, his/her answers in Hindi will not be valued.

**Question No.1 is compulsory**

Candidates are also required to answer any five questions from the remaining six questions.

**Marks**

**1 (a)** **Auditing versus Investigation:** As Per **SA 200** "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. **5**

Audit is generally objected to find out whether the accounts show true & fair view. It is a critical examination of books of accounts. Investigation on the other hand is critical examination of the accounts with a special purpose.

For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, e.g., the extent of waste and loss, profitability, cost of production etc. It extends scope beyond books of accounts. For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe. Fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor.

**(b)** Auditor checks specific assertions that the items of financial statements portray and also gives his opinion in the form of overall assertion in respect of financial statements taken as a whole. **5**

The specific assertions are –

**(a) Existence –** That the asset or liability exists at a given date.

**(b) Rights and obligations –** The asset is a right of the entity and the liability is an obligation of the entity at a given date.

**(c) Occurrence –** That a transaction or event has occurred which pertains to the entity

**(d) Completeness –** There are no unrecorded asset/liabilities or transactions

**(e) Valuation –** An asset or liability is recorded in the proper amount and recorded

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at appropriate carrying value.

**(f) Measurement –** A transaction is recorded in the proper amount and revenue or expenses is allocated to proper period.

**(g) Presentation –** An item is disclosed, classified and described in accordance with accounting policies and legal requirements.

The overall assertions opined by the auditor about the financial statements are:

**(a)** The profit and loss account give a true and fair view of the results – profit or loss for the period ended on the last date of the accounting period.

**(b)** The balance sheet gives a true and fair view of the status or financial position of the entity as on the last date of the accounting period.

**(c)** According to **AS 9** on **Revenue recognition**, revenue from sale of goods should be recognized when the seller has transferred to the buyer, the property in the goods for a price or when the seller has transferred all significant risk and rewards and the seller repairs no effective control over goods and no significant uncertainty exists regarding the amount of consideration and its collectibility. **5**

In the given case the goods as well as the risk and ownership has been transferred by Bhart Ltd., to Indian Automobile Ltd., on the basis of invoice and delivery of material.

In the instant case, therefore, Bhart Ltd., should recognise sale at full 100% of the invoice value in spite of the fact that 10% payment will be released after one year. However, depending upon the past experience regarding collectibility of 10% amount, they can make a provision for the amount that is not likely to be realised.

Hence, the treatment given by the company is not correct and if they do not correct it, the auditor should qualify his report.

**(d)** **Types of Companies under CARO, 2003:** CARO, 2003 applies to all companies including a foreign company as defined u/s 591 of the Companies Act, 1956. The Order specifically exempts banking companies, insurance companies and companies which have been licensed to operate under section 25 of the Act. The order also exempts from its application a private limited company which fulfils certain conditions. The CARO also contains definition of companies engaged in different kinds of activities, viz., manufacturing, mining, chit fund, etc. For instance, it defines manufacturing company as a company engaged in any manufacturing process as defined in the Factories Act, 1948; finance company as a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing; investment company as a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature, etc. **5**

(Note: As per the Amendments made by the Companies (Auditor's Report) (Amendment) Order, 2004 in the Companies (Auditor's Report) Order, 2003 the following companies engaged in different kinds of activities, viz., finance company,



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investment company, manufacturing company, mining company, processing company, service company and trading company (Clause ( c ) to ( i) of Paragraph 2 ) are omitted).

**2 (a)** According to the **SA 540**, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure" accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. SA 540 addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. **8**

Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

(i) Accounting estimates arising in entities that engage in business activities that are not complex.

(ii) Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

(i) Accounting estimates relating to the outcome of litigation.

(ii) Fair value accounting estimates for derivative financial instruments not publicly traded.

**Additional examples of accounting estimates are:**

(i) Allowance for doubtful accounts.



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(ii) Inventory obsolescence.
(iii) Warranty obligations.
(iv) Depreciation method or asset useful life.
(v) Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability
(vi) Outcome of long term contracts.
(vii) Financial Obligations / Costs arising from litigation settlements and judgments.

**(b)** **Rate of Gross Profit on Sales:** When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause decrease in the Gross Profit of the manufacturing company: **8**

(i) Undervaluation of closing stock or overvaluation of opening stock either due to wrong valuation of stock or mistake in stock taking .
(ii) Change in the basis of stock valuation. For example, opening stock was valued at market price above cost when closing stock valued at cost which is below the market price.
(iii) Inclusion in the current year, the amount of goods purchased in the previous year, that were received and taken in the same year.
(iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.
(v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.
(vi) Excess provision for wages or direct expenses have been made .
(vii) Goods sent out for sale on approval or on a consignment basis not included in closing stock.
(viii) Value of unusual stock of consumable stores (fuel and packing materials) are not shown as stock or not adjusted from corresponding expenses .
(ix) Expenses which should be charged in the in Profit and Loss Account but wrongly charged to the Trading Account.
(x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.
(xi) Goods sold or given as samples or destroyed, not accounted for.

**3 (a)** Focus points for doing propriety audits of government expenditure: The Propriety audit is to vet the expenditure in the annals of financial wisdom and uprightness. It is to check to bring out the improper, avoidable, or in fructuous expenditure even though such expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit in so far as the various formalities regarding rules and regulations are concerned but may still be highly wasteful. It is not audit of sanction or against norms. It is a qualitative, opinion-based expression of auditor's findings as regards the efficiency, effectiveness and economy dimensions of expenditure. **8**

In this regards, the following main points should be kept for consideration:

(1) The expenditure should not be prima facie more than what the occasion demands. Public money should be spent by the officers as of his own with utmost

diligence and care.

(2) No order for sanction of expenditure should be made by an authority which results in pecuniary gains directly or indirectly.

(3) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

(4) There should not be profiteering by the authority or anybody where the expenditure is in the nature of compensating.

(5) Wastages are avoided in expenditure. The cost of administering should not eat off the benefits of the expenditure.

(6) The expenditure should percolate down the beneficiary without corruption.

(7) The expenditure should bring out optimum, enduring benefits instead of mere frittering away the public money on meeting day to day needs repeatedly

**3 (b)** **Non-disclosure of interest of directors in records maintained by the company** **8**

A company is required to maintain a register under section 301 in terms of section 297 of the Companies Act, 1956. While auditing the company accounts, the CARO 2003 requires the auditor to verify such transactions.

It is quite likely that there may be situations where the company has not properly maintained the register required to be maintained by it under section 301. In such a case, the auditor should obtain the necessary information regarding the loans taken by the company from companies, firms or other parties in which the directors are interested, from the management of the company. However, while reporting on this clause, the auditor should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register.

If the interest of a director in a transaction, entered into by the company has not been disclosed in the record maintained by the company, as required by Section 301 of the Companies Act, 1956 the auditor would not be responsible for failure to track down the frauds, provided also that there did not exist any circumstances to arouse his suspicion that some information had been held back deliberately and had duly reported the violation of the legal requirements. So long as there is no such suspicion, he is only expected to exercise normal caution and care.

**4 (a)** **Computer Aided Audit Techniques (CAATs):** The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. Computer Aided Audit Techniques (CAATs) are such techniques applied through the computer which are used in the verifying the data being processed by it. System characteristics resulting from the Computerised Information System (CIS) Environment that demand the use of Computer Aided Audit Techniques (CAAT) are: **8**

**(i) Absence of input documents:** Data may be entered directly into the computer systems without supporting documents. In on-line transaction systems, written evidence of individual data entry authorization, e.g., credit limit approval may not be

available.

**(ii) Lack of visible transaction trail:** Certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In CIS environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.

**(iii) Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In CIS environment, the results of processing may not be printed or only a summary data may be printed. Thus, lack of visible output may result in the need to access data retained on machine readable files.

**(iv) Ease of Access to data and computer programmes:** Data and computer programmes may be altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and allocation of, data and programmes by persons inside or outside the entity.

**(v) Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for **example –**

**(1)** Some transactions may be tested more effectively for a similar level of cost by using the computer.

**(2)** In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.

**(vi) Savings in time:** The auditor can save time by reviewing the CIS controls using CAAT than through other audit procedures.

**(vii) Effective test checking and examination in depth:** CAAT permits effective examination in depth of selected transactions since the auditor constructs the lost audit trail.

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4 **(b)** **Cut-off arrangement:** Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as "cut-off arrangement". It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and stock are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and stock. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that: **4**

**(i)** Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.

**(ii)** Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of stock into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking for perfect and correct presentation in the financial statements.

**4** **(c)** **Depreciation and Fluctuation in Value:** Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. It directly affects the earning capacity of an asset. Hence, it is a charge against the profit of the year. Fluctuation, on the other hand, is a temporary shrinkage or decrease and increase in the value of an asset usually due to external causes such as rise and fall in market price of an asset. But the fluctuation does not affect the earning capacity or working life of an asset. Hence, it is not taken into account and no charge is made against the profit of the year. Depreciation is only in connection with fixed assets while fluctuation is usually in connection with current assets. Depreciation generally means fall in the value of fixed asset while fluctuation may mean either increase or decrease in the value of any asset, current as well as fixed. Depreciation has a significant effect determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets. **4**

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**5 (a)** Section 224(6) of the Companies Act, 1956 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr X has been validly appointed and thereafter he had resigned. **6**

Thus a casual vacancy had been created on account of resignation. The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the Board cannot fill in that vacancy. The company in a general meeting can only fill the same. Thus, in this case P2R Ltd will have to call an extra-ordinary general meeting (EGM) and appoint another auditor. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

The provisions of the Companies Act, 1956 applicable for the appointment of an auditor in place of a retiring auditor would equally applicable in the instant case are given below:

**(i) Section 225(1)**: Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.

**(ii) Section 190(2):** Special notice is to be sent to all members of the company at least 7 days before the date of the AGM.

**(iii) Section 225(2):** On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

**(iv) Section 225(3):** Representation if any, received from the retiring auditor should be sent to the members of the company.

**(v) Section 224A:** Special resolution as required under this section should be duly passed.

**(vi) Section 224(1B):** Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 224(1B).

**(vii)** The incoming auditor should also satisfy himself that the notice provided for under Sections 224 and 225 has been effectively served on the outgoing auditor.

**(b) Special Consideration in and Audit of Limited Company** **6**

**1. Initial Verification**

(a) Examine basic documents, viz., Memorandum of Association and Articles of Association of the company, prospectus issued, etc.

(b) Check the certificate of incorporation and certificate of commencement of business.

(c) Examine transactions entered into by the company with reference to the date of these certificates.

(d) Verify the contracts entered into with vendors or other persons for purchase of property, payment of commission, etc.

**2. Board's Duties**

(a) Ensure that Board of Directors act well within their powers and no ultra vires act is ratified.

(b) Also check that the Board has not exercised the powers that are to be exercised by the members in their General Meeting.

(c) Verify that only acts that can be delegated are in fact delegated to others and that

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the Board takes decisions only by resolutions at properly constituted meetings.

(d) Inspect minutes of meetings of Board of Directors.

(e) Verify whether the Board has obtained sanction of the Central Government, wherever applicable, e.g., increase in remuneration to Directors in excess of specified amounts.

**3.** Compliance with relevant provisions of the Companies Act, 1956 relating to share capital; provision relating to Board provisions relating to accounts and audit, etc.

**4.** Compliance with provisions relating to Sections 224 to 233.

**(c)** **Performance Audit:** The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit. Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner. **4**

Economy audit looks into whether the entity has acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy and effectiveness. The procedure for conducting performance audit covers identification of topic, preliminary study, planning and execution of audit, and reporting. Normally speaking, the performance audit is conducted by the government in respect of various expenditure incurred. While the trend towards a comprehensive approach for conducting performance of full scope audit is visible, the coverage and depth of evaluation vary according to the statutory limitations, and the organisational constraints of C & AG

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**6 (a)** **Formation of opinion on accounts:** The principal aspect to be covered in an audit to form an opinion, an auditor has to look into following matters: **8**

(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.

(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 transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting

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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 organisation.
It will thus be realised that the duties of auditor are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

**(b) Salient Features of Financial Administration of Local Bodies** **4**

(i) **Budgetary Procedure:** The objective of local bodies budgetary procedure are financial accountability, control of expenditure, and to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or Council. Different aspects covered in budgeting are determining the level of taxation, fees, rates, and laying down the ceiling on expenditure, under revenue and capital heads.
(ii) **Expenditure Control:** At the State and Central level, there is a clear demarcation between the legislature and executive. In the local body, legislative powers are vested in the Council whereas executive powers are delegated to the officers, e.g., Commissioners. All matters of regular revenue and expenditures are generally delegated to the executive wing. For special situations like, reduction in property taxes, refund of security deposits, etc., sanction from the legislative wing is necessary.
(iii) **Accounting System:** Municipal Accounting System has been conventionally prepared under the cash system. In the recent past however, it is being changed to the accrual system of accounting. The accounting system is characterized by (a) subsidiary and statistical registers for taxes, assets, cheques etc., (b) separate vouchers for each type of transaction, (c) compulsory monthly bank reconciliation, (d) submission of summary reports on periodical basis to different authorities at regional and state level.

**(c)** **Maintenance of huge cash balance :** Cash balance is maintained to meet the day to day operational needs of an organisation. So the auditor has to perform audit procedures particularly having regard to the fact that maintaining such huge balance is highly prone to misappropriation and other forms of fraud. **4**

Accordingly, if the entity is consistently maintaining huge cash balance, which is not justified by its operational requirement needs, the Guidance Note on Audit of Cash and Bank Balances recommends that the auditor should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balance as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

**7 (a)** **Purchase Return** **4**

(i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.

(ii) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in this documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.

(iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.

(iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

**(b)** Audit working papers constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and clients' record. These include retention of permanent record in the nature of a document to show the actual audit work executed the nature of the, work, the extent of the work and important points, facts, dates and decisions having bearing on the audit of the accounts audited. The working papers, if properly maintained, can be used as defence in case of need. The audit working papers are found very useful in the following aspects as they: **4**

(i) aid in the planning and performance of the audit;

(ii) aid in the supervision and review of the audit work;

(iii) provide evidence of the audit work performed to support the auditor's opinion; and

(iv) act as an evidence in the Court of law when a charge of negligence is brought against the auditor

**(c)** **Management Representation: SA 580** "Written Representations" deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written **4**



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representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
Accordingly, similar to responses to inquiries, written representations are audit evidence. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

**(d)** Special Points in Audit of a Partnership Firm: Matters which should be specially considered in the audit of accounts of a partnership firm are as under: **4**
(i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
(ii) Examine the partnership deed signed by all partners and its registration with the registrar of firms. Also ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.
(iii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other such matters which are not of a routine nature.
(iv) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
(v) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
(vi) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreement.
(vii) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners. Also see various requirements of legislations applicable to the partnership firm like Section 44(AB) of the Income-tax Act, 1961 have been complied with.
(viii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

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**(e)** Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as:- **4**

(i) Management's consideration that cost of an internal control does not exceeds the expected benefits.

(ii) Most controls do not tend to be directed at unusual transactions.

(iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.

(iv) The possibility that control may be circumvented through collusion with employees or outsiders.

(v) The possibility that a person responsible for exercising control may abuse that authority.

(vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.

(vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

(viii) Inherent limitations of Audit.

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