PRACTICE MANUAL

Intermediate (IPC)Course

PAPER : 6

AUDITING AND ASSURANCE

VOLUME – III

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This practice manual has been prepared by the faculty of the Board of Studies. The objective of the practice manual is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. Students should also supplement their study by reference to the recommended text books. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the practice manual has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

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Revised Edition	:	July, 2013
Website	:	www.icai.org
E-mail	:	bos@icai.in
Committee / Department	:	Board of Studies
ISBN No.	:	978-81-8441-367-0
Price	:	₹
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002
Printed by	:	Sahitya Bhawan Publications, Hospital Road, Agra 282 003 July/2013/30,000 Copies

A WORD ABOUT PRACTICE MANUAL

The study material has been divided into three parts, namely, Volume I of the study material dealing with the conceptual aspects. Volume II comprises of Standards on Auditing and Guidance Notes. The Study Material has been designed having regard to the needs of home study and distance learning students in mind. The students are expected to cover the entire syllabus and also do practice on their own while going through the practice manual.

Volume I of the study material deals with the conceptual theoretical framework in detail. Its main features are as under:

- The entire syllabus has been divided into nine chapters.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and then can tackle the exercises.
- A question bank has been included after each chapter in Volume I

Volume II comprises of Standards on Auditing and Guidance Notes.

Volume III of the Study Material comprises the Practice Manual. It aims to provide guidance as to the manner of writing an answer in the examination. Main features of Volume III are as under:

- Important Definitions have been given for quick recapitulation. Students are expected to attempt the questions and then compare it with the actual answers.
- Compilation of questions appearing during last twenty examinations.
- Exercises have been given at the end of each topic for independent practice.

In case you need any further clarification/guidance, please send your queries at rajeev.sachdeva@icai.in and karuna.bhansali @icai.in.

Happy Reading and Best Wishes!

Paper – 6: Auditing and Assurance
Statement showing topic-wise distribution of Examination Questions along with Marks

Topics		Term of Examination														Total Marks	Avg. Marks
		Nov. 2009		May 2010		Nov. 2010		May 2011		Nov. 2011		May, 2012		Nov.2012			
Chapter No.	Chapter Name	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M		
Chapter-1	Nature of Auditing	3	**10**					1a,b,c,d 3a,b	**5 each** **8 each**	6a,b	**6,5**	1(a) 6(b)	5 8	4(b)	8	**78**	**11.1**
Chapter-2	Basic Concepts in Auditing	4a	**6**	8a	**5**	2c	**6**	2a	**8**	7b	**4**	4(a)	8	2(a) 2(b)	6 10	**53**	**7.6**
Chapter-3	Preparation for an Audit	4b 8a	**4** **3**	8b	**5**	7c	**8**	7c	**4**	1a 7a,e	**5** **4,4**	7(b) 7(c) 7(d) 7(e)	4 4 4 4	6(a)	8	**61**	**8.7**
Chapter-4	Internal Control			4a	**5**	2a,b	**4,6**	7b	**4**	2a 4a	**8** **8**	2(a)	8	7(c) 7(d)	4 4	**51**	**7.2**
Chapter-5	Vouching	8b	**5**	3	**10**	4c 7a	**4** **4**	2b 4a 7e	**8** **8** **4**	1b	**5**	3(a)	6	6(b) 7(a) 7(e)	8 4 4	**70**	**10**
Chapter-6	Verification of Assets and Liabilities	5b 7b,c	**5** **5,5**	6a	**5**			4b	**8**	1d 6c 7c,d	**5** **5** **4,4**	1(c) 4(b) 7(a)	5 8 4	1(c)	5	**68**	**9.7**
Chapter-7	The Company Audit - I	2(a,b,c) 7a	**8,6,6** **5**	2(a,b,c) 4b	**6,6,8** **5**	1b,d 4b 5c	**5,5** **4** **4**	6a	**8**	1c 7b	**5** **8**	1(d) 3(b) 3(c)	5 6 4	1(b) 1(d) 3(b)	5 5 6	**140**	**20**

						6a 7b	**4** **4**					6(a)	8	7(b)	4		
Chapter-8	The Company Audit - II	6a,b	**5,5**	7a 7b	**5** **5**			6b 7a	**8** **4**	2b 3b	**8** **5**	1(b) 2(b)	5 8	1(a) 5(b)	5 8	**71**	**10.1**
Chapter-9	Special Audits	5a 8c	**5** **5**	5a	**5**	5a,b	**8,4**	5a,b 7d	**8 each** **4**			5(a)	8	3(a) 5(a)	10 8	**73**	**10.2**
	Standards on Auditing and Guidance Notes & Accounting Standards			5b 6b	**5** **5**	1a,c 3a,b 4a,d,e 6b,c,d	**5,5** **8,8** **4,4,4** **4,4,4**			3a 5a,b	**8** **8,8**	5(b)	8	4(a)	8	**100**	**14.3**

Note: 'Q' represents question numbers as they appeared in the question paper of respective examination. M represents the marks which each question carries.

The question papers of all the past attempts of IPCC can be accessed from the BOS Knowledge Portal on the Institute's website www.icai.org.

CONTENTS

1

Nature of Auditing

BASIC CONCEPTS

"An audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

Aspects to be covered in Audit

The principal aspect to be covered in an audit concerning final statements 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.

(ii) Reviewing the system and procedures.

(iii) Checking of the arithmetical accuracy of the books of accounts.

(iv) Verification of the authenticity and validity of transactions in the books of accounts

(v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature.

(vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record.

(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.

Basic principles governing an Audit

Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. The basic principles as stated in this guideline are:

1. Integrity, objectivity and independence.

2. Confidentiality.
3. Skills and competence
4. Work performed by others.
5. Documentation
6. Planning
7. Audit Evidence
8. Accounting System and Internal Control
9. Audit conclusions and reporting

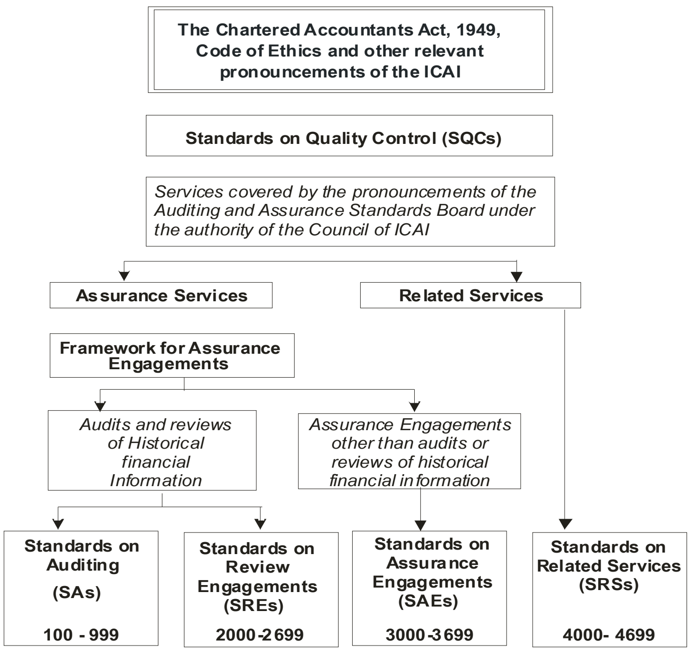
Types of Audit

Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e.,

1. Audit required under law.
2. Voluntary audit.

A diagrammatic representation of the structure of Standards under the new Preface is given below:

Diagrammatic Representation of the Structure
of Standards Under the New Preface



The SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. While discharging their attest function, it will be the duty of members of the Institute to ensure that the SAs are followed.

Question 1

(a) 'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defence as an auditor?

(b) 'Doing a statutory audit is full of risk'. Narrate the factors which cause the risk.

Answer

(a) As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

(b) 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. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

An independent audit whether performed in terms of applicable financial reporting framework or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks. Factors which may cause such risk in conducting an audit are discussed below:

(i) ***Exercising judgement on the part of the auditor*****:** The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.

(ii) ***Nature of audit evidence*****: Much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom.** The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such an evidence may far exceed the benefits.

(iii) ***Inherent limitations of internal control*****:** Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite clear that an audit suffers from control risk on account of inherent limitations of internal control and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

Question 2

Write a short note on – Errors of Commission.

Answer

Errors of Commission: When a transaction has been mis-recorded either wholly or partially it is called as a error of commission. Error of commission can happen in the following ways:

Errors in posting,

Errors in Casting,

Errors in carrying forward,

Errors occurring during extraction of balances etc.

Posting errors may be of a wrong account, wrong amount or wrong file. For example, amount received from Mr X and credited to Mr Y, purchase of ₹ 360 from Mr A posted in his account at ₹ 630 or sales returns from Mr X posted as the debit of his account, etc.

The first type of errors will not affect the trial balance, however, the other two will affect the agreement of trial balance.

Casting errors are the errors committed while making the totals. This error affects the trial balance.

Error of carry forward and errors of extraction of balances also affect the trial balance.

Error of duplication is another type of error of commission which means recording the same transaction twice.

Such errors however, do not affect the trial balance but they will affect the Profit and Loss A/c (over statement of expenditure).

Question 3

Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.

Answer

In planning and performing his examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are:

(i) Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all dak and marking it to the relevant sections or two persons are responsible for receipt of dak but the same is not followed in actual practice, etc.

(ii) Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.

(iii) Unusual pressures within the entity, for example, industry is doing well but the company is not performing accordingly, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.

(iv) Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.

(v) Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

Question 4

Write a short note on - Operational Audit.

Answer

Operational Audit: Operational Audit involves examination of all operations and activities of the entity.

The objects of operational audit include the examination of the control structure and of the relation of department controls to general policies. It provides an appraisal of whether the department is operating in conformity with prescribed standards and procedures and whether standards of efficiency and economy are maintained. It is concerned with formulation of plans, their implementation and control in respect of production and marketing activities.

Traditionally, internal audit focused on accounting operations of the entity. However, operational audit covers all other operation such as marketing, manufacturing, etc.

Thus, operational audit in its initial stages developed as an extension of internal auditing. The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation.

Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey.

Question 5

"The auditors should consider the effect of subsequent events on the financial statement and on auditors report" according to SA 560 – Comment.

Answer

Effect of Subsequent Events: SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of balance sheet and the date of the audit report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events, the auditor should:

(a) obtain an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) inquire of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether there have been any developments regarding contingencies.
- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

(c) Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Read the entity's latest subsequent interim financial statements, if any.

(e) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

(f) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or

(g) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

Question 6

Mention any twelve title of Statements on Standards on Auditing and the date from which it comes into force.

Answer

The Council of the ICAI has issued following Standards on Auditing (SAs)

S. No	SA	Title of Standard on Auditing	Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
4	SA 220	Quality Control for Audit of Financial Statements	April 1, 2010
5	SA 230	Audit Documentation	April 1, 2009
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements	April 1, 2009
8	SA 260	Communication with Those Charged with Governance	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	April 1, 2010
10	SA 299	Responsibility of Joint Auditors	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008

13	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
14	SA 330	The Auditor's Responses to Assessed Risks	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010
16	SA 450	Evaluation of Misstatements Identified during the Audits	April 1, 2010
17	SA 500	Audit Evidence	April 1, 2009
18	SA 501	Audit Evidence - Specific Considerations for Selected Items	April 1, 2010
19	SA 505	External Confirmations	April 1, 2010
20	SA 510	Initial Audit Engagements-Opening Balances	April 1, 2010
21	SA 520	Analytical Procedures	April 1, 2010
22	SA 530	Audit Sampling	April 1, 2009
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	April 1, 2009
24	SA 550	Related Parties	April 1, 2010
25	SA 560	Subsequent Events	April 1, 2009
26	SA 570	Going Concern	April 1, 2009
27	SA 580	Written Representations	April 1, 2009
28	SA 600	Using the Work of Another Auditor	April 1, 2002
29	SA 610	Using the Work of Internal Auditors	April 1, 2010
30	SA 620	Using the Work of an Auditor's Expert	April1, 2010
31	SA 700	Forming an Opinion and Reporting on Financial Statements	April 1, 2012
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report	April 1, 2012
33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	April 1, 2012
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements	April 1, 2011
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	April 1, 2010
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework	April 1, 2011

37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	April 1, 2011
38	SA 810	Engagements to Report on Summary Financial Statements	April 1, 2011

*(**Note:** Candidates may mention any twelve SAs. A list is given for the information of candidates.)*

Question 7

What are the auditor's responsibilities for detection of Frauds and Errors?

Answer

Auditor's Responsibilities for Detection of Fraud and Error: As per SA 240 "The Auditor's Responsibilities relating to fraud in an audit of Financial Statements", an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

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.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance; hence, in an audit, the auditor does not guarantee that material misstatements, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

(a) failure to obtain reasonable assurance,

(b) inadequate planning, performance or judgment,

(c) absence of professional competence and due care, or,

(d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error, which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a significant fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

Question 8

State briefly the qualities of Auditors.

Answer

Qualities of Auditors: The auditor should possess specific knowledge of accountancy, auditing, taxation, etc. which are acquired by him during the course of his theoretical education.

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 1956, Co-operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact; caution; firmness; good temper; judgement; patience; clear headedness and commonsense; reliability and trust, etc.

In short, all those personal qualities required to make a good person contribute to the making of a good auditor. In addition, the auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, SA 200 mentions integrity, objectivity and independence as one of the basic principles.

Auditing is a profession, calling for wide variety of knowledge to which no one has yet set a limit, the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Question 9

(a) Give your comment on the following:

Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2009-10. The closing stock of the company as on 31.3.2009 amounting to ₹ 100 lacs continued as it is and became closing stock as on 31.3.2010. The auditors of the company propose to exclude from their audit programme the audit of closing stock of ₹ 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.

(b) What are the obvious assertions in the following items appearing in the Financial Statements?

(i) Profit and Loss Statement

Travelling Expenditure	₹ 50,000

(ii) *Balance Sheet*

Debtors ₹ 2,00,000

Answer

(a) Verification of Stocks SA 510 "Initial Audit Engagements – Opening Balances", requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) the closing balances of the preceding period have been correctly brought forward to the current period;

(b) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(c) appropriate accounting policies are consistently applied.

When the financial statements for the preceding period were audited by the another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. The contention of the management that the stock has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the stock lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude the audit of closing stock from his audit programme.

(b) (i) Travelling Expenditure: ₹ 50,000

- Expenditure has been actually incurred for the purpose of travelling.
- Travelling has been undertaken during the year under consideration.
- Total amount of expenditure incurred is ₹ 50,000 during the year.
- It has been treated as revenue expenditure and charged to profit and loss account.

(ii) Debtors: ₹ 2,00,000

- These include all sales transaction occurred during the year.
- These have been recorded properly and occurred during the year
- These constitute assets of the entity.

- These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

Question 10

Write short note on the following:

(a) General Purpose Financial Statements

(b) Going Concern Concept

Answer

(a) General Purpose Financial Statements: As defined in SA 700-"Forming an Opinion and Reporting on Financial Statements", General purpose financial statements are Financial statements prepared in accordance with a general purpose framework.

A financial reporting framework designed to meet the common financial information needs of a wide range of users is called General purpose framework.

The term "General Purpose Financial Statements" normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Accounting Standards are applicable to all General Purpose Financial Statements.

(b) Going Concern Concept: AS 1, "Disclosure of Accounting Policies", lays down that the "Going Concern", is one of the fundamental accounting assumption underlying financial statements. This Going Concern concept envisages that the entity will continue for the foreseeable future. Accounts are prepared on this concept unless there are indication that going concern concept is not holding good for a particular entity. On account of this basic concept of going concern, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified, the entity may not be able to realise its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. AS 1, "Disclosure of Accounting Policies", also requires that no specific disclosure is required in case the same has been followed in the preparation of financial statements. In case this assumption is not followed, the fact should be disclosed.

SA 570 “Going Concern”, establishes standards on the auditor’s responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

Question 11

Answer the following:

(i) What is an Audit Engagement letter?

(ii) Discuss the situations where it is necessary to issue audit engagement letter each year for repetitive audits.

Answer

(i) Audit engagement letter : Audit engagement letter is a communication issued by auditor to the auditee (the client) expressing therein *inter alia,* the fact of acceptance of his audit engagement, the objectives and scope of his audit, the extent of auditor's responsibilities and management responsibility for compilation of accounting, application of accounting principles, standards, fees etc. As per SA 210, “Agreeing the Terms of Audit Engagements”, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement. But if Law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement.

(ii) Need for the Issue of Audit Engagement Letter: As per SA 210 , “Agreeing the Terms of Audit Engagements”, 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.

When it is repetitively issued: However, the auditor may think of issuing a fresh engagement letter in one or more circumstances described below :

(i) When it appears that the client has misunderstood the objective and scope of audit.

(ii) Where there has been change in management, board, or ownership so that it is felt that it is pertinent to remind them of the engagement terms again.

(iii) Where any revision by way of addition, deletion, or modifications had been contemplated in the engagement letter originally issued.

(iv) Where significant changes had occurred in nature, volume of the business transactions of the client which warrant the scope and terms of engagement to be altered to be in tune with them.

(v) Where there has been necessity to modify audit approach to be in line with the pronouncements of ICAI, the Companies Act and the like.

Question 12

State the matters which the statutory Auditor should look into before framing an opinion on accounts on finalisation of audit of accounts? Discuss over all audit approach.

Answer

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:

(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 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.

Question 13

Write short notes on Audit versus Investigation.

Answer

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.

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.

Question 14

Comment on the "Auditor's professional responsibilities are governed by basic principles which should be complied with whenever an audit is carried out"?

Answer

Basic Principles Governing an Audit: The basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried are described below:

(i) ***Integrity, objectivity and independence*****:** The auditor should be straight forward, honest and sincere in his approach to his professional work. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever is actual effect, as being incompatible with integrity and objectivity.

(ii) ***Confidentiality*****:** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) ***Skills and Competence*****:** The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence along with a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

(iv) ***Work performed by others*****:** When the auditor delegates work to assistants or uses work performed by other auditors and experts, he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(v) ***Documentation*****:** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) ***Planning:*** *The* auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

(vii) ***Audit evidence*****:** The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) ***Accounting system and Internal Control*****:** The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wises to rely in determining the nature, timing and extent of other audit procedures.

(ix) ***Audit Conclusions and Reporting*****:** The auditor should review and assess the conclusions drawn from the audit evidence obtained and from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

The audit report should contain a clear written opinion on the financial information and should comply the legal requirements. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

(**Note**: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics. But in general abovementioned principles are basic principles only)

Question 15

What are the inherent limitations of audit?

Answer

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.***

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 that is relevant 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.***

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.

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.s***
- ***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.

Question 16

What is the importance of having the accounts audited by an independent auditor?

Answer

Advantages of having the accounts audited by an independent auditor are:-

(i) It safeguards the financial interest of persons not associated with the management like partners or shareholders.

(ii) It acts as a moral check on the employees from committing fraud.

(iii) It is helpful in settling tax liability, negotiations for loans and for determining purchase consideration for sale/merger.

(iv) It is also helpful in settling trade or labour disputes for higher wages/bonus.

(v) It helps in detection and minimizing wastages and losses.

(vi) It ensures maintenance of adequate books and records, statutory register etc.

Question 17

Discuss the types of audits required under law.

Answer

Audits required under Law: Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e., audit required under law and voluntary audits.

The organisations which require audit under law are the following:

(i) Companies governed by the Companies Act, 1956;

(ii) Banking companies governed by the Banking Regulation Act, 1949;

(iii) Electricity supply companies governed by the Electricity Supply Act, 1948;

(iv) Co-operative societies registered under the Co-operative Societies Act, 1912;

(v) Public and charitable trusts registered under various Religious and Endowment Acts;

(vi) Corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.

(vii) Specified entities under various sections of the Income-tax Act, 1961.

(viii) Audit required under Sales-tax and VAT by various State Government.

Question 18

Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI - Discuss

Answer

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.

EXERCISES

1 *State your opinion on the following:*

  (a) *"The duties of auditors are limited to the verification of the arithmetical accuracy of the books of accounts"*

  (b) *"The audit of financial statements relieves management of its responsibilities."*

  (c) *Some material misstatements remained unreported by auditors.*

2. *State with reasons your views on the following:*

Mr. X, a partner of X & Co., Chartered Accountants died of a heart attack on 30.03.10 after completing the entire routine audit work of T Ltd., Mr Y one of the partners of the firm, therefore signed the accounts of T Ltd without reviewing the finalization work done by the assistants.

3 *"Generally an audit is not concerned with the propriety of business conduct", Comment.*

4. *Distinguish between Auditing, Accounting and Investigation.*

2

Basic Concepts in Auditing

BASIC CONCEPTS

Auditor's Independence: Independence is the keystone upon which the respect and dignity of a profession is based. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest.

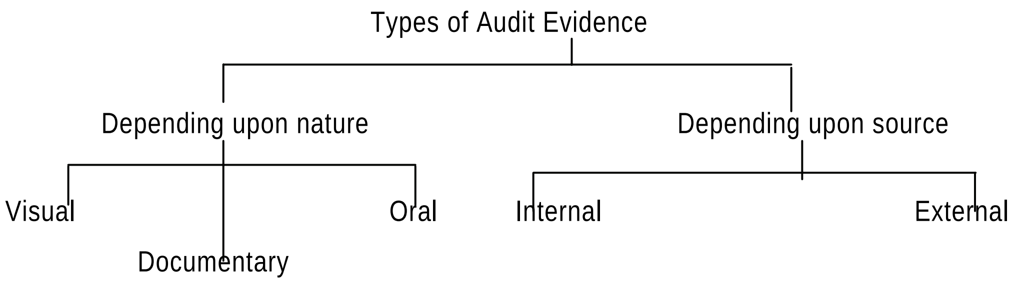
True and Fair: The phrase “true and fair” in the auditor’s report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

Audit Evidence: Information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the SAs:

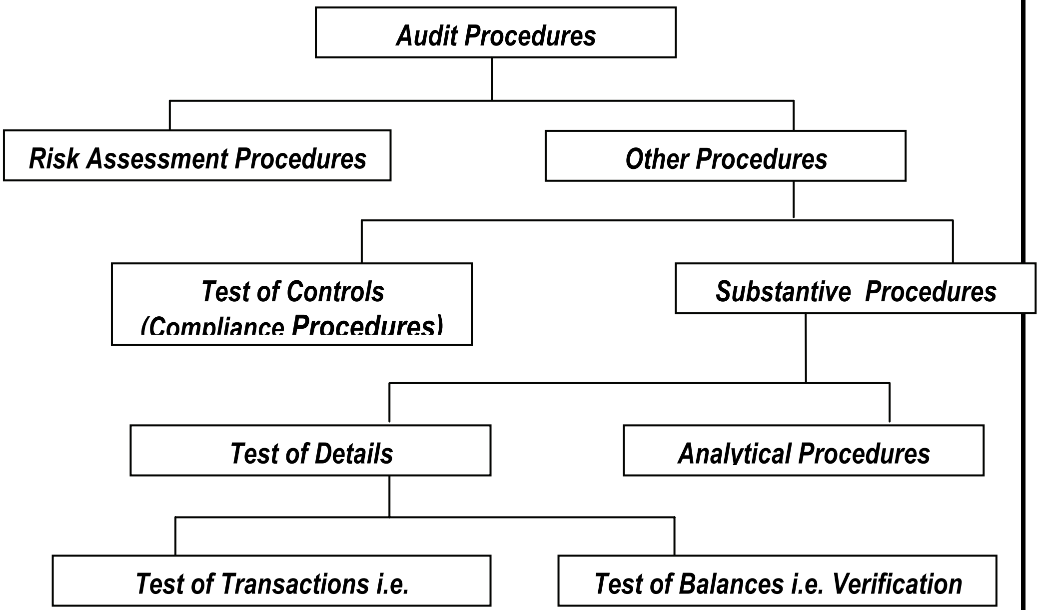
(i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and also by the quality of such audit evidence.

(ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

Types of Audit Evidence



Audit Procedures to Obtain Audit Evidence



Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

Fundamental Accounting Assumptions: AS 1 states that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The following have been generally accepted as fundamental accounting assumptions:

(i) Going Concern

(ii) Consistency

(iii) Accrual

Question 1

What is the importance of having the accounts audited by independent professional auditors?

Answer

Importance of Audit by an Independent Professional Auditor : The principal advantage of an independent audit lies in the fact that the society is able to get an informed, objective and forthright opinion on the financial statements of enterprises which are used in making significant economic decisions by interested segments of the society, e.g., shareholders, creditors, bankers, etc. Irrespective of the fact whether audit is compulsory, statutory or voluntary, the audit of accounts by an independent professional auditor becomes important for every individual and every type of organisation.

It is only through audited accounts by an independent professional auditor that the shareholders of a company are assured that the funds invested by them are safe and they are being used for only the purposes for which they were raised and collected. The chief utility of audit lies in ensuring reliable financial statements on the basis of which the state of affairs may be easy to understand. Information contained in the statement of accounts of a business are primarily intended for the owners.

However, many others make use of the information for different purposes.

- Management of the business uses it for decision-making purposes.
- Lenders and creditors examine it to establish the degree of safety of their money.
- Government levies tax putting a *prima facie* reliance on the statements and regulates the socio-economic state of affairs on a summary view of the information contained in various accounting statement made available to it.
- Investors review the information for making investment decisions
- Financial analysts can use the information to assess the performance of an entity.

Financial statements are of great significance to workers as well; they want to be assured that reasonable and legitimate share of the revenue earned by the organisation has been paid to them as bonus and the distribution pattern has not violated the norms of social justice.

To ensure the acceptable degree of reliability and accuracy of the financial statements, examination and appraisal of accounts and the financial picture by an independent auditor is necessary.

In the company form of organisation, there is a divorce between ownership and management - shareholders are so scattered that they have no direct control on the day-to-day administration of the company while in a proprietary concern, accounts may be audited to get funds from financial institution, etc. and a partnership firm may get its accounts audited to decide questions such as valuation of goodwill at the time of admission, retirement and death of a partner.

The report of an independent auditor is, therefore, the only real safeguard available to the various parties interested in the financial affairs of the entity. It is due to the independence of the auditor, leading to an objective report, that the risk of people being misled by untrue or fraudulent financial statement is minimized. As a by-product, managements get attuned to open and truthful financial statements.

Question 2

Write short notes on the following:

(a) Preliminary Expenses

(b) *Fundamental Accounting Assumptions*

Answer

(a) Preliminary Expenses: This term is applied to expenses incurred in connection with the formation of a limited company. They generally include the following expenses:

(i) Legal costs in drafting the memorandum and articles of association;

(ii) Capital duty and other fees on registration of the company;

(iii) Cost of printing the memorandum and articles of association;

(iv) Cost of statutory books and the companies seal, etc; and

(v) Any other expense incurred to bring into existence the statutory books of the company.

As per the Revised Schedule VI, the unamortised preliminary expenses should be disclosed in the balance sheet under the heading "Other Non-Current Assets/Current assets" (depending on the remaining period of amortisation.

The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined.

(b) Fundamental Accounting Assumptions: As per AS 1 on "Disclosure of Accounting Policies" accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements. There is no single list of accounting policies which are applicable to all circumstances. The choice of the appropriate accounting principles and the methods of applying those principles in specific circumstances call for judgement by the management. The profit or loss can be significantly affected by the accounting policies followed. Therefore disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

In this context, AS 1 states that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The following have been generally accepted as fundamental accounting assumptions:

(a) *Going Concern*: The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

(b) ***Consistency*****:** It is assumed that accounting policies are consistent from one period to another.

(c) ***Accrual*****:** Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

Thus, if the fundamental accounting assumptions, viz., Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Question 3

(i) What is"Audit Evidence"?

(ii) What are the various methods of obtaining audit evidence? Mention the same in brief.

(iii) Discuss the principles, which are useful in assessing the reliability of audit evidence.

Answer

(i) Audit Evidence: As per SA 500 "Audit evidence" Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

(ii) Methods of Obtaining Audit Evidence: The auditor obtains evidence by one or more of the following methods:

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.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

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. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

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. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

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

Reperformance: Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

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.

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.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

(iii) Reliability of Audit Evidence: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Question 4

Explain the advantages of "Audit Working Papers".

Answer

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:

(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.

Question 5

Write a short note on – Disclosure of Accounting Policies.

Answer

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 by the 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 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.

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.

Question 6

How would you proceed to check the misappropriation of cash in a trading concern?

Answer

Steps to check misappropriation of cash: Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc.

The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for.

It is, therefore, the duty of the auditors to see that in the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the foregoings.

Some of the methods through which cash may be misappropriated include:

(a) Omission cash receipts:

   (i) cash sales not recorded;

   (ii) teeming and lading;

   (iii) casual receipts of miscellaneous nature not entered; and

   (iv) sale proceeds of fully written off assets not recorded.

(b) Recording of less amounts than that actually received.

(c) Recording of more amounts than that actually expended, e.g., discounts or rebates not taken into account while making payments, etc. Inclusion of fictitious payments in cash book e.g. wages paid to 'ghost' or 'dummy' workers, salary paid to apprentices whose tenure of services expired, etc.

(d) Intentional errors in totaling, balancing and carrying over of cash book balances.

   With a view to check misappropriation of cash, the existence of internal check system is quite essential. In particular, the following may be noted:

   (i) Ascertaining the existence of system of cash receipts and disbursements of cash sales and purchases and existence of internal checks at various stages is quite important. In particular, the separation of duties and incompatible functions, e.g., an employee who receives and deposits cash and cheques should not prepare sales invoices, or reconcile bank accounts, and authorised signatory should not approve vouchers for payment.

(ii) Checking of cash receipts with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by itself would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated.

(iii) Checking of date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.

(iv) Verify cash sales with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof, as entered in the Cash Book.

(v) Check receipt of cash from the customers against price of good sold with the counterfoils of receipt issued to them. Also compare entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in customers' accounts, which ought to have collected in whole, are cleared in small instalments.

Question 7

What are Audit working papers and why should they be carefully preserved by the Auditor?

Answer

Audit Working Papers: As per SA 230(Revised) "Audit Documentation" Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

Working papers are the

(a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

(b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides they serve a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, working papers available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel

Retention of working papers: Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Question 8

Explain the compliance procedure and also substantial procedures as audit methods of collecting evidences for forming an audit opinion.

Answer

Collection of evidences to form audit opinion: Auditor should obtain sufficient and appropriate audit evidences and test them before framing an opinion about the assertions the financial statements reveal. For this, the auditor checks evidences through (a) Compliance procedure and (b) Substantial procedure.

Compliance procedures are tests designed to obtain reasonable assurance that those internal control on which audit reliance is to be placed are in effect. It seeks to test that (a) there exists internal control, (b) the existing internal control is effective and (c) and the internal control is working without break or lacunae during the period under review.

When internal control is found to be to an acceptable level, the accounting entries generated in such a system is more reliable than in one where the control is weak.

Mere satisfaction about the existence of internal control may not be sufficient for auditors to express opinion about the assertions the financial data in the form of balances and transactions. These i.e. transactions and balances need to be tested. This is done by audit procedure called substantial checking.

Substantial procedures are designed to obtain audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

The substantial procedures involve (a) checking of transactions and balances and (b) analytical review. The checking of transaction and balances involves vouching of sales, purchases, payments, receipts and scrutiny of ledgers.

The analytical procedure involves critically examining the accounts in an overall manner and it may entail computation of ratios, trend analysis so as to dwell in length for examination of unusual or unexplained deviations.

Question 9

Discuss the concept of "True and Fair".

Answer

Concept of "True and Fair": The concept of "true and fair" is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

What constitutes "true and fair" has not been defined in the legislation. However, section 211(5) of the Companies Act, 1956 states that the balance sheet and profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company if they do not disclose any matters which are not required to be disclosed by virtue of the provisions of Schedule VI to the Companies Act, 1956, or by virtue of any notification or any order.

Therefore the auditor must see that the accounts are drawn up as per requirements of the provisions of Schedule VI, and whether they contain all matters required to be disclosed therein. In case of companies governed by special Acts, say, banking, electricity, etc. the auditor should see, whether the relevant disclosure requirements are complied with.

Thus, what constitutes a true and fair view is a matter of the auditor's judgement in the particular circumstances of the case. In specific terms to ensure truth and fairness, an auditor has to see:

(i) that the assets are neither undervalued or overvalued;

(ii) no material asset is omitted;

(iii) the charge on assets, if any, is disclosed;

(iv) material liabilities should not be omitted, and liabilities are neither undervalued or overvalued;

(v) accounting policies have been followed consistently;

(vi) all unusual, exceptional, non recurring items have been disclosed separately;

(vii) accounts have been drawn as per requirement of Schedule VI to the Companies Act; and

(viii) the accounts have been drawn in compliance to the relevant accounting standards. In case of deviation from accounting standards, disclosure should be made of the reasons for such deviation and financial effects, if any arising due to such deviation

Question 10

Explain with reference to the relevant Standard on Auditing Appropriateness of going concern assumption?

Answer

Appropriateness of Going Concern Assumption: As per SA 570 "Going Concern" In some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity. However, the auditor should consider the risk that the going concern assumption may no longer be appropriate. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

The risk assessment procedures required by paragraph 10 help the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

Question 11

What are accounting estimates according to the Standards on Auditing 540? Give examples.

Answer

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.

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

- Accounting estimates arising in entities that engage in business activities that are not complex.
- 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:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.

Additional examples of accounting estimates are:

- Allowance for doubtful accounts.
- Inventory obsolescence.

- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Financial Obligations / Costs arising from litigation settlements and judgments.

Question 12

Write short note on Auditor's Independence.

Answer

Auditor's Independence: Independence is the keystone upon which the respect and dignity of a profession is based. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest. The independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometime imposed by law. In the context of auditors, his independence is necessary so as to enable him to express unbiased opinion on financial statements. The user of the financial statement will rely on the opinion of the auditor only when he is convinced about his independence. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons.

The chartered accountant is not known personally to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act, 1956, has therefore enacted specific provisions to give concrete shape to this vital concept:

(i) The provisions disqualifying certain types of persons from undertaking audit of limited companies.

(ii) Provisions relating to ceiling on the number of audits that can be undertaken by a chartered accountant.

(iii) Provisions requiring special resolution for appointing auditors in certain cases.

(iv) Other provisions on appointment, re-appointment and removal of auditors, are designed with sufficient independence to carry out the audit in the larger interest of shareholders and other users.

(v) Power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence.

Question 13

Answer the following:

(i) Explain, what do you mean by Analytical procedures. How such procedures are helpful in auditing?

(ii) Explain concept of 'Materiality'.

Answer

(i) **SA 520 'Analytical Procedures':** As per SA 520 the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example: comparable information for prior periods, anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation and similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example: among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages and Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Analytical procedures are used for the following purposes:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

(ii) Concept of Materiality: Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

1. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference.
2. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:
   (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
   (b) Understand that financial statements are prepared, presented and audited to levels of materiality;
   (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
   (d) Make reasonable economic decisions on the basis of the information in the financial statements.
3. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Question 14

What is meant by external confirmation? Mention four situations where external confirmation may be useful for auditors.

Answer

External confirmation: As per SA 505 "External Confirmations" Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

The auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. Following are examples of situations where external confirmations may be useful.

(i) Bank balances and other information from bankers

(ii) Account receivables balances

(iii) Stock held by third parties

(iv) Account payable balances.

Question 15

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

Answer

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

- Method of depreciation, depletion and amortization-Straight Line Method, Written Down Value method.
- Valuation of inventories – FIFO, LIFO, weighted average etc.
- Treatment of goodwill – write off, retain.
- Valuation of investment –at cost, market or net realizable value etc.
- Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.
- Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.

Note: (The above list is not exhaustive. There may be other examples as well.)

Question 16

What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure?

Answer

In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

(i) Existence - that an assets or liability exists at a given date.

(ii) Rights and obligations - that an asset is a right of the entity and a liability is an obligation at a given date.

(iii) Occurrence - that a transaction or event took place which pertains to the entity.

(iv) Completeness - that there are no unrecorded assets, liabilities or transaction.

(v) Valuation - that an asset or liability is recorded at an appropriate carrying value.

(vi) Measurement - that a transaction is recorded in the proper amount and revenue *or* expenses are allocated to proper period.

(vii) Presentation & disclosure - that an item is disclosed, classified and described in accordance with recognized accounting policies, practices and statutory requirements.

Question 17

Distinguish between Internal evidence and External evidence.

Answer

Internal evidence and external evidence: Evidence which originates within the organization being audited is internal evidence. Example – sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization; for example, purchase invoice, supplier's challan and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g., an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

Question 18

In auditing, the auditor checks the specific assertions of the items appearing in the financial statements and opines about the overall assertions they signify. Explain specific assertions and overall assertions in this context.

Answer

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

The specific assertions are –

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

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

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

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

(e) Valuation – An asset or liability is recorded in the proper amount and recorded at appropriate carrying value.

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

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

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

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

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

Question 19

'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.'

Justify this statement in the light of responsibilities of Joint Auditors under SA 299.

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 1956. Main features of the said SA are discussed below:

- ***Division of Work**:* Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- ***Coordination**:* Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(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; and

(v) for ensuring that the audit report complies with the requirements of the relevant statute.

(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.

(vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(viii) each joint auditor is entitled to assure 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.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 20

Write short notes on the following:

(a) Substantive Procedures

(b) Audit Working Papers.

Answer

(a) Substantive Procedures: These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions

(i) The asset or a liability should exist at a given date.

(ii) The asset should be owned by the entity and the liability is an obligation of the entity at a given date.

(iii) There should not be any unrecorded assets, liabilities or transactions.

(iv) Assets or liabilities should be recorded at appropriate carrying values.

(v) Transaction or event that took place should pertain to the entity during the relevant period.

(vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period.

(vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

(b) Audit Working Papers: The audit working papers constitute the link between the auditor's report and the client's records. SA 230 (revised) on "Audit Documentation" states that Audit Working papers *are t*he record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The object of Audit working papers is to provide:

(i) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides above, they serve a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Working papers should contain audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The auditor shall assemble the audit working papers in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. The retention period for audit working papers ordinarily is no shorter than ten years from the date of the auditor's report, or, if later, the date of the group auditor's report. Unless otherwise specified by law or regulation, audit working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients.

Question 21

What do you mean by the term 'Sufficient Appropriate Audit Evidence'? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence.

Answer

Meaning of sufficient appropriate audit evidence: The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

SA 500 on 'Audit Evidence' further expounds this concept. According to it, the sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. Further, SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

In general the various factors which may influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under:

(i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.

(ii) The materiality of the item.

(iii) The experience gained during previous audits.

(iv) The results of auditing procedures, including fraud and errors which may have been found.

(v) The type of information available.

(vi) The trend indicated by accounting ratios and analysis.

EXERCISES

1 State with reasons your views on the following:

(a) An assistant of X & Co. Chartered Accountants detected an error of ₹ 5 per interest payment which recurred number of times. The General Manager (Finance) of T Ltd. advised him not to request for passing any adjustment entry as individually the errors were of small amounts. The company had 2,000 Deposit Accounts and interest was paid quarterly.

(b) The company produced photocopies of fixed deposit receipts as the original receipts were kept in the iron safe of the director finance who was presently out of the country on company business.

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

3 State with reasons (in short) whether the following statements are true or false

(i) An auditor is considered to lack independence, if the partner of the audit firm owns the building in which the client's business is situated.

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

3

Preparation for an Audit

BASIC CONCEPTS

Audit process

(a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.

(b) Examination and evaluation of the nature, extent and efficacy of the system of internal control.

(c) Ascertaining the arithmetical accuracy of the books of accounts.

(d) Examining the documentary evidence and the authority in support of the transaction:

(e) Checking the validity of transactions with reference to :

- (i) provisions affecting the accounts and audit in any Act or Rules;
- (ii) rules and regulations governing the constitution and management of the organisation
- (iii) minute books for appropriate sanction;
- (iv) other legal documents and
- (v) well recognised accounting principles and practices

(f) Ensuring that there is adequate disclosure of information.

(g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.

(h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.

(i) Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.

(j) Determination of the significant accounting ratios and subjecting the accounts to ratio analysis to locate the areas showing departure from the expected state of affairs.

Audit techniques

For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following:

1.	Posting checking	2.	Casting checking
3.	Physical examination and count	4.	Confirmation
5.	Inquiry	6.	Year-end scrutiny
7.	Re-computation	8.	Tracing in subsequent period
9.	Bank Reconciliation		

Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. Infact without adequate knowledge of client's business, a proper audit is not possible. SA-315 on "**Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment**" deals in detail about the significance of such knowledge on the part of the auditor.

The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information. Among other things, the auditor can obtain such knowledge from :

- The client's annual reports to shareholders.
- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets, if any.
- The previous year's audit working papers and other relevant files.
- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- Discussions with client.
- The client's policy and procedures manual.
- Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
- Consideration of the state of the economy and its effect on the client's business.
- Visits to the client's premises and plant facilities.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgments regarding the appropriateness of accounting policies and disclosures.

Development of an Overall Plan:

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit :

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

Audit Programme

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view:

1. Stay within the scope and limitation of the assignment.
2. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
3. Apply only these steps and procedures which are useful in accomplishing the verification

purpose in the specific situation.

4. Consider all possibilities of error.

5. Co-ordinate the procedures to be applied to related items.

Meaning of Audit Sampling:

"Audit Sampling" means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

There are many methods of selecting samples. The principal methods are as follows:

(a) Random selection (applied through random number generators, for example, random number tables).

(b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

(c) Monetary Unit sampling is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(d) Haphazard selection, in which the auditor selects the sample without following a structured technique.

(e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.

Question 1

Comment on the "In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed".

Answer

Selection of Audit Sample: Audit Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population.

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

Question 2

What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of the SA 530, Audit Sampling?

Answer

Meaning of Audit Sampling: "Audit Sampling" means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

There are many methods of selecting samples. The principal methods are as follows:

(a) Random selection (applied through random number generators, for example, random number tables). Stratified Sampling is one of the methods of Random Sampling. This method involves dividing the whole population to be tested in a few groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgement. e.g. entire expense vouchers may be divided into:

    (i) Vouchers above ₹ 1,00,000

    (ii) Vouchers between ₹ 25,000 and ₹ 1,00,000

    (iii) Vouchers below ₹ 25,000

    The auditor can then decide to check all vouchers above ₹ 1,00,000, 50% between ₹ 25,000 and ₹ 1,00,000 and 25% of those below ₹ 25,000.

    The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

(b) Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

(c) Monetary Unit Sampling is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(d) Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(e) Block selection involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Question 3

Write a short note on the following:

(a) Audit Note-book

(b) Continuous Audit – Advantages and disadvantages.

Answer

(a) Audit Note Book : An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. Audit note books form part of audit working papers and for each year a fresh audit note book is maintained. In case an auditor classifies his working paper into permanent and current, then audit note book shall form part of the current file. It is in any case a part of the permanent record of the auditor available for reference later on, if required.

The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily. It is also used for recording the various queries raised in the course of the work and their state of disposal. In respect of disposed queries, explanation obtained and evidence seen would be recorded in the said book, while queries remaining undisposed of would be noted for follow up.

(b) Continuous Audit: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client, during the whole year round or when for the purpose, the staff attends at quite frequent intervals say weekly basis during the financial period.

A continuous audit is preferred for the following reasons:

(i) It makes it possible for the management to exercise a stricter control over the accounts in as much as one is able to check sooner the causes of any errors of frauds uncovered by such an audit.

(ii) The frequent attendance by the staff deters persons so inclined, from committing a fraud.

(iii) The accounting staff of the client is motivated to keep the books of account up-to-date.

(iv) The constant association of the auditor with the accounts and the affairs of the client provides him with an opportunity to obtain a more detailed knowledge of the client's affairs, one of the effects thereof is that he is able to discharge his duties more efficiently.

There are certain drawbacks also, in the continuous audit, as under:

(i) Due to the audit being carried out in several installments, the audit staff may fail to keep track of things which they had not checked on their last or an earlier visit as a result whereof some of the transactions may escape audit scrutiny. The safeguard against such a position can be that on each visit, elaborate notes and check-lists should be prepared and audit should be completed up to a definite stage each time so as not to leave any loose ends.

(ii) The books of account, after these have been checked, may be tampered by the client's staff. This is a more serious matter requiring appropriate safeguards and action on the part of the management.

(iii) The audit may be uneconomic if the size of the concern is small since a great deal of time and effort would be wasted each time in preparing for the audit and in attending to the requirements of the audit party.

Question 4

What do you understand by the term "Government Audit"?

Answer

Government Audit: Government audit is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them.

It also involves presentation of a report containing explanatory comments on audit findings, together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

Government audit serves as a mechanism or process for public accounting of Government funds. It also provides public accounting of the operational management, programmes and policy aspects of public administration as well as accountability of the officials administering them.

In India, the function of Government Audit is discharged by the independent statutory authority of the C&AG of India. The audit of government expenditure is one of the major components of the Government audit. Apart from this, audit of receipts, stores and stock and performance audit is also included.

The nature of government audit is different vis-a-vis financial audit since it involves aspects of accountability and propriety.

Initially, government auditing in India as elsewhere was primarily expenditure-oriented.

Gradually, audit of receipts-tax and non-tax was taken up. With the rapid growth of public enterprises, another major area of specialisation, i.e., commercial audit came into being.

There are also a large number of non-commercial autonomous bodies financed by government in diverse fields of development and of academic study and scientific or social research which are also required to be audited from the viewpoint of public accountability.

Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executive of the spending agencies to the sanctioning or controlling authorities.

The purposes or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C & AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

Question 5

Define the purpose of a 'Letter of Engagement'.

Answer

Letter of Engagement : The legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases, the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract.

The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards.

Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax returns, checking of the sales tax -returns, etc. besides audit. In such cases, there may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts, is also covered. It is, therefore, of the greatest importance, both for the accountant and client, that each party should be clear about the nature of the engagement. It must be reduced in writing and should exactly specify the scope of the work.

The audit engagement letter is sent by the auditor to his client which documents, the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. The ICAI has issued Standard on Auditing 210 on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

Note: SA 210 "Agreeing the Terms of Audit Engagement", lays down the standards on agreeing the terms of the engagement with the client and the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

Question 6

In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment".

Answer

Obtaining Knowledge of the business : The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 – "**Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment**", The auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

(b) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 7

Medical Council of India organised a three-day International Conference of Doctors in Delhi. You are asked to audit the accounts of the conference. Draft the audit programme for audit of receipt of participation fees from delegates to the conference. Mention any six points, peculiar to the situation, which you will like to include in your audit programme.

Answer

Audit of Receipts of Participation Fees : The organization of three-day International Conference of Doctors in Delhi by Medical Council of India is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas:

(I) Internal Control System

(i) Examine the organization structure of special cell created for the International Conference, if any, and division of responsibilities amongst persons and control/custody over receipt books.

(ii) Verify the internal control system for restricting the participation of unregistered delegates.

(II) Rate of Participation Fees

(i) Verify with reference to resolution passed by the Organizing Committee/Medical Council of India.

(ii) Also verify the rate from the literature/registration form circulated for promotion of conference.

(III) Receipts of Participation Fees

(i) Verify counter foil of the receipts issued for individual registration.

(ii) Ensure that receipts are issued for all the registration received in cash.

(iii) Trace the receipts in Bank Statement or Cash Book – as the case may be.

(iv) Verify Bank Reconciliation Statement and list out dishonoured cheques.

(v) Verify subsequent recovery in respect of dishonoured cheques.

(IV) Overall Checking

(i) Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.

(ii) Cross check the total number of delegates with reference to the following:

(a) Kits distributed to participants.

(b) Bill of caterer for providing meals during conference.

(c) Capacity of the Hall.

(d) Participation Certificate if any issued.

(V) ***Foreign Delegates:*** In case of foreign delegates – if registration fees are higher – ensure that they are registered at higher fees.

(VI) Special Issues

(i) Take out list of absentees and in case of nil absentees, probe the issue further.

(ii) If certain participants are exempted from payment of fees – obtain the list along with proper authorization in this regard.

Question 8

Explain the Inherent Risk with reference to the relevant Standards on Auditing.

Answer

Inherent Risk: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

As per SA 330 "**The Auditor's Responses to Assessed Risks**" , while designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk) and obtain more persuasive audit evidence the higher the auditor's assessment of risk.

As per **SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment**, for this purpose, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Question 9

Briefly explain Management Representation.

Answer

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 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.

Question10

Write a short note on - Audit Programme.

Answer

Audit Programme: An audit programme is a detailed plan of applying the audit procedure in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work. On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. For the purpose of framing an audit programme the following points should be kept in view:

- Audit objective

- Audit procedure to be applied
- Extent of check
- Timing of check
- Allocation of work amongst the team members
- Special instructions based on past experience of the auditee

Question 11

Answer the following:

(a) How does an audit programme help to plan and perform the audit?

(b) Draft an audit programme to audit the receipts of a cinema theatre owned by a partnership firm.

Answer

(a) The role of audit programme in audit plan and performance: The audit programme is helpful both in planning and performance stages of audit:

(1) The audit programme lists down areas of audit before commencement.

(2) The audit timing is built therein; thereby it becomes a schedule of audit plan.

(3) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.

(4) It specifies the procedures to be checked during the audit.

(5) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.

(6) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.

(7) The working papers of the audit staff can be reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting on the financial statements.

(8) It also helps in preparing a diary of the performance and plan and also base for billing the clients for the time and manpower involved in the audit.

(b) Programme for receipts of cinema theatre of a firm: Audit programme for checking the receipts of a cinema theatre of a partnership firm.

(1) The partnership deed should be first scrutinized.

(2) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.

(3) The internal control for collections from sale of tickets should be checked.

(4) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.

(5) Check the rough cash book and reconcile from the stock of ticket books issued, the cash to be collected each day.

(6) Check that the cash balance and ticket sales from stock is daily checked by the manager.

(7) Check that the collections are banked daily, the very next day.

(8) See rates for each class and the ticket rates are as per current prices.

(9) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.

(10) Check the relation between the amounts of tax collected and sales.

(11) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.

(12) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.

(13) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.

(14) Do surprise checking of cash balances.

(15) See that cash collections are insured and the policy is in force.

Question 12

What are audit working papers? Discuss various contents of Permanent Audit File and Current File.

Answer

Audit Working Papers: Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit. Working papers are the property of the auditor. As per SA 230 "Audit Documentation" refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used).

Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

In case of recurring audits, auditors generally prepare two types of audit files.

(1) Permanent Audit file: It includes –

(i) Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.

(ii) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.

(iii) A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.

(iv) Copies of audited financial statements for previous years.

(v) Analysis of significant ratios and trends.

(vi) Copies of management letters issued by the auditor, if any.

(vii) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.

(viii) Notes regarding significant accounting policies.

(ix) Significant audit observations of earlier years.

(2) Current Audit file: The current file normally includes:

(i) Correspondence relating to acceptance of annual reappointment.

(ii) Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.

(iii) Evidence of the planning process of the audit and audit programme.

(iv) Analysis of transactions and balances.

(v) A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.

(vi) Evidence that the work performed by assistants was supervised and reviewed.

(vii) Copies of communications with other auditors, experts and other third parties.

(viii) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.

(ix) Letters of representation or confirmation received from the client.

(x) Conclusions reached by the auditor concerning significant aspects of the audit.

(xi) Copies of the financial information being reported on and the related audit reports.

Question 13

What precautions should be taken by an auditor while applying test check techniques?

Answer

While adopting test check technique, an auditor should take following precautions:-

(i) The transactions of the concern should be classified under appropriate heads and may be stratified in case of wide variations between the transactions of the same kind.

(ii) Authorisations, documentations, recording of the transactions should be studied right from the beginning to end.

(iii) Evaluating the system of internal control for its efficiency, soundness and capability to produce reliable accounting and financial data.

(iv) Preparation of test check plan with clear audit objective understood by the audit staff.

(v) Un-biased selection of the transactions with reference to the random number tables or other statistical methods.

(vi) Identification of the areas where test check may not be done.

(vii) Based on degree of reliance and the confidence level required in the audit, the number of transactions to be selected for each test plan should be pre-determined.

(viii) Setting up criteria to judge what constitute material or immaterial errors. Further investigation of only material errors be carried out and all immaterial errors may be avoided.

Question 14

Should branch auditor of a company comply with the request of the principal auditor of the company to give photocopy of the working papers pertaining to the branch audit? Explain.

Answer

As per SA 230 “Audit Documentation”, Working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is not required to provide the clients or other auditors’ access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

Question 15

Write short notes on the Surprise checks.

Answer

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.

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.

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 stock, 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.

Question 16

The management of Ankita Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. It wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management. Comment.

Answer

Management Representation: The management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. There cannot be any restriction on scope of audit in case of statutory audit.

The management representation, according to SA 580 - Written Representations, cannot substitute other audit evidence *that the auditor could reasonably expect to be available* to the auditor.

The audit evidences available for checking receivables- say, invoices, debt acknowledgement documents, receipts, statement of accounts, confirmations etc., are available evidences which auditor is duty bound to verify.

Just because management had owned responsibility for the correctness of its evaluation of receivables, the auditor cannot shirk his responsibility. This is negligence on his part if he relies on the management representation without assessing the corroborative available evidences.

Question 17

The Vidhwat College, an institution managed by Dayal Trust, has received a grant of ₹ 1.35 crore from Government nodal agencies for funding a project of research on rural health systems in India. Draft an audit programme for auditing this fund in the accounts of the college. Comment.

Answer

Audit of grant fund of a college:

1. The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.
2. The government policy on grant should be checked with the relevant application, brochure, and sanction advices.
3. The conditions stipulated in award of grant should be studied.
4. The receipt of grant should be vouched with bank statement.
5. The budgeted heads of expenses for the project and actual utilization of the fund should be checked.
6. The purchase of capital items covered within the project should be correctly capitalized. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.
7. The expenses of revenue nature incurred from and out of grant in the form of salaries to field staff, materials purchased, traveling, survey and field work expenses and analysis and preparation of reports etc should be vouched with the relevant vouchers.
8. The expenses should be accounted as withdrawal of amounts from the fund. It is to be checked that these expenses are not accounted in income and expenditure of the college.
9. In balance sheet, the fund account should be shown as a liability with a separate schedule indicating the receipts, payments and balance as on the date of closing of accounts.
10. The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.
11. The physical verification of assets pertaining to the project should be done by the management of the college.
12. The progress of the project may be ascertained from the minutes, committee meeting extracts and reports. This must be done to ensure that the project fund is genuinely utilized for the purposes it intended for.

Question 18

In a system based audit, test checking approach provides a good base for the auditor to form his opinion on the financial statement. Give your comments.

Answer

Test Checking in System Based Audit: System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that:

(i) All the transactions and information have been recorded,

(ii) Fraud and errors, if any, in preparing the accounts will be identified,

(iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,

(iv) There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he assorts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is week, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

Question 19

Explain the Relationship between materiality and audit risk.

Answer

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.

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.

Question 20

Explain in brief, the utility of Working Paper to an auditor.

Answer

Utility of Working Paper: Audit working papers are very useful to the auditor in the following way:

(i) It provides guidance to the audit staff with regard to manner of checking the schedules.

(ii) The auditor is able to fix responsibility on the staff members who signs each schedule.

(iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.

(iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

Question 21

Comment on the following situations/statements:

(a) Auditor of AAS Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence.

(b) M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year.

Answer

(a) As per SA 580 on "Written Representations" in the course of audit, an auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. In such a situation he may rely on the submission by the management but he should seek corroborative audit evidence from sources inside or outside the entity and evaluate the representation made by management.

Management representation is not a substitute for other audit evidence. The auditor should seek and apply normal audit procedure. Mere possession of a certificate does not absolve the auditor from his liability. He should not seek or accept certificates when subject matter is such that it is capable of verification from internal and/or external evidences.

In the instant case, the stock of imported material lying with the transporter can be easily verified with purchase order, invoice, bill of entry, custom document, payment of F.C. etc.

Therefore the auditor in this instant case has not used available evidences. He should not have rested with the certificate obtained from the management and could have evaluated other evidences. He may be held liable for negligence and professional misjudgment.

(b) As per SA 230 on "Audit Documentations" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor's exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can't insist upon the auditor to handover the working papers of the previous year.

Question 22

What does SA 230 says about utility, ownership, custody and retention of working papers?

Answer

Utility of working papers*:* According to SA 230 on 'Audit Documentation' working papers help in planning and performance of the audit, supervision and review of the audit work and provide evidence of the audit work performed to support the auditor's opinion.

Ownership of working papers*:* Working papers are the property of the auditor and he may, at his discretion, make portions of or extracts from his working papers to his client.

Custody of working papers: The auditor should adopt reasonable procedures for safe custody and confidentiality of his working papers.

Retention of working papers*:* Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Question 23

Mention, any four, areas where surprise check can significantly improve the effectiveness of an audit.

Answer

Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are:

(i) Verification of cash and investments.

(ii) Inventory

(iii) Internal control and internal checks

(iv) Books of prime entries and statutory registers.

Question 24

Write short notes on the following:

(a) Advantages of Statistical sampling in Auditing.

(b) Contents of Audit Note-book.

Answer

(a) Advantages of statistical sampling in Auditing: The advantages of using statistical sampling technique in auditing are:

(i) Sample size does not increase in proportion to the increase in the size of population.

(ii) Sample selection is more objective and based on law of probability.

(iii) This provides a means of estimating the minimum sample size associated with a specified risk and precision level.

(iv) It also provides a means for deriving a calculated risk and corresponding precision.

(v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistake are not large.

(b) Contents of Audit Note book: Audit note book contains large variety of matters observed during the course of audit. Significant matters observed during audit which should be recorded in audit note book are normally the following:

(i) Audit queries not cleared immediately.

(ii) Mistakes or irregularities observed during the course of audit.

(iii) Unsatisfactory book-keeping arrangements, costing method.

(iv) Important information about the company which is not apparent from the accounts.

(v) Special points requiring consideration at the time of verification of annual accounts.

(vi) Important matters for future reference.

Question 25

Write short note on Knowledge of Client's business.

Answer

Knowledge of client's business - as per SA315, the auditor "**Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment**" 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

Question 26

(a) Explain concept of materiality and factors which act as guiding factors to this concept.

(b) Describe a set of instructions, which an auditor has to give to his client before the start of actual audit.

Answer

(a) Concept of materiality: SA 320 "Materiality in Planning and Performing an Audit", establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.

The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not.

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

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 above. It has qualitative dimensions as well.

(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 VI requires disclosure of items of expenditures which are in excess of one percent or₹ 500, whichever is less.

(vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

(b) Following instructions are given by the auditor to the client before the start of audit:

(i) The accounts should be total up and trial balance and final accounts to be kept ready.

(ii) Vouchers should be serially arranged.

(iii) Schedule of debtors and creditors should be prepared.

(iv) Schedule of outstanding expenses, prepaid expenses and accrued income to be kept ready.

(v) A list of bad and doubtful debts should be prepared.

(vi) Schedule of investments should be prepared.

(vii) Certified list of goods returned to be prepared.

(viii) Statement of permanent capital expenditure to be prepared.

(ix) Schedule of deferred revenue expenditures to be prepared.

(x) Names and addresses of managers and other officers should be kept ready.

Alternative answer

(1) It is the responsibility of the management to prepare the financial statements, to select and consistently apply the appropriate accounting policies

(2) Management is responsible for the maintenance of adequate accounting records and internal controls for safeguarding assets of the company

(3) Unrestricted access to whatever records, documentation and other information required in connection with the audit.

(4) Management's responsibility for making judgements of estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity.

(5) Management's responsibility for preparation of the financial statements as a going concern.

Question 27

(a) X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the Company. In the course of audit of the company, the auditor was unable to obtain appropriate sufficient audit evidence regarding receivables. The client requested for a change in the terms of engagement.

(b) Write short note Audit risk at the account balance level and at the class of transactions level.

Answer

(a) Change in terms of engagement

1. An auditor who is required to change the engagement which requires lower level of assurance before the completion of engagement should consider the appropriateness of doing so.

2. But when the terms of engagement are changed, both the auditor and the client should agree on the new terms.

3. However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.

4. In the instant case, the auditor was unable to obtain sufficient evidence regarding receivables. The client requested him for a change in the terms of the agreement to avoid qualified/adverse opinion. Hence there is no reasonable justification for change in the terms of engagement.

5. Thus the auditor should not agree for change in the terms of engagement letter.

(b) Audit risk at the account balance level and at the class of transactions level

Majority of audit procedures are directed to and carried out at the account balance level and the class of transactions level. At these levels, the auditor uses professional judgment to evaluate numerous factors to assess inherent risk:

(i) Financial statement of accounts likely to be susceptible to mismanagement.

(ii) The complexity of underlying transactions which might require the use of the work of an expert.

(iii) The amount of judgment involved in determining account balances.

(iv) Susceptibility of assets to loss or misappropriation.

(v) The completion of unusual and complex transactions, particularly at or near year end.

Question 28

(a) "The auditor is faced with sampling risk in both tests of control and substantive procedures."

Comment on this statement with reference to SA 530 on "Audit Sampling".

(b) What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

Answer

(a) Sampling Risk: (SA 530) : Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(b) Extent of reliance on analytical procedures (SA-520): The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(i) Materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material.

(ii) Other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts.

(iii) Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(iv) Assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

(v) The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Question 29

Write short notes on the following:

(a) Reliability of external confirmations.

(b) Physical verification of fixed assets "at reasonable intervals".

(c) Factors governing modes of communication of auditor with those charged with governance.

(d) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption.

Answer

(a) Reliability of external confirmations: As per SA 505 "External Confirmation", the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures.

The factors that affect the reliability of confirmations include:

(i) The control which the auditor exercises over confirmation request and responses;

(ii) The character of respondents and

(iii) Any restrictions included in the response or imposed by the management

(b) Physical verification of fixed assets "at reasonable intervals": Clause 4(i) (b) of CARO 2003 requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable interval. "Reasonable Intervals" depends upon the circumstances of each case. The factors to be considered in this regard includes the number of assets, nature of assets, relative value of assets, difficulty in verifications, situation and spread of the assets etc.

The management may decide about the periodicity of physical verification of fixed assets considering the above factors while an annually verification may be reasonable; it may impracticable to carry out the same in some cases. Even in such cases the verification program should be such that all assets are verified at least once in every three years where verification of all assets is not made during the year, it will be necessary for the auditor to report the fact, but if he is satisfied regarding the frequency of verification, he should also make a suitable comment to that affect

The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account.

It would be appropriate for the auditor to obtain a management representation letter confirming that the fixed assets are physically verified by the company in accordance with the policy of the company. The management representation letter should also mention the periodicity of the physical verification of fixed assets. The letter should also include the details of the material discrepancies noticed during the physical verification of the fixed assets. If no discrepancies were noticed during the physical verification, the management representation letter should also mention this fact.

(c) Factors governing modes of communication of auditor with those charges with governance : As per SA 260, “Communication with Those Charge with Governance” the auditor may decide whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

(i) The size, operating structure, control environment, and legal structure of the entity.

(ii) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity’s general purpose financial statements.

(iii) Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.

(iv) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(v) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(vi) Whether there have been significant changes in the membership of a governing body

(d) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption : As per SA 570, “Going Concern**”,** the following are the relevant procedures that are relevant in this connection:

- Analyse and discuss cash flow, profit and other relevant forecasts with management.
- Review events after the balance sheet date for items affecting the entity's ability to continue as a going concern.
- Analyse and discuss the entity's latest available interim financial statements.
- Review the terms of debentures and loan agreements and determine whether any have been breached.
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- Review the status of matters under litigation and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such

parties to provide additional funds.

- Consider the entity's position concerning unfilled customer orders.

Question 30

Write short note on the following:-Stratified sampling.

Answer

Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgement.

The reason behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

EXERCISES

1 *The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles". Explain*

2 *Distinguish between:*

(a) *Concurrent Audit and Annual Audit.*

(b) *Audit Principles and Audit Techniques.*

3 *Write short notes on the following:*

(a) *Continuous Audit*

(b) *Audit Working Papers*

4 *Comment on the following:*

(i) *Concurrent audit provides a supplementary management tool.*

(ii) *Audit Risk and its Assessment.*

5 *State briefly six important aspects to be considered by an auditor while conducting an audit.*

6 *What are Audit Working Paper and why should they be carefully preserved by the auditor?*

7 (a) *What precautions are to be taken in the application of test-checking techniques?*

(b) *Mention any of the four items which are not suitable for test-checking.*

4

Internal Control

BASIC CONCEPTS

Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

Internal Control in CIS Environment: The internal controls include both manual procedures and procedures designed into computer programs. They comprise the overall controls affecting the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls :

a. Organization and management controls

b. Application systems development and maintenance controls

c. Computer operation controls.

d. Systems software controls.

e. Data entry and program controls.

CIS Application Controls :

A. Controls over input.

B. Controls over processing and computer data files.

C. Controls over output.

"**Internal check:** Internal check has been defined by the Institute of Chartered Accountants of England and Wales as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud".

A Flow Chart: It is a graphic presentation of each part of the company's system of internal control.

Internal Audit: It is a thorough examination of the accounting transactions as well as that of the system according to which these have been recorded, with a view to reassuring the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the management

Examination in Depth: It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods.

Audit Trail: An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output.

Audit Risk: Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. There are three components of audit risk:

(i) **Inherent risk**: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls; and

(ii) **Control risk**: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control; and

(iii) **Detection risk**: the risk that the practitioner will not detect a material misstatement that exists.

Audit around the Computer: Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done.

Auditing through the Computer: This approach involves actual use of computer for processing the information by auditor

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. CAATs are such techniques applied through the computer which are used in the verifying the data being processed by it.

Requirements of CARO, 2003 : Clause 4(vii) of CARO, 2003 requires the auditor to comment whether the company has an internal audit system commensurate with the size and nature of the business. The clause is required to be commented upon by the auditor in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned.

Question 1

"The overall objective and scope of an audit does not change in an EDP environment". Comment

Answer

The principal objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to ensure that the financial statements reflect a true and fair view. The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. This would involve assessment of reliability and sufficiency of the information contained in the accounting records and other source data by study and evaluation of accounting system and internal controls in operation.

The overall objective and scope of an audit does not change in an EDP environment but the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Thus when auditing in an EDP environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how EDP affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The auditor should also have sufficient knowledge of EDP to implement the auditing procedures, depending on the particular audit approach adopted.

Thus, it is clear from the above that overall objective and scope of audit does not change irrespective of fact that whether the accounting information is generated manually or through EDP.

Question 2

Write a short note on - Examination in Depth.

Answer

Examination in Depth: It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, a purchase of goods may commence when a predetermined re-order level has been reached. The ensuing stages may be summarised thus:

(i) Requisitions are pre-printed, pre-numbered and authorised;
(ii) official company order, also sequentially pre-numbered, authorised and placed with approved suppliers only;
(iii) receipt of supplier's invoice;
(iv) receipt of supplier's statement;
(v) entries in purchases day book;
(vi) postings to purchase ledger and purchase ledger control account;
(vii) cheque in settlement;
(viii) entry on bank statement and returned "paid" cheque (if requested);
(ix) cash book entry;
(x) posting from cash book to ledger and control account, taking into account any discounts.
(xi) receipt of goods, together with delivery/advice note;
(xii) admission of goods to stores;
(xiii) indication, by initials or rubber stamp on internal goods inwards note, of compliance with order regarding specification, quantity and quality;
(xiv) entries in stores records.

It should be noted that the above list is not necessarily comprehensive, nor does its constituent stages inevitably take place in the sequence suggested. The important point to note is that from the moment it was realised that once a re-order level had reached, a chain of events was put in motion, together leaving what may be termed as "audit trail". Each item selected for testing must be traced meticulously, and although sample sizes need not be large, they must, of course, be representative.

It is an acceptable practice to check a slightly smaller number of transactions at each successive stage within a depth test, on the statistical grounds (based on probability theory) that the optimum sample size decreases as the auditor's "level of confidence" concerning the functioning of the system increases. Examination in depth has been found indispensable in modern auditing practice and, if intelligently conducted, its reconstruction of the audit trail reveals more about the functioning (or malfunctioning) of the client's system in practice than the haphazard and mechanical approach to testing.

Question 3

'Doing an audit in an EDP environment is simpler since the trial balance always tallies' Analyse critically?

Answer

Audit in EDP environment : Though it is true that in EDP environment the trial balance always tallies, the same can not imply that the job of an auditor becomes simpler. There can still be some accounting errors like omission of certain entries, compensating errors, duplication of entries, errors of commission in the form of wrong A/c head is posted., possibility of "Window Dressing" and/or "Creation of Secret Reserves" where the trial balance tallied . . At present, due to complex business environment the importance of trial balance cannot be judged only upto the arithmetical accuracy but the nature of transactions recorded in the books and appear in the trial balance should be focused.

The emergence of new forms of financial instruments like options and futures, derivatives, off balance sheet financing etc have given rise to further complexities in recording and disclosure of transactions. In an audit, besides the tallying of a trial balance, there are also other issue like estimation of provision for depreciation, valuation of inventories , obtaining audit evidence, ensuring compliance procedure and carrying out substantive procedure, verification of assets & liabilities their valuation etc. which still requires judgement to be exercised by the auditor.

Responsibility of expressing an audit opinion and objectives of an audit are not changed in the audit in EDP environment. Therefore, it can be said that simply because of EDP environment and the trial balance has tallied it does not mean that the audit would become simpler.

Question 4

Write a short note on - Audit Trail.

Answer

Audit Trail: An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail.

For example, the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt , to management's own healthy scepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor.

It is once iterated that there is an abundance of documentation upon which the auditor can use his traditional symbols of scrutiny, in the form of colored ticks and rubber stamps. Specifically:

(i) The output itself is as complete and as detailed as in any manual system.

(ii) The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction.

Question 5

What are the different design and procedural aspects of EDP systems?

Answer

The different design and procedural aspects of EDP systems are:

(i) **Consistency of Performance:** EDP systems perform functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction type and conditions that could occur are anticipated and incorporated into the system.

(ii) **Programmed Control Procedures:** The nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g., protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.

(iii) **Single Transaction Update of Multiple or Data Base Computer Files:** A single input to the accounting system may automatically update all records associated with the transaction (e.g., shipment of goods documents may update the sales and customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.

(iv) **Systems Generated Transactions:** Certain transactions may be initiated by the EDP system itself without the need for an input document. The authorization of such transactions may neither be supported by visible input documentation nor documented in the same way as transactions which are initiated outside the EDP system (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized terms contained in a computer program).

(v) **Vulnerability of Data and Programme Storage Media:** Large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic discs and tapes. These media are vulnerable to theft, or international or accidental destruction.

Question 6

Explain the Internal controls in an EDP Environment.

Answer

Internal controls in an EDP Environment: The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programmes. Such manual and computer controls affect the EDP environment (general EDP controls) and the specific controls over the accounting applications (EDP application controls).

General EDP Controls: The purpose of general EDP controls is to establish a framework of overall control over the EDP activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. These controls may include:

(a) Organisation and management controls are designed to establish an organizational framework over EDP activities, including:

   (i) Policies and procedures relating to control functions.

   (ii) Appropriate segregation of incompatible functions.

(b) Application systems development and maintenance controls are designed to establish control over:

   (i) Testing, conversion, implementation and documentation of new or revised systems.

   (ii) Changes to application systems.

   (iii) Access to systems documentation

   (iv) Acquisition of application systems from third parties.

(c) Computer operation controls are designed to control the operation of the systems and to provide reasonable assurance that:

   (i) The systems are used for authorised purposes only.

   (ii) Access to computer operations is restricted to authorised personnel.

   (iii) Only authorised programs are used.

   (iv) Processing errors are detected and corrected.

(d) Systems software controls include:

   (i) Authorisation, approval, testing, implementation and documentation of new systems software and systems software modifications.

   (ii) Restriction of access to systems software and documentation to authorised personnel.

(e) Data entry and program controls are designed to provide reasonable assurance that :

   (i) An authorisation structure is established over transactions being entered into the system.

   (ii) Access to data and programs is restricted to authorised personnel.

   (iii) Offsite back-up of data and computer programmes.

   (iv) Recovery procedures for use in the event of theft, loss or international or accidental destruction.

   (v) Provision for offsite processing in the event of disaster;

EDP Application Controls: The purpose of EDP application controls is to establish specific control procedures over the accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis. These include:

(a) *Controls over input are designed to provide reasonable assurance that:*

(i) Transactions are properly authorised before being processed by the computer.

(ii) Transactions are accurately converted into machine readable form and recorded in the computer data files.

(iii) Transactions are not lost, added, duplicated or improperly changed.

(iv) Incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis.

(b) *Controls over processing and computer data files are designed to provide reasonable assurance that:*

(i) Transactions, including system generated transactions, are properly processed by the computer.

(ii) Transactions are not lost, added, duplicated or improperly changed.

(iii) Processing errors are identified and corrected on a timely basis.

(c) *Controls over output are designed to provide reasonable assurance that:*

(i) Results of processing are accurate.

(ii) Access to output is restricted to authorised personnel.

(iii) Output is provided to appropriate authorised personnel on a timely basis

Question 7

Write a short note on - the Audit Risk.

Answer

Audit Risks: As per “SA 200 (Revised) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor’s business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Three components of audit risk are:

- ♦ Inherent risk (risk that material errors will occur);
- ♦ Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
- ♦ Detection risk (risk that any remaining material errors will not be detected by the auditor).

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.

Control risk - Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.

Detection risk - For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;

- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

Question 8

Can the External Auditor rely upon the work of an Internal Auditor?

Answer

Reliance on the Work of Internal Auditor: The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors ", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).

- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

Question 9

What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool.

Answer

Audit Trail: 'Audit trail' refers to a situation where it is possible to relate, on a "one – to –one" basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction of each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross – referencing. In first and early second generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the EDP environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example:

i. Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions such as discounts and interest calculations may be generated by computer programmes with no visible authorization of individual transactions.

ii. The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers invoices may be matched by a computer programme. In addition, programmed control procedures such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.

iii. Output reports may not be produced by system or a printed report may only contain summary totals while supporting details are retained in computer files.

Special audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The auditor can use the computer to test:

- the logic and controls existing within the system, and
- the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. The effectiveness and efficiency of auditing procedure may be enhanced through the use of CAATs. Properly, two common types of CAATs are in vogue, viz., test pack or test data and audit software or computer audit programmes.

Question 10

Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau?

Answer

Requirements of Internal Control System at a Service Bureau: Various requirements to establish or evaluate a system of internal control for applications processed at a service bureau are stated below:

1. Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.
2. Need for a system testing including all clerical procedures at the user company.
3. Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.

4. Planning procedure so that error is identified by documents provided by the bureau. The user must ensure that prompt correction and resubmission of rejection to meet the bureau processing schedule.
5. Establishing a system in the user company to ensure that all exceptional reports are received from bureau.
6. Establish clerical control to verify the accuracy of computer processing.
7. Normally, user has no physical control over the files; therefore, high control over the maintenance of data on master files should be established.

Question 11

"Installation of Computer Operating System has created both benefits and problems for auditors". Explain the Statement?

Answer

Computer Operating Systems and the Auditor: The installation of computer operating system is an integral and absolutely essential part of a computer even in a stand alone PC-based environment. In fact it is difficult to visualize a computer to be operational without installation of the operating system. With the advancement of technology, the operating systems are part of the server or hard disc and provide lots of options and flexibility to the user. The provision of all these built-in-features is quite beneficial to user and the auditor alike. The data stored in the system can be extracted depending upon the requirement, e.g., records relating to students can be region-wise, city-wise, examination centre-wise, etc to compare the performance. At the same time, these advanced features of operating systems have given rise to several general hazards associated with it. In these circumstances, it becomes essential to restrict the access to data by ensuring proper security system such as passwords and other access controls, etc. However, such system at time can be hacked and then the entire data base is vulnerable to manipulation. Thus, from the auditor's point of view installation of operating system have created both benefits and problems. The major benefits flow from the fact of examination of execution of transactions, taking samples, etc. while problems might arise to potential manipulation of the data. It may however, be noted that benefits from the operating system for outweigh the problems associated with it.

Question 12

Explain briefly the approaches to EDP auditing?

Answer

Approaches to EDP Auditing: Computerisation of accounts does not affect the basic objective of auditing. However, the auditor would need to modify his audit procedures, approach and technical capabilities so as to be able to form an opinion on the accounts processed in a computerised environment. The auditor must plan whether or not to use the computer. The two approaches are commonly called "auditing around the computer" and "auditing through the computer".

Audit around the Computer: Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into account. Rather the principle of conventional audit like examination of internal controls and substantive testing is done. The auditor views the computer as a black box, as the application system processing is not examined directly. The main advantage of auditing around the computer is its simplicity. Audit around the computer is applicable in the following situations:

(i) The system is simple and uses generalised software that is well tested and widely used.

(ii) Processing mainly consists of sorting the input data and updating the master file in sequence.

(iii) Audit trail is clear. Detailed reports are prepared at key processing points within the system.

(iv) Control over input transactions can be maintained through normal methods, i.e. separation of duties, and management supervision.

Generalised software packages, like payroll and provident fund package, accounts receivable and payable package, etc. are available, developed by software vendors. The auditor may decide not to go in details of the processing aspects, if there are well tested widely used packages provided by a reputed vendor. However, he has to ensure that there are adequate controls to prevent unauthorised modifications of the package. However, it may be noted that all such generalised packages do not make the system amenable to audit. Some software packages provide generalised functions that still must be selected and combined to achieve the required application system. In such a case, instead of simply examining the systems input and output, the auditor must check the system in depth to satisfy him about such system. The main disadvantages of the system of auditing around the computer are:

(a) It is not beneficial for complex systems of large scale in very large multi unit, multi locational companies, having various inter unit transactions. It can be used only in case of small organisations having simple operations.

(b) It is difficult for the auditor to assess the degradation in the system in case of change in environment, and whether the system can cope with a changed environment

Audit through the Computer: The sophistication of computers have finally reached the point where auditors can no longer audit around the system. They are forced to treat the computers as the target of the audit and audit through it. Auditing through the computer requires that the auditor submits data to the computer for processing. The results are then analysed for the processing reliability and accuracy of the computer programme. Technical and other developments that necessitated this approach include the following:

- On-line data entry.
- Elimination or reduction of print-outs.
- Real time files up dating.

The auditor can use the computer to test:

(a) the logic and controls existing within the system; and

(b) the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

There are several circumstances where auditing through the computer must be used:

(i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.

(ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer programme may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.

(iii) The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.

(iv) There are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing, the auditor also can assess the system's ability to cope with environment change.

The primary disadvantages of the approach are generally high costs and the need for extensive technical expertise when systems are complex. However, these disadvantages are really not that important if auditing through the computer is the only viable method of carrying out the audit.

Auditing through computer may be conducted through test data, computer programme, etc.

Question 13

Write a short note on - Independence of Internal Auditor.

Answer

Independence of Internal Auditor: The concept of independence is equally relevant for internal auditor also. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. Internal auditor is part of the management but he evaluates the functioning of the management at different levels.

Therefore, to be efficient and effective, the internal auditor must have adequate independence. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. To ensure his independence he is made responsible directly to the Board of Directors through audit committee. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.

Question 14

Why are Computer Aided Audit Techniques (CAAT) required in EDP audit? What are the advantages of CAATs?

Answer

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. 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 nature of EDP processing that demand the use of Computer Aided Audit Techniques (CAAT) are:

(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 an EDP 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 EDP systems, the results of processing may not be printed or only a summary data may be printed. Thus, the 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.

Advantages of CAAT

(i) ***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 –

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

(b) 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.

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

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

Question 15

What are the special steps involved in framing a system of Internal Check?

Answer

General Considerations in Framing a System of Internal Check: The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:

(1) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.

(2) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

(3) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.

(4) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(5) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.

(6) The system of Budgetary Control should be introduced.

(7) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.

(8) The financial and administrative powers should be sub divided very judicially and the effect of such division should be reviewed periodically.

(9) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

Question 16

In a medium size trading organisation the accountant was given additional responsibility of making recoveries from the debtors. On one occasion, when an insurance claim of ₹ 25,000 was received, he credited the same to the account of a debtor and misappropriated the cash which he had recovered from the said debtor. Pinpoint weaknesses in the internal control system which led to this situation. Comment.

Answer

Following two essential features of internal control are relevant here:

(i) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and

(ii) Segregation of accounting and custodial functions.

Weakness in internal control system in the instant case:

(a) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.

(b) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.

(c) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system.

Question 17

Answer the following:

(a) State any four important elements of input control in processing of data in a computerised accounting system.

(b) What are the disadvantages of the use of an audit programme?

Answer

(a) Control over input in a computerized data system (any four)

(i) The input fed into the computer should be authorized. The authorization levels should be checked. The authorization is effected by levels of access to the entry for the computer system. The access control is operated through use of password and logging procedures.

(ii) The system should devise controls to check that data input are accurate.

(iii) The input document should be reviewed and verified by another person after preparation.

(iv) Transaction should be accurately converted into machine readable language and recorded in a computer data file.

(v) The transactions are not lost, duplicated, or changed without authorization.

(vi) There should be validity and cross reference checks inbuilt in the system to throw light on errors which appear in the process of feeding input.

(vii) Incorrect transactions are thrown out by a list which must be corrected, resubmitted before the process could run on the inputs.

(viii) The check digit total of financial information contained in the document or hash total may be used to act as a control tool.

(ix) The serial control may be used in inputting data that are to follow serial sequence. Any deviation in serial sequence will have to be automatically signaled out.

(b) Disadvantages of the use of an Audit Programme

(i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on.

(iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(iv) A hard and fast programme may kill the initiative and innovation of efficient and enterprising assistants.

Question 18

Write a short note on - Statutory Auditor versus Internal Auditor.

Answer

Statutory Auditor versus Internal Auditor:

STATUTORY AUDITOR	INTERNAL AUDITOR
1. The extent of the work undertaken by statutory auditor arises from the responsibility placed on him by the statutes.	The extent of the work undertaken by the internal auditor is determined by the management.
2. The approach of this auditor is governed	The approach of this auditor is with a view to

by his statutory duty to satisfy himself that the accounts to be presented to the shareholder show a true and fair view of the financial position.	satisfy that the accounting system is efficient, so that the accounting information presented to the management is accurate and discloses material facts.
3. This auditor is responsible directly to the shareholder.	This auditor is responsible to management.
4. External auditor is not the employee of the company so he has independent status.	Internal auditor is an employee of the company. So he can not enjoy independence that statutory auditor has.

Question 19

What are the inherent limitations of Internal Control system?

Answer

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:-

(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.

Question 20

What are the aims of internal control so far as Financial and Accounting aspects are concerned?

Answer

Aims of Internal Control in relation to Financial and Accounting Aspects: Internal controls relating to financial and accounting aspects are concerned with achieving the following objectives –

(a) transactions are executed in accordance with management's general or specific authorisation;

(b) all transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(c) assets and records are safeguarded from unauthorised access, use or disposition; and

(d) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Thus, it is clear from the above that internal controls relating to accounting and financial aspects primarily aim at providing the flow of work through various stages so as to segregate the authorising, recording and custodial aspects of the transaction.

For example, in a transaction involving purchase of fixed assets, the Board may authorise the Purchase Manager to purchase fixed assets, the recording of the purchase is performed by the Accounts Department, while the custody of assets rests with User Department. At the authorisation stage, the internal controls aim at ensuring that transactions are executed in accordance with the management's authorisation, general or specific. Thus, it ensures compliance with prescribed policies and procedures.

The internal controls at the recording stage, in particular, aim at ensuring that no single person can handle a transaction from the beginning to the end. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains knowledge of the design of the accounting and internal control systems, and their operation.

For example, an auditor may perform a "walk-through" test that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things.

➢ The size and complexity of the entity and of its information system.

- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity's documentation of specific internal controls.
- The auditor's assessment of inherent risk.

Question 21

Explain in brief the Relationship between Statutory Auditor and Internal Auditor.

Answer

Relationship between Statutory Auditor and Internal Auditor: The function of an internal auditor being an integral part of the system of internal control, it is obligatory for a statutory auditor to examine the scope, independence and effectiveness of the work carried out by the internal auditor. CARO, 2004 also requires the statutory auditor to comment on the internal audit system.

Though the roles and primary objectives of internal and statutory audit differs, some of their means of achieving their respective objectives are similar. Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures. Depending upon such evaluation, the statutory auditor may be able to adopt less extensive procedures.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.

It must however be mentioned that the area of co-operation between the statutory and internal auditor is limited by the fact that both owe their allegiance to separate authorities, the shareholders in the case of statutory auditor and the management in the case of internal auditor.

Question 22

Distinguish between the Internal Control Questionnaire and Internal Control Evaluation.

Answer

Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE): The internal control questionnaires show the area where weakness occur or likely to occur. They do not give any idea of the importance of those weaknesses. The Internal Control Evaluation brings to light importance of those weakness disclosed by ICQ.

Main points of distinctions are:

(i) ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation in materiality. ICE isolates the main control objectives within the area of review.

(ii) Weaknesses are highlighted by answer "Yes" on ICE compared with 'No' on ICQ.

(iii) Answer 'no' in ICQ indicates a weakness real or potential, but its significance is not revealed. Whereas ICE requires audit personnel to state whether, an apparent weakness may prove to be material in relation to the accounts as a whole.

(iv) The 'Control Checklist' in ICE is more than a summary of key control factors, and is no substitute for ICQ.

Question 23

State the circumstances where the auditing through the computer must be used.

Answer

Auditing Through the Computer: There are several circumstances where auditing through the Computer must be used:

(i) The application system processes large volumes of input and produces large volumes of output that makes extensive direct examination of the validity of input and output difficult.

(ii) Significant parts of the internal control system are embodied in the computer system.

(iii) The logic of the system is complex and there are portions that facilitate use of the system or efficient processing.

(iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

Question 24

Why are computer assisted audit techniques (CAAT) needed in a Computer Information Systems (CIS) environment and how it helps the auditor in obtaining and evaluating audit evidences?

Answer

Computer Assisted audit techniques (CAAT) may be required in a CIS environment in the following circumstances:

- The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- The lack of visible output may necessitate access to data retained on files readable only by the computer.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

(*i*) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.

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

Question 25

How would you assess the reliability of internal control system in computerised information system?

Answer

For evaluating the reliability of internal control system in CIS, the auditor would consider the followings:-

(i) That authorised, correct and complete data is made available for processing.

(ii) That it provides for timely detection and corrections of errors.

(iii) That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.

(iv) That it ensures the accuracy and completeness of output.

(v) That it provides security to application softwares & data files against fraud etc.

(vi) That it prevents unauthorised amendments to programs.

Question 26

A company has ₹ 60 lakh of paid up Capital and ₹ 3 crore of average Annual Turnovers of past three years preceding the financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary. Comment as an auditor of the above company.

Answer

As per CARO provisions, an auditor is required to comment on the Company's internal audit system if its paid up capital and reserves exceeds ₹ 50 lakh as at the commencement of the financial year or its average annual turnover exceeds ₹ 5 crore for consecutive three financial years preceding the financial year concerned, whether the company has an internal audit system commensurate with size and nature of the business.

Therefore, in the above case, because company's paid up capital and reserves exceeds ₹ 50 lakh, the auditor has to comment under CARO that the company does not have an internal audit system.

Question 27

In a CIS environment, what are the different Design and Procedural aspects, which are different from those found in Manual systems?

Answer

These different design and procedural aspects of systems include:

(i) Consistency of performance: CIS system performed functions are more reliable provided that all transactions types and conditions that could occur are anticipated and incorporated into the system.

(ii) Programme control procedures: These procedures can be designed to provide controls with limited visibility.

(iii) Single transaction update of multiple or data base computer file: A single input into the accounting system may automatically update all records associated with the transaction.

(iv) Systems generated transactions: Certain transactions may be initiated by the CIS system itself without the need for an input document. E.g., Interest may be calculated and changed automatically to customer's account balances.

(v) Vulnerability of data and programme storage media: Large volume of data may be stored on portable or fixed storage media, such as magnetic disks and tapes.

Question 28

Mention any six points to be considered for good internal control for collection of tuition fees from students of college.

Answer

Internal control points for collection of tuition fees:

(i) There must be a clear cut tuition fee structure approved by the college council.

(ii) The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.

(iii) The paying in slip when filled by the students, should be checked for its correctness as to applicable amount etc by one clerk and the amount should be entered in a scroll. He must initial the slip which authorises the cashier to accept the fees as per slip.

(iv) The cashier scroll and the authorising officer/s scroll should be checked by an officer daily.

(v) All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.

(vi) Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinised by college officers.

(vii) Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.

(viii) Delayed remittance should carry fines or compensating charges for delay.

(ix) When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.

Question 29

Write short note on Letter of Weakness.

Answer

Letter of weakness

(1) The auditor does compliance procedure to ascertain that the internal control system exist in the entity; it works effectively; it work continuously in the entity during review period.

(2) When he comes across any weakness in the control points, he issues letter of weakness.

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

(4) Lapses in operation of internal control too are reported in the communication of weakness.

(5) The communication of weakness is reporting to management of such weakness in design and operation of internal control as have come to notice of auditor during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

Question 30

(a) Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control.

(b) State clearly the circumstances where "Auditing through the computer" approach must be used.

Answer

(a) Internal Control Questionnaire: Internal control questionnaire is a comprehensive series of questions concerning internal control. It is the most widely used form for collecting information about the existence, operation and efficiency of internal control in the organisation.

In the questionnaire, questions are generally so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies *or* apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail.

(b) 'Auditing through the computer approach': The auditor can use the computer to test:

(a) The logic and controls existing within the system.

(b) The records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

Following are several circumstances where auditing through the computer approach must be used:

(i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.

(ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.

(iii) The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing.

(iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

Question 31

*Write short note on the Internal control in small business***.**

Answer

Internal control in small business: The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However, many controls which would be relevant to large entities are not practical in the small business e.g. in small business accounting work may be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severally limited.

Inadequate segregation of duties may, in same cases, be off set by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditors' opinion on the financial information may have to be obtained largely through the performance of substantive procedure.

EXERCISES

1 *State with reasons your views on the following:*

A senior assistant of X & Co., Chartered Accountants drew up his audit programme without evaluating internal controls of T Ltd. When the partner asked firm for the reason, he stated that the controls were developed by the General Manager (Finance) of T Ltd., who is a Chartered Accountants and had written a few books on "Internal Control", and, therefore there was no need to review the said area.

2 *"Installation of computer operating systems has created both benefits and problems for auditors" discuss the statement.*

3 *You have been appointed as Internal Auditor of a company and you have come across certain weaknesses in the Internal Control System. Draft a specimen form of Management Letter indicating at least four areas of weakness relating to internal Control*

4 *Mention six basic items with which the auditor should be familiar to understand the computer system used by the client.*

5 *State the steps that you would suggest for proper internal control over stores of a large Textile Mill Company.*

6 *What are the important features of distinction between computer based system of accounting and those of a conventional nature?*

7 *Comment on the use of computer facilities by a small enterprise may increase the control risk.*

8 *What matters should be taken into consideration for evaluating Internal Control over after sale-services?*

9 *Distinguish between Internal Check and Internal Audit*

10 *Write short note on Review and testing of the Internal Control systems*

5

Vouching

BASIC CONCEPTS

Vouching

The act of examining vouchers is referred to as vouching. it is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

(i) that the date of the voucher falls within the accounting period;

(ii) that the voucher is made out in the client's name;

(iii) that the voucher is duly authorised;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

Audit of cash transactions

A. General Considerations

(i) Internal Control System

(ii) Correctness of book-keeping records

(iii) Observance of accounting principles.

(iv) Evidence of Transactions.

(v) Validity of Transactions

(vi) Disclosure in the Final Accounts

B. Casting or Totalling

Sometimes the totals of a wage bill are inflated by over totalling the column in which the wages payable are entered. Where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced

C. Bank Reconciliation Statement

Bank reconciliation is an important accounting control. It is expected the students will be familiar with the method of preparing Bank Reconciliation Statement, as described in the text book. A copy of the statement duly signed by the accountant of the client after it has been checked, should be kept in record by the auditor along with other working papers, for future reference.

Audit of trading transactions

General Considerations

In addition to matters which are listed in the audit of cash transactions, certain other principal matters that should be taken into account while vouching trading transactions are:

(i) Correctness of book-keeping record

(ii) Observance of accounting principles

(iii) Checking of stock and record

Internal Control in Respect of Trading Transactions

Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc. The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for. It is, therefore, the duty of the auditors to see that the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the fore goings.

Internal Control in Respect of Services

The provision of service also constitutes trading, e.g., those rendered by a contractor, estate agent, repairer of motorcars, etc. In those cases, the internal check should provide for the regulation of the charges for the services rendered, either according to an agreement entered into with the parties, to whom the services have been provided, or on the basis of costs incurred in providing the service, a record in respect whereof is maintained. It is the duty of the auditor to verify that an appropriate internal check exists in respect of different types of transactions entered into by the client to ensure that all the income receivable has been properly accounted for and adequate precautions have been taken to control expenses.

Cut-off arrangement

It the arrangement where the 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.

Balance Sheet Audit

A Balance Sheet audit consists of the verification of all includible Balance Sheet items, together with the examination of expense and income accounts which are so closely related to these items that it cannot be properly verified without such analysis and test.

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements

The process of external confirmations, ordinarily, consists of the following:

- Selecting the items for which confirmations are needed.
- Designing the form of the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining response from the third party.
- Evaluating the information or absence thereof

Question 1

How will you vouch and/or verify the following?

(a) Recovery of Bad Debts written off

(b) Goods sent out on Sale or Return Basis

(c) Borrowing from Banks

Answer

(a) Recovery of Bad Debts written off

(i) Ascertain the total amount of bad debts.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(b) Goods sent out on sale or return basis

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) See that price of such goods is unloaded from the sales account and the debtor's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.

(iv) Confirm that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing stock.

(c) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

Question 2

Give your comments and observations on the No entry is passed for cheques received by the auditee on the last day of the year, but not yet deposited with the bank.

Answer

Cheques Received on the last day of Accounting Year: It is a quite normal that in any on going business entity many a times cheques are received from the customers on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the debtors' ledger should ensure that proper accounting entries have been passed by crediting respective debtors' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

Question 3

How will you vouch/verify the following:

(a) Goods sent on consignment

(b) Foreign travel expenses

(c) Receipt of capital subsidy

(d) Provision for income tax

Answer

(a) Goods Sent on Consignment

(i) Verify the accounts sales submitted by the consignee showing goods sold and stock of goods in hand.

(ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment stock was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. 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 account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the stock in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown distinctly under stocks.

(b) Foreign Travel Expenses

(i) Examine T.A. bills submitted by the employees stating the details of tour, details of expenses, etc.

(ii) Verify that the tour programme was properly authorised by the competent authority.

(iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill, hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.

(iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.

(v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Part I of Old Schedule VI (applicable upto financial year 2010-2011) to the Companies Act, 1956. Under the Revised Schedule VI which is applicable w.e.f. 1-4-2011, the requirements of AS 11 of Companies (Accounting Standards) Rules, 2006, as notified under section 211(3C) of Companies Act, 1956, would be applied.

(c) Receipt of Capital Subsidy

(i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(d) Provision for Income Tax

(i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.

(ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.

(iv) Compute tax payable as per the latest applicable rates in the Finance Act.

(v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.

(vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

Question 4

'In vouching payments, the auditor does not merely check proof that money has been paid away.' Discuss.

Answer

Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching is not merely to ascertain that money has been paid away; but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

(i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;

(ii) a transaction pertains to entity and took place during the relevant period;

(iii) all transactions which have actually occurred have been recorded;

(iv) all transactions were properly authorised; and

(v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records

Question 5

How will you, as an auditor, vouch and/or verify the following ?

(i) Deferred Revenue Expenditure

(ii) Goodwill

Answer

(i) Deferred Revenue Expenditure: This is a type of revenue expenditure, whose benefit extends to more than one accounting year during which it is actually incurred. Accountancy principles require that only that part of the expenditure which is pertaining to the accounting period should be debited to the profit and loss account of the year. Remaining amount should be carried forward in the balance sheet and it should be written off against the future income, depending upon the number of years during which the benefit of expenditures is likely to be enjoyed. This type of expenditure is known as deferred revenue expenditure. Part of such revenue expenditure is to be treated as assets for the purpose of disclosure in the balance sheet for the time till the benefit of such expenditure is fully exhausted.

Some examples of deferred revenue expenditure are expenditure on an advertisement campaign to launch a product in the market, discount allowed on subscription to debentures, development expenses in the case of mines and plantations, etc. While verifying deferred revenue expenditure, this may satisfy himself that:

(a) it is proper to defer the expenditure;

(b) the period of amortisation of the expenditure is reasonable;

(c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;

(d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue / other benefits related to the expenditure continue to exceed the amount of unamortized expenditure.

(Students should note that consequent upon to issuance and application of AS 26 on Intangible Assets, the necessary principles under this Standard need to examined to ensure whether such kind of deferral should be made or not.)

(ii) Goodwill:

(a) Ensure that goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

(b) Check the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the book value of the assets or where a specific sum has been paid for the goodwill.

(c) See that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in the company's accounts by way of writing up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company.

(d) See whether goodwill has been written off as a matter of financial prudence as per the principles enunciated under AS 26 on Intangible Assets of Companies (Accounting Standards) Rules, 2006..

Question 6

How will you vouch and/or verify the following ?

(a) Sale proceeds of Scrap Material.

(b) Trade Marks and Copyrights.

(c) Machinery acquired under Hire-purchase system.

(d) Work-in-progress.

Answer

(a) Sale Proceeds of Scrap Material

(i) Review the internal control on scrap 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 scrap materials.

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

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

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

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

(vii) Ensure that there exists a proper procedure to identify the scrap 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 scrap materials as to its reasonableness.

(b) Trade Marks and Copyrights

(i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.

(ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trade marks and copyrights have been duly registered.

(iii) Verify existence of copyright by reference to contract between the another and noting down the terms of payment of royalty.

(iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trade marks and copyrights have been capitalised.

(v) Verify existence of copyright by reference to contact between the author and the entity and to check the payments of royalty made to author.

(vi) Ascertain that the legal life of the trade marks and copyrights have not expired.

(vii) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.

(c) Machinery acquired under Hire-purchase system

(i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.

(ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, and terms of payment and rate of purchase.

(iii) Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest.

(iv) Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account.

(d) Work-in-Progress

The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. The auditor may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date. Cost sheets of work-in-progress should be verified as follows:

(i) Ascertain that the cost sheets are duly attested by the works engineer and works manager.

(ii) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof.

(iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimated cost expected.

(iv) Ensure that the allocation of overhead expenses had been made on a rational basis.

Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

(v) Ensure that the Work-in-Progress as at Balance Sheet date has been appropriately disclosed in Balance Sheet as per the requirements of Part I of Revised Schedule VI (applicable w.e.f 1.4.2011) to the Companies Act, 1956

Question 7

State briefly how you will verify the following:

(a) Building

(b) Bank Balances

(c) Bills Payable

Answer

(a) Building:

(i) Verify the cost by reference to the architect's certificate as well as the contractor's receipts for amounts paid in case building is completed during the year. If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charges have been allocated to the account and same are reasonable.

(ii) Check whether depreciation has been provided on a consistent basis.

(iii) Confirm the existence of building either through physical observation or other documentary evidence.

(iv) Check the title deeds and verify that building is owned by the entity.

(v) Ascertain whether any charge has been created on the building. If so, the same has been disclosed.

(vi) Examine lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc.

Also ensure that all covenants in the lease deed have been fulfilled by the client.

(vii) If revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.

(viii) In case of a company, ensure that buildings under lease have been separately disclosed as per the requirements of Revised Schedule VI (applicable from 1.4.2011) to the Companies Act, 1956.

(b) Bank Balances:

(i) Verify bank balance by reference to bank statements.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment! write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) Check the form of Balance Sheet as per Part I of Schedule VI which requires that the bank balance should be segregated as follows: (i) With Scheduled Banks. And (ii) with others. In the last mentioned case, the nature of interest, if any, of a director or his relative with each of the bankers should be disclosed. The nature of deposit in each case should be stated, e.g., current, fixed, call, etc. in case of a non-scheduled bank, its name and the maximum balance that was held by it during the year should also be disclosed. With effect from financial year 2011-2012, under the requirements of Revised Schedule VI (applicable from 1.4.2011) to the Companies Act, 1956, the presentation and disclosure requirements should be complied with.

(c) Bills Payable: These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. Steps involved in their verification are:

(i) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.

(ii) Trace all the entries in the Bills Payable Book to the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.

(iii) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

(iv) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.

(v) Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

Question 8

Write short note on - Cut-off arrangement.

Answer

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:

(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.

Question 9

Give your comments on the it is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems.

Answer

Verification of Sale Proceeds of Scrap : An auditor is required to review the production and cost records for the determination of the extent of scrap materials that may arise in a given period. Normally speaking, in the ordinary course of his duties the auditor would expect that scrap generated in the company, if any, are property accounted for. The existence of an accounting and costing system would provide evidence about the adequacy and reliability of accounting records. The records should adequately show the details of sale of scrap. Besides the rates at which the scrap have been sold, correct billing of the same and their identification that good quality material has not been mixed up, are the other aspects to be examined by the auditor. As per CARO, 2003, the auditor was required to report whether the company is maintaining reasonable records for the sale and disposal of scrap.

Therefore, just because the sale proceeds are not significant and the company has a good accounting and costing system, the auditor cannot overlook other aspects.

Question 10

While conducting the audit of the accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply risen in comparison to the previous year. State the steps you would take to satisfy yourself.

Answer

There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that of the previous year; the most likely causes are as under:

(i) ***Increase in Sales Prices:*** The selling price of the finished products may have been increased. Enquiries should be made by auditor as to whether there have been general or specific price increase and the reasons for the same. The auditor should obtain copies of the company price lists prevailing at different point of time and make the relevant comparison.

(ii) ***Reduction in Cost of Manufacturing:*** The cost of manufacturing may have reduced substantially. The auditor should examine the stock and purchases records in respect of large purchases of raw materials, comparing current costs with those in the previous year and detailed information supporting the possibility should be sought from the company.

(iii) ***Alteration in Sales-mix:*** The mix of sales may have been altered, resulting in the sales of more profitable items. Detailed sales analysis should be made for the period in order to ascertain whether the more profitable lines constituted a large proportion of the total sales.

(iv) ***Impact of Automation*****:** The mechanisation or automation of certain manufacturing processes may have resulted in considerable saving in labour cost and this possibility could be easily verified by comparisons of wages records.

(v) ***Adherence to Cut-off Procedures:*** The company cut-off procedures as regards closing stock and work-in-progress should be investigated, as any change in the procedure as compared with the previous year would cause a difference in the gross profit ratio. It should also be seen that the procedure laid down has been observed by the concerned personnel and rightly adhered to. The auditor should test relevant transaction and ensure that everything is incorporated in the financial statement.

(vi) ***Manipulating Sales*****:** The possibility of items which have been sent to customers on 'sale or return' basis being included in sales should be investigated, as this would give effect for increase in the rate of gross profit.

Question 11

How will you verify/vouch the following?

(a) Sales Commission Expenditure.

(b) Sales Return.

Answer

(a) Sales Commission Expenditure

(1) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes the commission should be in accordance with the terms and conditions as specified.

(2) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.

(3) Ensure that the sales in fact have taken place and the same has been charged to profit and loss account.

(4) Compare the amount incurred in previous years with reference to total turnover.

(b) Sales Return

(i) Examine the accounting basis for such transactions with reference to corresponding Debit Note to Debit Note. The relevant correspondence may also be examined.

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

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

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

Question 12

Write a short note on- Vouching.

Answer

Vouching: The act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transaction recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of transaction on its inclusion in the final statements of account. After examination, each voucher is marked in a manner to ensure that it may not be presented again in support of another entry. The following points need careful consideration while examining a voucher:

(i) that the date of the voucher falls within the accounting period;

(ii) that the voucher is made out in the client's name;

(iii) that the voucher is duly authorised;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

Question 13

As an auditor, comment on the travelling expenses of ₹ 2.25 lakhs shown in Profit and Loss Account of X Ltd., including a sum of ₹ 1.10 lakhs spent by a Director on his foreign travel for company's business accompanied by his mother for her medical treatment.

Answer

Personal Expenses Charged to Revenue Account: As per the provisions of Section 227(1A) of Companies Act, 1956, the auditor shall enquire whether personal expenses have been charged to revenue account and make a report to the members in case he is not satisfied with the answer.

In this case, the auditor should examine documentary evidence in support of the travelling expenses of ₹ 1.10 lakhs incurred by the director and ascertain the personal component thereof. Then he should enquire as to whether such personal expenses incurred by the company are covered by contractual obligations or by any accepted business practices. In case, the answer is negative, the auditor should make a report thereon and qualify his audit report.

Question 14

How will you verify/vouch the Purchase return?

Answer

Purchase Return

(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.

Question 15

Write a short note on -Scrutiny of General Ledger.

Answer

Scrutiny of General Ledger:

(i) The General Ledger contains all the balances which are ultimately included in the Profit and Loss Account and the Balance Sheet. Its examination therefore is undertaken last of all.

(ii) The scrutiny of General Ledger should be carried out with due care in as much as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.

(iii) Entries in the General Ledger usually are posted in a summary form from the books of original entries such as Cash Book, Journal, Sales Book, Purchase Book and other subsidiary books. Therefore, it should be confirmed that all the postings on various accounts have been verified, totals, etc. checked.

(iv) It should also be ascertained that balances in all the income and expense accounts have been adjusted: (a) according to standard accounting practices (i.e., all unpaid, prepaid expenses have been adjusted and accrued Income and prerecorded income is properly adjusted); and (b) on a consideration of the legal provisions which are applicable to the concern.

(v) The balances in the General Ledger should be traced to the trial balance and from the trial balance to the final accounts.

Question 16

While conducting the audit of accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply decreased in comparison to the previous year. State the steps you would take to satisfy yourself.

Answer

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:

(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.

Question 17

As an Auditor, comment on the SMT Enterprises entered into a contract for sale of its goods worth ₹ 24 lacs with ST Ltd. The goods were inspected, approved and finalised by the inspection team of ST Ltd. ST Ltd. made the whole payment of ₹ 24 lacs. However, it requested SMT Enterprises to dispatch the goods in six equal monthly instalments from October, 2009 to March, 2010. In the month of January, 2010, due to natural calamity, ST Ltd. informed SMT Enterprises to stop dispatches of the remaining three instalments until further notice. At the time of finalising its accounts for the financial year 2009-10, SMT Enterprises booked sales amounting to ₹ 12 lacs and showed remaining ₹ 12 lacs as Advance against Sales.

Answer

Recognition of Revenue (AS 9): AS 9 requires that revenue from sale of goods should be recognized when the following conditions are followed:

(i) The seller has transferred the property in the goods for a price to the buyer or all significant risks and rewards of ownership have been transferred to the buyer, and the seller has not retained effective control of the goods transferred to a degree usually associated with ownership.

(ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods.

In the given case, the sale transaction carried by SMT Enterprise fulfills all the condition stated above. Hence, the accounting entry passed by SMT Enterprise recognising partial revenue to the extent of goods dispatched is not correct. The entire amount of ₹ 24 lakhs should be recognised as sales.

Question 18

How will you vouch and/or verify the Premium paid for insurance of a Motor car?

Answer

Premium paid for insurance of a motor car: Vouch from the following:

(i) Insurance cover note issued by the insurance company verifying the car no. and period of insurance coverage.

(ii) Verify that no claim bonus is given – where entitled – by the insurance company.

(iii) Ensure that proper adjustment is made for pre-paid insurance premium.

Question 19

How will you vouch/verify the following?

(a) Liability towards gratuity

(b) Expenditure incurred for promotion of a product

(c) Balances with excise authority

(d) Receipt of special backward area subsidy from Government.

Answer

(a) Liability towards gratuity:

1. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.
2. The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined.
3. The auditor should treat the actuary as an expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 620.
4. The auditor should check the technical competence of actuary, the input fed to the actuary, the assumptions made by the actuary, the methodology adopted by the actuary, opinion given etc.
5. The auditor should bear in mind the relevant pronouncements of AS 15 "Employee benefits" in this regard. He should check whether the expenses of provision for gratuity are towards a defined benefit plan or contribution plan.
6. If the contributions are made to outside agency, say the insurance companies, he should check the premium paid, the acknowledgement receipts issued by the insurance company, the coverage of policy etc. Premium due but not paid, prepaid premium etc should be appropriately accounted.
7. If the company maintains its trust for gratuity, the auditor may peruse whether the trust is an approved one under income tax law, whether the trust accounts are audited, copy of the latest accounts etc.
8. The contribution should be appropriately disclosed in the accounts as per Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) to the Companies Act, 1956.

(b) Expenditure incurred for promotion of a product

1. The expenditure incurred for promotion of a new or existing product may entail future benefits. It may be like advertisement in the papers, television, sales exhibition, participation in trade fair, issue of promotional pamphlets, free gifts etc.

2. The auditor should vouch the authority and accuracy of the transactions. He should read the contract with advertisement agencies, promotional policies decided by the management from the board minutes etc.
3. He should check the amounts paid to the agencies from bank book. He should check the accuracy, he should ascertain whether tax had been deducted in accordance with the tax law provisions if any applicable in this regard.
4. He should check whether the unpaid amounts and accrued liability towards promotional advertisement contracts had been duly provided for in the accounts.
5. The huge expenditure should not be treated as deferred revenue expenditure. According to AS 26, these are not intangible assets that may be carried over the periods of accounting. These must be expensed with in the year in which these arise.

(c) Balance with excise authority

1. The balance with excise authority in PLA account should be checked with the statements of accounts/records kept with excise section of the unit.
2. The remittance into the account, the utilization out of it etc should be cross checked with bank book, clearance forms etc.
3. The balance confirmation may be checked.
4. The balance should be shown under current assets and advances in balance sheet.
5. It is to be ensured that the balances in PLA is used only to the extent of liability after adjusting Cenvat credit where available.

(d) Receipt of special backward area subsidy from Government

1. The claim for backward area subsidy submitted to the authorities should be studied.
2. It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature is to facto.
3. The accounting of grant should be in accordance with AS 12 “Accounting for Government Grants” of ICAI. The revenue grant can be taken to income statement, with appropriate disclosure.
4. The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to profit and loss account each year in proportion to depreciation of that asset charged in profit and loss account.
5. The receipt of the grant should be checked with bank statement, remittance challan etc.

6. The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

Question 20

As an Auditor, comment on the Gear Ltd. is engaged in manufacturing and supply of gear boxes to Indian Automobile Ltd. As per terms of supply, full price of the goods are not released by Indian Automobile Ltd. but 10% thereof is retained and paid after one year, if there is satisfactory performance of the parts supplied. Gear Ltd. accounts for only 90% of the invoice value as sale at the time of supply and balance 10% is accounted as sale in the year of receipt of payment.

Answer

According to AS 9 on Revenue recognition, revenue from sale of goods should be recognised 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 retains no effective control over goods and no significant uncertainty exists regarding the amount of consideration and its collectibility.

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

In the instant case, therefore, Gear 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.

Question 21

In the course of audit of a trade, you noticed that although there is no change in either selling or purchase price of the goods, there is considerable increase in Gross Profit Ratio in comparison to previous year. What matters would you examine to assess the reason for such increase?

Answer

In assessing the reason for considerable increase in Gross Profit Ratio, the auditor should examine the followings:

(i) Under valuation of opening stock due to non-inclusion of certain items or applying lower rate to one or more items of stock.

(ii) Over valuation of closing stock either by the inclusion of fictitious items or over valuing some of the items of Stock.

(iii) Change in the method of valuation of opening and closing stock. For example, opening stock was valued at lower of cost and market value, whereas closing stock has been valued at market price which is higher than cost.

(iv) Goods sold but not delivered are included in stock.

(v) Goods delivered last year but sales invoice raised in current year.

(vi) Recording of fictitious sales to boost up profits.

(vii) Goods returned to supplier awarding dispatch and included in closing stock.

(viii) Goods returned by customers but not debited to sales return and included in closing stock.

(ix) Inclusion in the closing stock of goods received for sale on approval or consignment basis.

(x) Treatment of goods sent on consignment basis as regular sales.

(xi) Non-provision of outstanding expenses like wages, carriage inward etc.

(xii) Wrong allocation of expenses in Trading and Profit & Loss Account.

Question 22

How will you vouch/verify the following?

(a) Sale of Investments.

(b) Payment of Revenue Expenses.

(c) Amount due to Subsidiary companies.

Answer

(a) Sale of Investments

(i) See that sale of investment has been made on the proper authorisation of Board or other competent authority.

(ii) Ascertain the method of selling investments. It may be either through broker, directly or through a bank. See the broker's sold note.

(iii) See that the difference between the carrying amount and the sales proceeds, net of expenses, is recognised in the Profit & Loss Account. Ensure that when only a part of the holding of an individual investment is sold, the carrying amount is allocated on the basis of average carrying amount of the total holding of the investments.

(iv) See that proper disclosures as required by AS 13 are made as follows:

(1) Interest, dividends, rentals on investments are to be shown in P& L A/c at Gross Value and TDS as advance tax paid.

(2) Showing separately profit & Loss on disposal and changes in carrying amount of current and long term investments.

(b) Payment of Revenue Expenses

(i) See that all payments have been duly authorised by a competent authority.

(ii) Ensure that all payments relates to business.

(iii) Ensure that all payments have been received by the correct payee and acknowledged by a receipt note or in the voucher itself.

(iv) See that expenses relate to the period under audit.

(v) Ensure that no personal expenses are charged as business expenditure.

(vi) See that all payments have been correctly recorded in the books under appropriate sub-head.

(vii) See that if the payment relates to prior period it is classified so and the amount payable is correctly authorised.

(viii) See mode of Payment cash, cheque etc., and relate to corresponding entry in cash or Bank book.

(ix) Verify the cash memos, invoice with the amount paid.

(x) Ensure that if any payment relates to period that extends to next year, a proportionate amount is carried forward as Pre-paid expenses.

(c) Amount due to subsidiary companies

(i) Examine whether the subsidiary company is authorised by its memorandum of association to advance loan to its holding company.

(ii) In the absence of such a power, see whether such power could be inferred from the other objects of the company.

(iii) Verify the interest rate and particulars of security, if any, furnished.

(iv) Inspect the documents executed by the holding company.

(v) Verify the loan agreement and see that terms of loan have been duly complied with.

(vi) Verify that the loan has been properly reflected in the Balance Sheet as per the requirements of Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) to the Companies Act, 1956.

Question 23

How would you vouch/verify the following?:

(a) Rental Receipts.

(b) Assets acquired on Hire-purchase.

(c) Cash Sales.

Answer

(a) Rental Receipts

(i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.

(ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.

(iii) Scrutinize the account of collecting agent when the rent is collected by such agent.

(iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.

(v) Investigate into abnormal rent outstanding.

(vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.

(vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.

(b) Assets acquired on Hire purchase

(i) Inspect the hire purchase agreement to ascertain the terms and condition, the installment and amount of interest included in the installment.

(ii) Ensure that these are treated as assets acquired under finance lease as per AS-19.

(iii) Verify that initial recognition of lease should be as an asset and a liability at equal amounts.

(iv) If it is reasonably certain that lessee will get ownership at the end of the term, see that asset is depreciated over its useful life. Otherwise confirm that asset is depreciated over the shorter of its useful life and the lease term.

(v) Ensure that it is shown separately in the Balance Sheet.

(c) Cash Sales

(i) Examine the system of internal check to ascertain any loopholes therein.

(ii) Ascertain the practice followed in the matter of issuing cash memos and trace the memos into cash sale summary.

(iii) Ensure that the date of cash memos tally with the entry in the cash book/summary.

(iv) Verify that prices of goods sold have been correctly recorded and check the calculation.

(v) Verify the entry in the goods outward book with the sales summary.

(vi) See that the cancelled cash memos are not removed from the receipt book.

Question 24

How would you vouch/verify the following?

(a) Payment of Retirement Gratuity to employees.

(b) Recovery of Bad Debts written off.

Answer

(a) Payment of retirement gratuity to employees: This may be vouched in the following manner:-

(i) Examine the basis on which gratuity payable is worked out-actuarial or agreement or on the assumption that all employees retire on the balance sheet date.

(ii) Ensure that the basis of computing gratuity is valid.

(iii) Verify computation of liability of gratuity on aggregate basis.

(iv) Check the amount of gratuity paid to employees who retired during the year with reference to the no. of years of service rendered by the retiring employees.

(v) If the concern has taken an insurance policy see that the annual premium has been charged to Profit & Loss account.

(vi) Ensure that the concern has adhered to the accounting treatment in accordance with AS-15 (revised).

(vii) Ensure that the following disclosure requirements of Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) have been followed:

In respect of Profit and Loss Account, a Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items: (i) (a) ***Employee Benefits Expense*** [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses];
➢ **Long-term provisions:** The amounts shall be classified as: (a) ***Provision for employee benefits;*** (b) Others (specify nature)
➢ **Short-term provisions:** The amounts shall be classified as: (a) ***Provision for employee benefits;*** (b) Others (specify nature).

(b) Recovery of bad debts written off

(i) Verify the relevant correspondence with the debtor whose accounts were written off as bad.

(ii) See that the amount recovered is credited to a separate account recovery of bad debts written off.

(iii) Verify the acknowledgement receipt issued.

(iv) Examine notification from the court, bankruptcy trustee, collecting agencies.

(v) Check credit manager's file for the amount received and see that the amount has been deposited in the bank promptly.

(vi) Review the internal control system regarding writing off and recovery of bad debts.

Question 25

Comment on - Vouching of payment of taxes.

Answer

Vouching of Payment of Taxes:

(i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made there under.

(ii) Review adjustments, expenses disallowed, special rebates etc. with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to payment of advance tax, self assessment tax and other demands.

(iv) 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.

(v) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.

(vi) 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.

(vii) Ensure that the requirements of AS 22 on 'Accounting for Taxes on Income' have been appropriately followed for the period under audit.

Question 26

State any six important points to be examined by you, as an auditor, in verifying the correctness of bank balance of an Educational Institution which deposits all its collection/receipt in separate collection account of a bank.

Answer

For verifying the balances lying with bank in collection account, the auditor should adopt following procedure:

(i) Examine and compare the pay-in-slips with the entries in the ledger account of the educational institute.

(ii) Check the casting, carry forwards and balancing of ledger account.

(iii) Compare the entries in the ledger account with the bank statement.

(iv) Review the bank reconciliation statement for its correctness.

(v) Scrutiny the subsequent period bank statement to ensure that items of reconciliation are subsequently cleared.

(vi) Verify the balance confirmation certificate.

Question 27

How would you vouch/verify the following?:

(a) Advertisement Expenses.

(b) Sale of Scrap.

Answer

(a) Advertisement Expenses: It should be vouched on the following basis :

(i) Verify the bill/invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.

(ii) See that advertisement relates to client's business.

(iii) Inspect the receipt issued by the agency.

(iv) Ascertain the nature of expenditure – revenue deferred and see that it has been recorded properly.

(v) Ascertain the period for which payment is made and see that pre-paid is carried forward to balance sheet.

(vi) Compare the statement of account with the ledger account.

(vii) See that all outstanding advertisement bills have been provided for.

(b) Sale of scrap:

(i) Review the internal control as regards generation, storage and disposal of scrap.

(ii) Check whether the organization is maintaining reasonable record for generation of Scrap.

(iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.

(iv) Check the rates at which scrap has been sold and compare the rate with previous year.

(v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.

(vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.

(vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

Question 28

How would you vouch/verify the following?

(a) Insurance Claim

(b) Preliminary Expenses.

(c) Customs Duty.

Answer

(a) Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims, the auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen Counterfoils of the receipts issued to the insurance company should also be seen. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. The copy of certificate/report containing full particulars of the amount of loss should also be verified. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the profit and loss account is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

(b) Preliminary expenses: The auditor takes following steps to vouch/verify preliminary expenses:

1. All such kind of expenses should be related to the formation of the enterprise.
2. With all preliminary expenses, relevant supporting documents should be there.
3. He should examine company’s minute’s book to determine the pattern of writing off of the preliminary expenses over the period.
4. He must check that if such kinds of expenses are incurred by the promoters or they have been reimbursed to the promoters, it is as per the instructions of the BOD and the powers in AOA.
5. He should make a cross check of the amount of preliminary expenses with that of amount mentioned in the prospectus, statutory report and balance sheet.

(c) Custom Duty

1. Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.
2. If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent's bill.
3. If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.
4. Make a list of disputed cases to have knowledge of the amount of duty payable and the provisional payment. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.
5. Lastly, the auditor verifies the duty drawback.

Question 29

On 31.12.2008, Amudhan Company Limited invested ₹ 45 lakhs in cumulative fixed deposits of Algar Bank Ltd. The deposits carry interest @10% per annum compoundable quarterly and amount of interest is added to the principal and is due and payable on the maturity date which is 5 years from the date of investments.

For the year ended 31st March, 2009, the company did not book any revenue of interest on the ground that interest amount is not available at their disposal till maturity date of investment. Comment.

Answer

(i) According to Section 209 of the Companies Act, 1956 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.

(ii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown under current assets in the balance sheet as per Schedule VI Part I requirement.

(iii) As such, the profits and current assets are understated and true and fair views of the accounts are thus vitiated.

(iv) On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report.

Question 30

(a) *M, Statutory Auditor of ABC Ltd wants to verify cash on hand as on 31st March, 2009. The Management informs Mr. M. that it is not possible to cooperate, as cashier has been hospitalized. Advise Mr. M. on how to deal with the situation.*

(b) *As an auditor of a Limited Company, you observe that during the month of March, 2009, sales invoices were not recorded in books of accounts. You also observe that payment of wages was much higher compared to last year. Keeping in mind the above, analyse possible ways of manipulation of accounts*

Answer

(a) The scope of audit may be limited for varied reasons, (i) the entity may impose restriction on scope of audit, (ii) the limitation may be imposed by circumstances.

When the audit is carried out under and as per statute, the auditor should not accept the assignment when his duties are curtailed by agreement, unless required by any Law.

When audit is carried out in accordance with the entity's terms voluntarily, the auditor may indicate his scope in his audit report.

Sometimes, the circumstances may impose restrictions on audit scope. For example, if the auditor is appointed after the year end, he may not be able to participate in inventory checking or sometimes, the records required may not be available so that the auditor may not be able to check details in the manner he liked. Such limitations in scope may warrant an auditor to express disclaimer of opinion or qualified opinion in his audit report depending upon the circumstances.

The non co-operation of ABC Limited will amount to limitation on scope of auditors.

(b) Manipulation of Accounts: Accounts are falsified in order to conceal the true position of the business for some purpose. Frauds are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed:

(i) to avoid incidence of income-tax or other taxes by showing profits at a lower figure.

(ii) for delaying a dividend when there are insufficient profits by showing profits at inflated figures.

(iii) to withhold declaration of dividend even there is adequate profit.

(iv) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the following nature:

(i) Recording fictitious sales or omission of sales

(ii) Recording fictitious purchases or suppression of purchases

(iii) Over valuation or under valuation of stock.

(iv) Recording fictitious expenses or omission of expenses

(v) Taking credit for accrued income not likely to be received or omission of income.

(vi) Revenue expenses changed to capital and vice-versa. SA 240 "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements" deals with the auditor's responsibilities for the detection of material misstatement resulting from fraud and error. It requires a considerable skill and vigilance on the part of an auditor. In doubtful cases he may refuse to believe the information supplied to him by any officer of the concern.

An auditor, who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

Question 31

How would you vouch/verify the following:

(a) Production incentive paid to workers.

(b) Bad debt

Answer

(a) Production incentive paid to workers

1. The auditor should trace the total production incentive paid to workers from P&L Account to prime records/division wise/dept wise records.
2. The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.
3. The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by the accounts department.
4. He should check list of payment and also acquitted disbursement slips of select departments/periods for scrutiny of various data generated in the fields for their accuracy and completeness.
5. The auditor should make an overall analytical procedure of ensuring the expense booked is commensurate in quantum with statistical data on production and strength of workers.

(b) Bad debts

1. The amount of bad debts should be traced to the schedule of bad debts written off during the year.
2. Major amount of bad debts in the schedule be taken for scrutiny.
3. Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.
4. Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.
5. The bad debts should be properly disclosed in P&L account according to its materiality.
6. If provision had already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.

Question 32

XYZ Ltd. Co. gave a donation of ₹ 50,000 each to a Charitable Society running a school and a trust set up for the service of Blind during financial year ending on 31st March, 2009. The average net profits of the company for the last three years were 15 lakhs. Comment.

Answer

Donation to Charitable Institutions

Section 293 of the Companies Act, 1956 provides that the Board of Directors of a public listed company can contribute with the approval of the company in General Meeting to a charitable organisation and other such organizations not directly related to the business of the company or the welfare of its employees subject to the limit as under:

(i) ₹ 50, 000/- or

(ii) 5% of the average net profits of the last three years, whichever is greater.

Facts of the case: The company has given donation of ₹ 50,000/- each to the two charitable organisations which amounts to 1,00,000. Assuming that the charitable organisations are not related to the business of the company, the average profits of the last 3 years is ₹ 15 lakhs and the 5% of this works out to ₹ 75,000. Hence the maximum of donation could be ₹ 75,000 only.

Conclusion: By paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of Section 293 of the Companies Act, 1956. Hence the auditor should qualify his audit report accordingly.

Question 33

How would you vouch/verify the following.:

(a) Goods sent out on Sale or Return Basis.

(b) Bank overdraft.

Answer

(a) Goods sent out on sale or return basis

(i) A record of goods sent out on sale or return basis should be kept in a specially ruled day book. In this book, first memoranda entries are made.

(ii) When the goods are sold, entry is made by debiting the party and crediting the Sales Account.

(iii) The auditor should refer the memoranda record to confirm that on receipt of acceptance from each party, his account is debited and corresponding sales account is credited.

(iv) For the goods in respect of which period of approval has expired are either received back subsequently and customer's accounts debited.

(v) He should ensure that for the stock of goods sent out on approval, the period of approval, in respect of which had not expired till the close the year, are included in closing stock.

(b) Bank Overdraft

(i) The auditor should ensure that the facility of overdraft is authorised by the Board's resolution / partner's resolution.

(ii) Pursue the agreement with the bank and see whether the overdraft is clean or against hypothecation or pledge of company's property.

(iii) Verify the register of charges and ensure that the charge has been registered with Registrar of Companies.

(iv) Verify the rate of interest and other terms and conditions from the agreement.

(v) Verify the amount of overdraft from the books of accounts and compare it with the passbook.

(vi) If the overdraft is against hypothecation of assets like stocks, a certificate from the bank should be obtained.

(vii) If the overdraft is against hypothecation of assets or pledge of company's property, see that overdraft is properly shown under 'secured loans' and nature of security has been property disclosed.

Question 34

A trader is worried that inspite of substantial increase in sales compared to earlier year, there is considerable fall in Gross Profit after satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants to ensure that purchases have been truthfully recorded.

How will you proceed with this assignment?

Answer

There are three steps involved in such an assignment.

A. Study and evaluation of internal control system

B. Vouching of purchase transactions

C. Analytical procedures

A. Study and evaluation of internal control system

This involves the following steps:

(i) Internal check: It should consist of the segregation of duties at the following points:

(a) Requisitioning the goods: Specified employees from the stores department or from the production department's store unit should prepare and approve a purchase requisition for raw materials or goods used in production. The purchase requisition is sent to the purchase department.

(b) Ordering the goods requisitioned: The purchase department is responsible for negotiating the best prices, fixing delivery dates with suppliers and ensuing that appropriate quality goods are obtained. It should prepare a serially numbered purchase order.

(c) Receiving the goods ordered: Goods ordered should be inspected and counted by the receiving department. If satisfied, it prepares serially numbered receiving report or goods received note and forwards its notification copies to the stores, purchase department and finance department.

(d) Preparing the payment voucher: The accounts payable department or accounts payable unit of finance department will receive the invoices and process for its payment and accounting.

(ii) Physical controls

(a) Physical controls over inventory include locked warehouses and store-rooms and limiting access to them to authorised personnel and

(b) Printed and prenumbered forms should be used for purchase requisitions, purchase orders, receiving reports and vouchers.

(iii) Authorised procedures

(a) Re-order points should be established for various inventory items that may trigger a manual request.

(b) Authorisation procedures should be designed for all the four control points – requesting the goods, ordering the goods requisitioned, receiving the goods ordered and preparing the payment voucher.

(iv) Internal review

(a) It should ensure that there is adequate separation of duties and proper authorisation procedures with regard to processing and recording of purchase transactions.

(b) Paid invoices should be reviewed to ascertain the accuracy of the recording of these invoices and if possible, these invoices should be traced back to purchase requisition through receiving reports or goods received notes and purchase orders.

B. Vouching of purchases transactions

The auditor should vouch credit purchases in the following manner:

(i) Examine purchase book: The auditor should examine the transactions recorded in the purchase book with reference to related purchase invoice.

(ii) Examine purchase invoices: The auditor should select a small sample of vendors' invoices at random and should conduct in-depth audit on them i.e., trace the transaction from placing the order to the entries in inventory goods for actual receipt and payment made to the suppliers. In respect of imports, documents such as bill of lading, customs clearance, etc. should be examined. The auditor should ensure that subsidies, rebates, duty drawbacks or other similar items have been properly accounted for.

(iii) Examine the numerical sequence of source documents: The auditor should ensure the numerical sequence of source documents such as purchase requisitions, purchase orders, receiving reports and vouchers have been maintained and missing numbers have been duly accounted for.

(iv) Examine cut off points: In order to ensure that purchases were recorded at that point of time when title was passed to the client, the auditor should examine cut-off points on prenumbered purchase requisitions, purchase orders and goods received notes. The auditor should, then, trace the goods received notes pertaining to a few days before the end of the period under audit to the related purchase invoices. Such a comparison would ensure that purchases represented by such invoices have been recorded as the purchases of the period under audit.

(v) Examine transition with related parties carefully.

C. Analytical procedures

The auditor should compare item-wise and location-wise both quantity and value of purchases for the current period with the corresponding figures for the previous period and ensure that major variations are explained and justified. Various analytical ratios should also be calculated and compare.

Question 35

What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance?

Answer

Auditing an account of Bought Ledger : The structure of every account in the Bought Ledger is: opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule VI to the Act. The maximum account due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed alongwith the names of companies (Part I, Schedule VI to the Companies Act, 1956)..

Question 36

List out some examples of fraud that can be done by ledger keeper in Bought ledger and sales ledger.

Answer

Ledger Keeper & Frauds

Examples of frauds that can be done by ledger keeper in bought ledger:

(i) Crediting the account of a supplier on the basis of a fictitious invoice, showing that certain supplies have been received from the firm, whereas in fact no goods have been received or on the basis of duplicate invoice from a supplier, the original amount whereof has already been adjusted to the credit of the supplier in the Bought Ledger, and subsequently misappropriating the payment made against the credit in the supplier's accounts.

(ii) Suppressing a credit note issued by a supplier in respect of return or an allowance and misappropriating an amount equivalent thereto out of the payment made to him. For if a credit note issued by a supplier either in respect of goods returned to him or for an allowance granted by him, is not debited to his account, the balance in his account in the Bought Ledger would be larger than the amount actually due to him. The ledger-keeper thus will be able to misappropriate the excess amount standing to the supplier's credit.

(iii) Crediting an amount due to a supplier not in his account but under a fictitious name and misappropriating the amount paid against the credit balance.

Examples of frauds that can be done in sales ledger:

(i) Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(ii) Adjusting an unauthorised credit or fictitious rebate, allowance, discount, etc. in the account with a view to reduce the balance and when payment is received from the debtor, misappropriating an amount equivalent to the credit.

(iii) Writing off the amount receivable from a customer's bad debt account and misappropriating the amount received in payment of the debt.

Question 37

Give various factors which result in increase in Gross profit.

Answer

Factors which increase the gross profit

(i) Undervaluation of opening stock; it may be either the effect of non-inclusion of certain items of stocks or that of valuation of the stock at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of stock. In such a case, the increase in the rate of gross profit would be preceded by a fall in the rate of gross profit in the previous year.

(ii) Overvaluation of closing stock, either by the inclusion therein of fictitious items of stock or over-statement of values of some of them.

(iii) Alteration of the basis of valuation of closing stock, e.g., where the opening stock was valued at cost or market rate whichever was lower, valuing the closing stock at the market price which is higher than cost.

(iv) Increase in the value of some of the items included in the opening stock above cost, on account of which the unsold stock of these items at the close of the year is valued at cost.

(v) Under-statement of opening stock or over-statement of closing stock, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing stock or when goods were delivered and taken out of stock last year, but sales invoices is raised in the current year.

(vi) Entry of fictitious purchases to boost up the profits, if such a practice has been resorted to, it would have the effect of reducing the rate of gross profit in the ensuing year.

(vii) Inclusion in the closing stock of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by customers, the cost whereof has not been credited to parties.

(viii) Inclusion in the closing stock of goods received for the sale on approval or on a consignment basis.

(ix) Treatment of goods sent out for sale on consignment basis as regular sales.

(x) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated; provision for outstanding wages or carriage inward may not have been made.

(xi) Wrong allocations of expenses, e.g., carriage inwards either in whole or in part may be wrongly taken to the Profit and Loss Account.

Question 38

What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

Answer

Extent of reliance on analytical procedures (SA-520)

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing.

Question 39

Explain, what are the factors to be considered while "Vouching of travelling expenses"

Answer

The following factors are to be considered while "Vouching of Travelling Expenses":

(i) Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

(ii) As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

(iii) The voucher for travelling expenses should normally contain the under mentioned information:

(1) Name and designation of the person claiming the amount.

(2) Particulars of the journey.

(3) Amount of railway or air fare.

(4) Amount of boarding or lodging expenses or daily allowance alongwith the dates and times of arrival and departure from each station.

(5) Other expenses claimed

(iv) If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source.

(v) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified.

(vi) The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be sanctioned by the Board.

(vii) The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.

(viii) Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

EXERCISES

1 As an auditor, comment on the following situations/statements:

(a) An assistant of X & Co. Chartered Accountants wanted to verify the cash in hand and investments of T Ltd. The General Manager (Finance) of T Ltd. suggested to the assistant of X & Co. that it was not necessary as his staff had done the same only few days back and no discrepancies were noted.

(b) Z ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch new product as Revenue Expenditure. The product did not pick up and the sales were negligible.

(c) Z ltd. acquired a car for its managing Director on Hire-purchase basis. The interest payable as well as penalty payable for late payment of installments was added to the cost of the car.

(d) The sale proceeds from scrap which did not have significant value need not be verified if the company had a god accounting and costing system.

2 State briefly, how would you audit following year end adjustments made by a manufacturing company:

3 A trader is worried that in spite of substantial increase in sales as compared to the earlier year there is considerable fall in gross profit. After satisfying him that sales and expenses are correctly recorded and that *the valuation of inventories is on consistent basis, he wants you to ensure the purchase have been truthfully recorded. In the circumstances, how you would proceed with the assignment?*

4 *During the audit of company's accounts, the directors bring the following matters to your attention as not being reflected in the company's accounting records:*

5 *A decision was taken shortly before the year end to pay an interim dividend of ₹ 10,000 on Equity Capital one month after the year end date.*

6 *How would you verify and vouch the following?*

- *(a) Remuneration paid to directors.*
- *(b) Cash Sales.*
- *(c) Income-tax Payment*
- *(d) Proposed Dividends.*
- *(e) Discounted Bills Receivable dishonored.*
- *(f) Bills Receivable*
- *(g) Excise Duty*
- *(h) Outstanding liabilities for expenses*
- *(i) Sale proceeds of Rejected Materials.*
- *(j) Consignment transactions in the books of consignee.*
- *(k) Interest and Dividends received.*
- *(l) Preliminary expenses*
- *(m) Advertisement Expenses.*
- *(n) Refund of General Insurance Premium Paid.*
- *(o) Empties or Containers.*

7 *Write short notes on the following*

- *(a) Outstanding Assets.*
- *(b) Control Accounts.*

8 *State briefly the audit objectives of the following:*

- *(i) Examination of Bank Reconciliation Statement.*
- *(ii) Reconciliation of the aggregate balances of the individual Sales Ledgers with the Sales Ledger Control Account.*
- *(iii) Review of the work performed by the different personnel of the Cash Department.*

6

Verification of Assets and liabilities

BASIC CONCEPTS

Verification –

- Verification is a process to verify the ownership, valuation, possession and existence of a particular Asset or liability.
- Verification establishes the correspondence of actual facts or details with those represented in accounts.
- Verification relates to the assets and liabilities appearing in the balance sheet.
- Verification is generally carried out at the end of year.
- To confirms the existence, ownership, possession, completeness, valuation and disclosure of items relating to balance sheet.
- Verification is based on observation as well as documentary examination.
- Verification requires experienced people and done by the senior staff.
- Verification includes valuation

Question 1

Comment on the "The cash-book showed a huge cash balance on hand consistently throughout the year".

Answer

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.

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.

Question 2

Comment on the "Responsibility for properly determining the quantity and value of inventories rests with the management of the entity".

Answer

The Guidance Note on Audit of Inventories specifies that the responsibility for properly determining the quantity and value of inventories rests with of the management of the entity. Therefore, it is the responsibility of the management the entity to ensure that the inventories included in the financial information are physically in existence and represent all owned by the entity.

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. He is also required to determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items are well-designed and operate properly.

This responsibility of the management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The entities usually maintain detailed stock records in the form of Stores/Stock ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case. In valuation aspects, compliance with AS 2 should also be ensured.

As per SA 501 on "Audit Evidence : Additional Considerations", the following principles are laid down by ICAI:

(i) When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable, due to factors such as the nature and location of the inventory, so that the auditor could observe the compliance of management's procedures in this regard;

(ii) If he is unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded;

(iii) Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation;

(iv) When inventory is situated in several locations, the auditor would consider at which locations attendance is appropriate, taking into account the materiality of the inventory and the risk of material misstatement and the assessment of inherent and control risk at different locations;

(v) The auditor would review management's instructions regarding:

- application of control procedures, for example, collection of used stock sheets, accounting for unused stock-sheets, tagging and count and recount procedures;
- identification of the stage of completion of work in progress, slow moving, obsolete, damaged or rejected items, inventory owned by a third party, and
- arrangements made regarding the movement of inventory between areas and the shipping and receipt of inventory before and after the cut-off date.

(vi) The auditor would also consider cut-off procedures including details of the movement of inventory just prior to, during and after the count to ensure that such movements are appropriately included and/or excluded, as applicable from such inventory. For example, (a) goods purchased but not received are included in the inventories; and (b) goods sold but not despatched are excluded from the inventories;

(vii) For practical reasons, the physical inventory count may be conducted at a date other than period end. This will ordinarily be adequate for audit purposes only when the control risk is assessed at less than high. The auditor would assess whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded;

(viii) The auditor performs audit procedures over the final inventory listing to assess whether it accurately reflects actual inventory counts;

(ix) When inventory is under the custody and control of a third party, the auditor would ordinarily obtain direct confirmation from the third party/ arrange with the entity for sending requests for such confirmation as to the quantities and condition of inventory held on behalf of the entity. Further, depending on materiality of this inventory the auditor would also consider the following:

- the conduct of the third party in the past with the entity and independence of the third party;
- observing, or arranging for another auditor to observe, the physical inventory count;

- obtaining another auditor's report on the adequacy of the third party's accounting and internal control systems for ensuring that the inventory is correctly counted and adequately safeguarded;
- inspecting documentation regarding inventory held by third parties;
- subsequent receipt of goods from third parties.

(x) The auditor should obtain a written representation from management concerning (a) the completeness of information provided regarding the inventory; and (b) assurance with regard to adherence to laid down procedures for physical inventory count;

Audit Conclusions and Reporting: If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion

Question 3

As an auditor, what would you do in the following situations?

(a) The method of depreciation on plant and machinery is to be changed from SLM basis to WDV basis from the current year.

(b) The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year.

Answer

(a) Change in the method of depreciation: As per "Accounting Standard 6 Depreciation Accounting", the method of depreciation should be applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if:

The adoption of the new method is required by statute (or)

For compliance with an accounting standard (or)

It is considered that the change would result in a more appropriate presentation of financial statements of the enterprise.

Therefore, the auditor must ensure that the change in method of depreciation on plant and machinery from SLM to WDV basis from the current year is made in accordance therewith. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. Further, it should be ensured that the deficiency (since change is from SLM to WDV) arising to be adjusted in the year of change by way of a charge to the profit and loss account. The auditor may also ascertain that the change in the method and the effect thereof on the profits of the entity is quantified and disclosed. If it is not done by the management, the auditor has to bring it to the notice of the shareholders through qualification in the audit report.

(b) Semi-finished goods lying with third parties: Semi-finished goods are the assets of the company and therefore such goods, though, at present not with the company, should be included in the closing stock under the head "stock with processors". The auditor shall be required to undertake the following steps in respect of inventories lying with third parties:

1. Ensure that semi-finished goods have been included for valuation of inventory since these belong to the company.
2. Obtain confirmation letters from such third parties in respect of quantity lying with them at the end of the year. The auditor may also consider carrying out the appropriate audit procedure to obtain assurance about the condition of such inventory.
3. Examine the basis of valuation. In this case, it shall have to be done on the basis of the cost of work-in-progress and having regard to stage of completion and accordingly accounting for conversions costs.
4. Check that the disclosure requirements as specified in schedule VI to the Companies Act, 1956 and AS 2, "Valuation of Inventories" have been followed

Question 4

Give your comments and observations on the following:

(a) Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the year-end.

(b) The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.

(c) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.

Answer

(a) Confirmation of Balances: Direct confirmation of balances from debtors/creditors in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor.

"Guidance Note on Audit of Debtors, Loans and Advances" issued by the ICAI recommends that the debtors may be requested to confirm the balance either:

As at the date of the balance sheet; or

As at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially mis-stated.

Therefore, it is not necessary that balances of debtors/ creditors should necessarily be verified only at the end of the year only. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically, i.e., Dec, 31 as a cut-off date in one year and June 30 in another year and so on. Therefore, the statement that balance confirmation from debtors/creditors can only be obtained for balances standing in their accounts at the year-end is not correct.

(b) **Certificate from an Expert:** The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of an expert. SA 620 on “Using the Work of an Expert” also states that an expert may be engaged / employed by the client. It further requires the auditor to assess skill, competence and objectivity of the expert amongst other factors and evaluate the work of an expert independently to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA 620 before relying upon the certificate obtained by the management from the actuary.

(c) **Revaluation of Fixed Assets:** The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on ‘Accounting for Fixed Assets’ requires that “an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner’s interests under the heading of revaluation reserves and is regarded as not available for distribution”. Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

Question 5

State briefly the duty of an auditor with regard to each of the following:

(a) No depreciation has been charged for the year ended 31st March 2010, in respect of a spare Bus purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year.

(b) *A sum of ₹ 10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing ₹ 8,00,000. The amount is credited to the Purchases Account.*

(c) *Cost of structural alterations amounting to ₹ 60,000 to self-owned factory premises has been charged to Building Repairs.*

(d) *A loss of ₹ 2,00,000 on account of embezzlement of cash was suffered by the company and it was debited to Salary Account.*

Answer

(a) Depreciation on Stand-by Asset: As per AS 6 on "Depreciation Accounting", 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. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare bus was kept ready for use as stand-by, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2010. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

(b) Amount Received from an Insurance Company: AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only ₹ 8,00,000 while the insurance money received is ₹ 10,00,000. Purchases Account need not be credited since it would distort the purchases done during the year and as also the gross profit. Therefore, entire amount of ₹10 lacs needs to be taken to profit and loss account under an appropriate head. This is an income arising from an ordinary activity of the enterprise but having regard to amount involved and exceptional nature, a separate disclosure be made in the profit and loss account. Such disclosure would enable the users to understand the performance of an enterprise for the period.

(c) Cost of Structural Alterations: Any subsequent expenditure on fixed assets which increases the profitability or capacity arising from them beyond their previously assessed standards of performance amounts to capital expenditure and, thus, must form part of the cost of the asset. The words "structural alteration" would generally signify that some significant changes have taken place in the design of building to provide more strength to the building or expansion in the capacity of the building. Therefore, cost of ₹ 60,000 represents the cost of expansion or extension or may increase the life span of premises, it is a capital expenditure, and an adjustment entry debiting Buildings Account and crediting Building Repairs Account should be made and depreciation should also be provided accordingly.

(d) **Embezzlement of Cash:** AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", requires that "all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period". It further states that "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Embezzlement of cash during the course of business is a 'business loss'. It is a business hazard which can occur once in a while. Being material item, it is required to be disclosed under a distinct head in the profit and loss account.

Question 6

Explain the difference between Depreciation and Fluctuation in Value.

Answer

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.

Question 7

State how you would verify the following:

(i) *Buildings*

(ii) *Patent Rights*

Answer

(i) Buildings

(i) Examine the title deeds of buildings to see whether the client holds the title on the balance sheet date. If the property has been mortgaged, the title deeds will be in the possession of the mortgagee, from whom a certificate should be obtained to that effect.

(ii) Verify the original cost of buildings by reference to the deed of conveyance. If the building is constructed by the client, verify the original cost by reference to the cost as recorded in the books of account of the year in which the construction was completed.

(iii) Verify that appropriate depreciation has been provided against the buildings. In case no depreciation is provided on the buildings, a note to this effect should be given in the profit and loss account.

(iv) See the appropriate lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc. Also ensure that all convenants in the lease deed have been fulfilled by the client.

(v) See that the buildings have been valued at cost less depreciation. If any revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made. In case of a company, the requirements of Schedule VI have been complied with.

(vi) See that the relevant particulars of buildings have been entered in the fixed assets record maintained by the client.

(ii) Patent Rights : A Patent Right is an official right to investor to make, use or sell his invention.

(i) Obtain the schedule containing particulars of the patents owned by the client as on the balance sheet date. The particulars should contain the dates of registration of the patents with the related authorities and the dates in respect of the last renewal.

(ii) See that the total of the values of the patent rights shown in each list agree with the values shown in the respective ledger accounts.

(iii) Examine the cost of patent rights.

(iv) See that the renewal fees in respect of the patent rights have been paid and the same has been treated as a revenue charge.

(v) Ensure the compliance with the provisions of AS 26.

Question 8

(a) Explain the meaning of the term "subsequent events" as used in the SA 560.

(b) Should all type of subsequent events be considered by the auditor in his attest function?

(c) *Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in the financial statements.*

Answer

(a) Meaning of Subsequent Events: *SA 560 on* "Subsequent Events", defines the term "subsequent events" as events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report., "subsequent events" also refer to significant events which occurred upto the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

(b) Consideration of Subsequent Events by the Auditor: *SA 560* requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor's report. However, the exact manner of treatment would depend upon whether the event falls in the category of 'adjusting event' or 'non-adjusting event'. As per Accounting Standard (AS) 4, events occurring after the date of the balance sheet are of two types, viz., adjusting events which provide further evidence of conditions that existed at the date of the balance sheet; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the date of the balance sheet.

Therefore, an auditor is required to consider all subsequent events while discharging his duties and determine whether those shall have to be adjusted or simply required to be disclosed. However, the auditor should perform work as near as practicable to the date of the auditor's report.

(c) Audit Procedures: The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedure to identify "subsequent events" requiring adjustment or disclosure in financial statements as laid down in *SA 560* is as under:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those change with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.

- Whether there have been any developments regarding contingencies.
- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

  (a) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

  (b) Reading the entity's latest subsequent interim financial statements, if any.

  (c) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

  (d) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or

  (e) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

Question 9

Write a short note on the Contingent Liability.

Answer

Contingent Liability: Accounting Standard (AS) 29 on 'Provisions, Contingent Liabilities and Contingent Assets', defines:

'Contingent Liability':

(a) is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) is a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

'Possible Obligation' – an obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

'Present Obligation' – an obligation is a present obligation if based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Contingent liability should not be recognised but disclosed if the possibility of an outflow of resources embodying economic benefits is not remote and the amount of obligation cannot be measured with sufficient reliability to be recognised as a provision. Contingent liability should be continually reviewed and if it becomes probable that an outflow of future economic benefits will be required, then contingent liability should be recognised as a provision.

As per the revised version of Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards), the Contingent Liabilities have to be presented in notes to accounts in the following manner:

Contingent liabilities and commitments (to the extent not provided for):

(i) Contingent liabilities shall be classified as:

- (a) Claims against the company not acknowledged as debt;
- (b) Guarantees;
- (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

- (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
- (b) Uncalled liability on shares and other investments partly paid

Other commitments (specify nature).

Question 10

As an auditor, comment on the following situations/statements:

(a) A Ltd wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue expenditure. The product did not pick up and the sales were negligible. It is anticipated that no material benefit will accrue in future from such heavy advertisement expenditure.

(b) *B Ltd. acquired a car for its Managing Director on hire-purchase basis. The interest payable as well as penalty for late payment of installments was added to the cost of the car.*

(c) *Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under Sundry Creditors.*

Answer

(a) Treatment of Heavy Advertisement Expenditure: Advertisement expenditure is generally of revenue nature and is thus written off to the profit and loss account in the year it is incurred. However, A Ltd. has incurred "heavy" advertisement expenditure to launch a new product. In such a case, it is the normal expectation that the benefit of such an expenditure is likely to bring benefits over a longer period. Therefore, heavy expenses for a new product, if campaign is successful, are normally treated as deferred revenue expenditure to be written off over a period of three to five years. Thus, deferral of expenditure is done only with the anticipation that benefit is likely to accrue in future accounting periods. It appears from the given facts that the product did not pick up and the sales were negligible. Therefore, it is almost established that the advertising effort is not going to succeed, i.e., no benefit is likely to flow in future. Thus, the entire expenses incurred should be written off to the Profit and Loss Account. Accordingly, the writing off of the entire expenditure to revenue is appropriate and correct.

(b) Car Purchased on Hire-Purchase Basis: The Managing Director's car was acquired on hire-purchase basis and, thus, the motor car account be debited with the cash price of car by raising a corresponding liability for the amount payable to the financing company. If the cash value is not readily available, it should be calculated by assuming an appropriate rate of interest. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account. In any case, the amount paid as penalty for late payment of installments should be debited as an expense instead of being added to the cost of the car. Under the circumstances, the auditor will have to qualify his report.

(c) Assets Purchased under Hire-Purchase System: Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest. Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. Thus the treatment followed by the company is correct.

Question 11

Write a short note on - the Cut-off Transactions relating to Inventories.

Answer

Cut-off Transactions relating to Inventories: Cut-off transactions imply a set of procedures applied to ensure separation of one year's transaction from those of the following year. An auditor is expected to devote his attention to the procedures followed by the management regarding cut-off. The auditor should satisfy himself that these procedures adequately ensure that (i) goods purchased for which properly has passed to the client have in fact been included in the inventories and that the liability has been provided for; and (ii) goods sold have been excluded from the inventories and credit has been taken for the sales.

Question 12

How will you vouch and/or verify the following?

(a) Retirement Gratuity to Employees.

(b) Sale Proceeds of Junk Materials

(c) Assets Abroad

Answer

(a) Retirement Gratuity to Employees

(i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

(ii) Verify computation of liability of gratuity on the aggregate basis.

(iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

(iv) See that the annual premium has been charged to Profit and Loss account.

(v) Ensure that the accounting treatment is in accordance with AS 15, "Accounting for Retirement Benefits in the Financial Statements".

(b) Sale Proceeds of Junk Materials

(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.

(c) Assets Abroad

(i) Examine the title deeds of immovable properties abroad.

(ii) Ensure that the immovable properties abroad have been properly classified and disclosed.

(iii) Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.

(iv) Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

Question 13

How will you vouch and/or verify the following ?

(a) Remuneration to directors.

(b) Consignment sales.

(c) Royalties received.

Answer

(a) Remuneration paid to Directors

(i) Refer to General Meeting or Board meeting resolution for the appointment and terms of appointment of the director.

(ii) Examine Articles of Association and general meeting resolution to determine the mode of payment-monthly, quarterly, or by way of commission.

(iii) Check agreement with the director.

(iv) Verify director's attendance in the board meetings.

(v) Ensure compliance with the provisions of Sections 198, 309, 349 and 350 and Schedule XIII of the Companies Act, 1956, where appropriate.

(vi) Check computation of the net profits and the commission payable to directors in terms of Revised Schedule VI to the Companies Act, 1956.

(vii) The following requirements in relation to Directors' Remuneration, etc. have been removed from the Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) to the Companies Act, 1956:

Payment to Directors including Managing Directors, managing agents, secretaries, treasurers & Manager, if any by the Company, subsidiary of the Company and any other person for following:

Managerial remuneration u/s. 198 of the Act paid or payable during the financial year to the directors (including managing director).

a) Expenses reimbursed to the managing agent under section 354.

b) Commission or other remuneration payable separately to managing agent or his associate under sections 356, 357 and 358.

c) Commission received or receivable under section 359 of the Act by the managing agent or his associate as selling or buying agent of the other concerns in respect of contract entered into such concerns with the company

d) The money value of the contracts for the sale or purchase of goods and materials or supply of services, entered into by the company with the managing agent or his associate under section 360 during the financial year.

e) Other allowance and commission including guarantee commission (details to be given).

f) Any other perquisite or benefits in cash or in kind. (Stating approximate money value where practicable)

g) Pension, gratuities, payments from provident funds, in excess of own subscription and interest thereon, compensation for loss of office, retirement consideration, etc.

(viii) Computation of net profit u/s. 349 with details of the commission payable as percentage of profits to the directors including Managing Directors/Manager (if any) should be stated by way of note.

(b) 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 stock 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 debtor for unsold goods and in valuation of stock, these goods should be included in stock at cost worked out on a consistent basis.

(c) 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 stock 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.

Question 14

Write short notes on the following:

(a) Outstanding Assets.

(b) Extent of Reliance on Analytical Procedures.

(c) Purpose of providing depreciation.

Answer

(a) Outstanding Assets: It is a well accepted accounting principle that all expenditure pertaining to the year alone should be charged against year's revenue and all income whether received or not should be accrued for the year. Following this principle one has to make certain year end adjustments in the books of account and outstanding assets are brought to book in that process. If expenditure has been made on certain revenue heads, the benefit of which is to be derived even after the year is over and adjustment is made to the original figure of expenditure so as to carry forward the sum that does not pertain to the year an outstanding assets is created. Similarly, if certain income has accrued for the year but has not been received, the amount that has so accrued is usually brought into books as year end adjustment and thereby creating an outstanding assets account.

Generally, outstanding assets are those items for which amounts are yet to be received though services, etc. have been rendered, or items for which benefit of service will be received later. For example, in case insurance amount has been paid in advance then the proportion thereof applicable to the period subsequent to the date of the balance sheet should be calculated and shown as an outstanding assets. Other examples of outstanding assets may include rent receivable, commission receivable, advertising amount paid in advance, interest receivable on loans, etc.

(b) Extent of Reliance on Analytical Procedures: As per SA 520 " Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(i) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(ii) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

(iii) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

(iv) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The tests of accounting-related controls. For example, an entity in establishing recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

(c) **Purpose of Providing Depreciation:** According to AS 6 on Depreciation Accounting, depreciation may be defined as, "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. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined". This is a measure of the exhaustion of the useful life of an asset during the accounting period. 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 fixed assets. The principal objective of depreciation on fixed assets is to allocate as an expense, the related depreciation amount on a year to year basis. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. The main purpose of providing depreciation is as under:

(i) To keep intact the capital invested in fixed assets - This is accomplished by retaining the amount of depreciation charged in the profit and loss account in the business.

(ii) To ascertain the true cost of production - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.

(iii) To determine the profit or loss for the year - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the profit and loss account for determining the profit or loss during a year;

(iv) To present a true and fair value of entity's assets in the balance sheet, since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the profit and loss account representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.

Question 15

"The Finance Manager of Belt Ltd. is of the opinion that before declaration of dividends it would not be necessary to set off the carried forward amount of debit balance in the Profit and Loss Account against current revenue profit but the same could be set-off against existing revaluation reserve". Do you agree as an auditor?

Answer

Adjustment of Carried Forward Losses against Revaluation Reserves: The Guidance Note on "Treatment of Reserve Created on Revaluation of Fixed Assets" recommends that the accumulated losses should not be adjusted against such revaluation reserve, since this would amount to setting of actual losses against unrealised gains. Debit balance in the Profit and

Loss Account is a fictitious asset. There is neither mandatory rule in accounting nor any legal requirement that fictitious assets must be written off before declaration of dividend. However, in arriving at divisible profits, the provisions of Section 205(2) (b) of the Companies Act, 1956 should be kept in view. The amount of loss or depreciation (contained in the debit balance of Profit and Loss Account) whichever is less should be set off against current revenue profit before declaration of dividends.

Since, mere revaluation of assets does not result in realised gain, and, thus, as per the sound accounting practice, the accumulated losses should not be adjusted against revaluation reserve because this would amount to setting off actual losses against unrealised gains. Therefore, if the debit balance in Profit and Loss Account is set off against revaluation reserve, and then dividend is declared from out of revenue profits, it would amount to payment of dividend out of capital without making good the amount of loss or depreciation whichever is less. Such a declaration will be violation of the provisions of Section 205 of the Companies Act, 1956. Hence, the opinion of the finance Manager of Belt Ltd. is not correct.

Question 16

How will you vouch and/or verify the following?

(a) Contingent Liabilities

(b) Excise Duty

(c) Recovery of Bad-debts written off

(d) Endowment Policies

Answer

(a) Contingent liabilities: Accounting Standard (AS) 29 on 'Provisions, Contingent Liabilities and Contingent Assets', defines *'Contingent Liability'* as a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

as a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

The auditor may take following steps:

i. Inspect the minute books of the company to ascertain all contingent liabilities known to the company.

ii. Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.

iii. Scrutinise the lawyer's bills to track unreported contingent liabilities.

iv. Examine bank letters in respect of bills discounted and not matured.

v. Examine bank letters to ascertain guarantees on behalf of other companies or individuals.

vi. Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.

vii. Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.

viii. Ensure that proper disclosure has been made as per Revised Schedule VI to the Companies Act, 1956 and AS 29, “Provisions, Contingent Liabilities and Contingent Assets”.

(b) Excise Duty: Excise duty is levied on manufacture. The liability for duty arises only at the point of time at which manufacturing is complete. The point of time at which duty is collected may be determined by consideration of administrative convenience. Normally excise duty is paid before the issue of excisable goods from the factory. For this, the auditor should take into consideration:

i. Ensure that excise duty is paid at the time of issue of exciseable goods from the godown at factory of the producer. The duplicate copy of the challan as issued by the bank is forwarded for the purpose of issue of the exciseable goods.

ii. Verify the amount of duty paid with the corresponding value of the goods issued from the stock register of the producer by applying test check. In case where the client maintains an advance deposit with Excise Department, the auditor should see that the permits are issued for delivery of the goods against the advance deposit and corresponding adjustment.

iii. Ascertain the rates of excise duty and apply it to the total sales and see that the amount actually paid does not exceed the amount thus calculated.

iv. Ascertain that in case of dispute about the amount of duty payable, a provisional amount may be paid in lieu of final amount. In such cases, the final amount determined as payable should be verified. If the provisional payment was more than the actual amount, the refund of such excess amount should be vouched.

v. The auditor may also physically verify RG 1 with actuals and see reconciliation of financial records with sales tax records.

(c) Recovery of Bad Debts written off

i. Check all correspondence and proper authorization of bad debts written off earlier and ensure that the decision of writing off of bad debts was recorded properly.

ii. Ascertain total bad debts and see whether all recovery of bad debts is recorded properly in the books of account and deposited into bank.

iii. Check all notifications from Court or bankruptcy trustee and all correspondence from debtors and collecting agencies.

iv Check Credit Manager's files for amount recovered and confirm acknowledgement receipts issued to trustee/debtors.

(d) Endowment Policies

i. Ascertain the specific purpose for which the endowment policy is taken, e.g., Sinking Fund policies for redemption of debentures, redemption of leases or policies taken for other similar purposes, etc.

ii. Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.

iii. Check that premium has been deposited in time and the policy is in force.

iv. Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

Question 17

Write short notes on the following:

(a) Intangible Assets

(b) Floating Charge

Answer

(a) Intangible Assets: An intangible asset is that asset which does not have a physical identity but which is used by the enterprise for production or supply of goods or for retails to other or for administrative purpose. Such asset does not have any physical existence but their presence in the business is indicated with a value placed thereon. These assets include rights and benefit to owners subject to their being useful. For example: goodwill, patents, copyright etc. AS 26, "Intangible Assets", applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. An intangible asset should measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.

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

(b) Floating Charge: Floating charge refers to a general charge on some or all the assets of an enterprise which is not attached to any specific assets and are given as a security against a debt. It has the effect of creating an immediate charge on the property of the company leaving the company to deal with the same in the ordinary course of business, but subject to the limitations imposed in the instrument of creating the charge. The floating charge, however, becomes fixed or crystallised and the creditor becomes entitled to proceed against the assets on which the charge was created, on violation of any of the terms of the instruments creating the charge. This charge is also required to be registered within 30 days of its creation under section 125 of the Companies Act, 1956.

Question 18

As an auditor, comment on the following situations/statements:

(a) You are the Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 20th July. The Sales Ledger balance at 31st March was ₹ 95, 000. By 20th July ₹ 65,000 only had been received against this amount as full and final payment.

(b) A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts.

Answer

(a) Consideration of Subsequent Events: SA 560 "Subsequent Events" requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements. AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of debtors as also the realisability aspect. The auditor's duties in respect of debtors remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from debtors. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31, 2004. Accordingly, the auditor would have now to see that in respect of outstanding amount of ₹ 30000, whether the amount of provision needs any revision.

(b) Joint Assets: AS 10, "Accounting for Fixed Assets", issued by the Institute, prescribes that in case of fixed assets owned jointly by enterprises, the extent of the entity's share in such assets, and the proportion in the original cost, accumulated depreciation and written down value should be stated in the Balance Sheet. Accordingly, the treatment followed by the companies reflecting 50% of the value of the machinery and changing 50% depreciation in their respective books of account is proper. However, such jointly owned assets should be indicated separately in the Fixed Assets Register maintained by the company.

(Note: Alternatively, AS 10 also recommends that the pro-rata cost of such jointly owned assets may be grouped together with similar fully owned assets and appropriate disclosure of the same should be made.)

Question 19

How will you vouch and/or verify the following?

(a) Personal expenses of directors met by the company.

(b) Preliminary expenses.

(c) Advances given to suppliers.

Answer

(a) Personal Expenses of Directors

(i) Check the articles of association, service contract, minutes of general meeting, etc., to check the authorisation for such payment.

(ii) Enquire to ensure that personal expenses are not camouflaged in any other revenue items as contemplated under section 227(1A) of the Companies Act, 1956.

(iii) Ascertain compliance with disclosure according to requirements of Schedule VI to the Companies Act, 1956.

(iv) Check documentary evidences to examine the payments reimbursed.

(v) Check compliance with requirements of CARO, 2003.

(NOTE: Reporting requirements of the Personal expenses of directors met by the company prescribed in MAOCARO, 1988 has been omitted in CARO, 2003).

(b) Preliminary Expenses: It is the expenditure incurred incidental to the creation, formation and floating of a company. It consists of stamp duties, registration fees, legal costs, consultants fees, expenses of printing of memorandum and articles, etc. The following should be checked:

(i) Check Board's minutes book containing the resolution approving the expenses claimed by promoters as having been spent in formation of the company.

(ii) Examine supporting papers and vouchers, contracts, agreements, etc. to support the promoters' claims. Also check bills and receipts issued by the printer of the memorandum and articles of association, share certificates, etc.

(iii) Check receipt for the registration fee paid for registration of the company.

(iv) Verify rates of stamp required to be affixed on the memorandum and articles of association.

(v) Ascertain Boards' minutes book for the decision to write off the preliminary expenses over a period. The quantum thereof which has not yet been written off for these expenses should be carried forward in the balance sheet under the head miscellaneous expenditure (to the extent not written off or adjusted) over a period of years.

(vi) Check that no expenses other than those what constitutes preliminary expenses are booked under this head, e.g. underwriting commission and brokerage paid.

(c) Advances to the Suppliers

(i) Obtain schedule of debit balances in creditors' account and pay particular attention to the age of the balances. Also scrutinise the bought ledger.

(ii) Enquiry should be made for long unadjusted outstandings and check as to whether any of them would require provisioning.

(iii) Examine that the advances have not been shown as deposits in balance sheet as per Section 227(1A) of the Companies Act, 1956.

(iv) Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.

Question 20

Write short note on Analytical review.

Answer

Analytical Review: SA 500 on Audit Evidence defines analytical review as those tests of details which consists of studying significant ratios and trends and investigating unusual fluctuation and items. Thus , analytical reviews are substantive audit procedure with the help of which auditor can perform tests of details in more efficient and effective manner. Therefore, analytical reviews are nothing best analytical review procedures which have been considered at length in SA 520 on "Analytical Procedures". According to SA 520, analytical procedures include the consideration of comparisons of the entity's financial information with, for example, comparable information for prior periods or anticipated results of the entity, such as budgets or forecasts. Consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages, between financial information and relevant non-financial information, such as payroll costs to number of employees also constitute analytical review procedures.

Analytical review procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, assessment of inherent and control risks, etc.

Question 21

Give your comments on "The CC Ltd., a Pharmaceutical Company, while valuing its finished stock at the year end wants to include interest on Bank Overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses".

Answer

Cost of Inventories: As per Accounting Standard 2 "Valuation of Inventories", cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. However, it makes clear that interest and other borrowing costs are usually not included in the cost of inventories because generally such costs are not related in bringing the inventories to their present location and condition. Therefore, the proposal of CC Ltd. to include interest on bank overdraft as an element of cost is not acceptable because it does not form part of cost of production.

Question 22

How will you vouch/verify the following?

(a) Advertisement expenses

(b) Goodwill

(c) Capital work-in-progress

(d) Wages paid to seasonal labourer

Answer

(a) Advertisement Expenses: The following steps may be taken by the auditor to vouch/verify the different items:

(i) Ascertaining the value of advertisement expenses to ensure that the said expense has been properly allocated.

(ii) Examining that such expenses relate to the client's business.

(iii) Review and examination of the complete list of media of advertisement indicating the dates, location, timing, etc., along with the amounts paid in respect of each category.

(iv) Examination of the receipts for amounts paid.

(v) Reviewing the contracts with the different agencies and ensuring that the billing conforms to the term and conditions specified therein.

(vi) Ensuring that all such outstanding expenses have been properly accounted for.

(b) Goodwill: Goodwill arises from business connections, trade name or reputation of an enterprise. AS 26, "Intangible Assets", states that internally generated goodwill is not to be recognised as an asset, as it is not an identifiable resource controlled by the enterprise, that can be measured reliably at cost. As per AS 10, "Accounting for Fixed Assets", goodwill should be recorded in the books, only when some consideration in money or money's worth has been paid for it. In light of the above discussions, the following points are to be noted for verification of goodwill:

(i) Examine the vendors' agreement on the basis of which assets of the running business have been acquired by the company as per the books of account or a specific amount has been paid for the goodwill.

(ii) Ensure that whenever business is acquired at a price, payable in cash or otherwise, which is in excess of the value of net assets taken over, such excess amount is the goodwill.

(iii) Ensure that only the amount paid to the vendors not represented by tangible or intangible assets, the value of which can be measured reliably has been debited to goodwill account.

(iv) See that goodwill has not been shown in the company's books by writing up the value of its assets, on revaluation, or by writing back the amount of goodwill earlier written off.

(v) Ensure that the goodwill not yet written off has been properly disclosed as per Schedule VI requirements.

(vi) See that the goodwill is being amortised as per financial prudence over a reasonable period.

(c) Capital Work-in-Progress: Capital Work-in-Progress denotes assets under installation. This could either be plant or machinery under construction, or that construction project for establishment of a new factory is under progress. The auditor should take the following steps to verify the same.

(i) Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.

(ii) Obtain the break up in details of the amount shown in the Balance Sheet under this head.

(iii) Check purchase cost of plant machinery or other assets with reference to the contract with, and amount paid to the suppliers.

(iv) Examine the allocation of common costs to the Capital Work-in-Progress in case such items have been constructed internally.

(v) Ensure that the assets already put to commercial use are not included under Capital Work-in-Progress.

(vi) Verify that only expenses incurred up to pre commissioning stage are capitalised under this head.

(vii) Obtain the certificate of the engineering department to ascertain the quantum of the Capital Work-in-Progress, and whether the value is correctly represented in the Balance Sheet, and its transfer to Fixed Assets on completion of the project or installation of the plant.

(viii) See that Capital Work-in-Progress is properly disclosed in the Balance Sheet under the head Fixed Assets as per the presentation and disclosure requirements of Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards)..

(d) Wages Paid to Seasonal Labourers

(i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.

(ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.

(iii) Ensure that the attendance is properly checked by the Time Keeping Department.

(iv) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.

(v) Check the computation of wages payable to the labourers, after taking into account the deductions.

(vi) Confirm that all the payment to the labourers have been acknowledged.

(vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.

(viii) Reconcile the number of seasonal labourers on payroll as per the Personnel Department's records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.

Question 23

As an auditor, comment on the following:

(a) As on 31.3.2009, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide

satisfactory after-sales services in relation to the software purchased from it. Before finalisation of the accounts for the year ended 31.3.2009 (the accounts were finalised on 14th June, 2009), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31.3.2009, which, it says, will be reversed in the next year.

(b) *SK Ltd. has fully computerised its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories at the year end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.*

Answer

(a) Events Occurring After the Balance Sheet Date: As per facts of the case on 31.3.2009, there was a claim against the company for damages by a customer for not providing after sales service. It is a condition prevailing as on the date of balance sheet. Part I of Schedule VI to the Companies Act, 1956 requires disclosure of claims against company not acknowledged as debt as a footnote under caption contingent liability if the same had not been provided for in the balance sheet. However, as on that date, the company had provided for the contingent liability perhaps in view of expectation that such a claim may crystallize as liability against it. The winning of the case by the company in its favour (before the accounts were approved) after the date of the balance sheet constitutes additional evidence that will be of help in deciding the treatment of the matter in the accounts as per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date". However, no provision would be needed as the case had been won by the company, since confirmed by subsequent event happening after the balance sheet date. The disclosure of facts of the case is, however, necessary with a view to keeping users of financial statements informed about the nature of event as well as the fact that no provision is necessary.

(b) Verification of Inventories – Auditors' Duties: The audit procedures to be performed by an auditor to obtain sufficient appropriate audit evidence in relation to inventories have been recommended in the Guidance Note on Audit of Inventories issued by ICAI. On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at stock-taking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management.

In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year.

Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. It must be tested, for example, in case of inventory, physically verifying the same as to see that no discrepancy exists. Pilferage, misappropriation is not the only cause for discrepancies. Inherent product qualities like shrinkage, evaporation, handling loss, etc. may also account for discrepancies. The auditor should require the management to conduct physical verification by or near the year end. If the management does not accept to the auditor's view the auditor may appropriately make modify in his audit report. CARO 2003 requires specific comment by auditor as to the adequacy and reasonableness of the *physical verification* of inventory. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for. Though the new order specifically omits the requirements of "fair inventory valuation" in accordance with accepted accounting principles and consistent method of valuation from year – to – year, since this is one of the basic requirements of Accounting Standards AS-2, the aspect should therefore still be verified.

Question 24

Under what circumstances change in accounting policies is permissible?

Answer

Change in Accounting Policies: Same accounting policies are adopted for similar events or transactions in each period so as to enable the user to compare the financial statements of an enterprise over a period of time. However, Accounting Standard 5, "Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies" provides that accounting policies can be changed under the following circumstances:

(1) if the adoption of a different accounting policy is required by statute; or

(2) for compliance with an accounting standard; or

(3) if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise. AS 5 also requires any change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by AS 5 should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. For instance, how an enterprise should deal with intangible items appearing in its balance sheet when it applies AS 26, Intangible Assets, for the first time.

Question 25

How will you verify/vouch the following ?

(a) Stock lying with Third Party

(b) Purchase of Motor Car

Answer

(a) Stock lying with third party

(1) Obtain confirmations from the third party including the time period and reasons thereof.

(2) Evaluate condition of goods and see whether adequate provision has been made.

(3) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(4) Ensure that the goods have been included in the closing stock though lying with third party.

(b) Purchase of Motor Car

(1) Ascertain whether the purchase of car has been properly authenticated.

(2) Check invoice of the car dealer to confirm purchase price.

(3) Examine registration with Transport Authorities to verify the ownership.

(4) Ensure that all expenses relating to purchase of car have been properly capitalized and the same have been disclosed properly in the balance sheet.

Question 26

State the different types of Analytical Review carried out in verification of inventories.

Answer

Analytical Procedures for Verification of Inventories: The auditor can adopt the following analytical procedures to verify the stock of inventories:

(i) Quantitative reconciliation of opening stocks, purchases, production, sales and closing stocks;

(ii) Comparison of closing stock quantities and amounts with those of the previous year.

(iii) Comparison of the stock turnover ratios for the current year with that of the previous year and with industry standards if available.

(iv) Comparison of the closing stock (Raw materials, closing work-in-progress and finished goods are percentage of total stocks) with the corresponding figures of the previous year.

(v) Comparison of current year gross profit ratio of the previous year.

(vi) Comparison of actual stock, purchase and sales figures with the budgeted figures if available.

(vii) Comparison of raw-material yield/wastage with previous year figures.

Question 27

How will you verify/vouch the following ?

(a) Purchase of quoted investment

(b) Discounted bill receivable dishonoured

(c) Amount due to subsidiary companies

Answer

(a) Purchase of Quoted Investment

(i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/ interest/right/bonus.

(ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.

(iii) Verify the amount paid towards purchase of investments.

(iv) Trace the amount in the cheque book counterfoils and bank statements.

(v) Obtain a schedule of investment from Management for physical verification at the year end.

(vi) Verify the investment certificate to confirm title.

(vii) Confirm compliance with statutory provisions such as 227(1A) and CARO, 2003 under section 227(4A) of the Companies Act, 1956.

(viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

(b) Discontinued Bill Receivable Dishonoured

(i) Obtain the schedule of discounted bills receivable dishonoured.

(ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.

(iii) Verify the bills receivable returned by the bank along with bank's advice.

(iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the debtor is also debited.

(v) Check that bank commission, if any, charged by the bank has been recovered from the party.

(c) Amounts due to Subsidiary Companies

(i) Examine whether the subsidiary company is authorized by its Memorandum of Association to advance the loan to the holding company.

(ii) Verify the interest rate at which the loan has been obtained and particulars of the security that has been furnished for confirming the amount of interest and disclosure of the charge in the Balance Sheet.

(iii) Inspect the documents executed by the holding company which constitute the basis of the loan and the provision in the Memorandum under which the loan has been raised.

Question 28

As an Auditor, comment on the following situations/statements:

(a) X Ltd. had a major break down in its plant in the month of February, 2010. In the month of March, 2010 it entered into an agreement with an engineering firm for the purpose of repairing its plant for a consideration of ₹ 180 lacs. The engineering firm started the repairing work in the month of April, 2010 and completed it in the same month. X Ltd. made the provision for said expenditure on repairs in its books of account for the financial year 2009-10 on the plea that the event of break down leading to repair expenditure had taken place in the financial year 2009-10, binding contract for repairs was entered into during the financial year 2009-10 and repair work was also completed before the financial statements were approved by the Board of Directors of the company.

(b) The management tells you that WIP is not valued since it is difficult to know the same in view of multiple processes involved and in any case opening and closing WIP would be more or less the same.

Answer

(a) Provisions, Contingent Liabilities and Contingent Assets (AS 29): As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability which can be measured only by using a substantial degree of estimation. In the instant case, the engineering firm, during the financial year 2009-10, did not carry out the repair work and hence no liability has arisen as at 31-03-10 as there was no obligation. Thus, the provision made by X Ltd. for repair work as on 31-03-10 is not correct as there was no obligation.

(b) Valuation of Inventories (AS 2): AS 2 deals with the principles and methods for determining the value at which inventories should be carried in the financial statements. Thus, items hold in the process of production is included in the definition of inventory.

Work in Process (WIP) is normally, valued by taking the basic cost of materials, labour and proportionate factory overhead incurred upto the stage of completion. In view of the above, the argument that the value of opening and closing WIP is more or less same is not tenable as the cost of material, labour and overhead might be different and accordingly, arriving at the different valuation of opening and closing WIP is possible.

In the given case, the management should have determined the stage of completion of the production and valued the work in process accordingly.

As per the CARO, 2003, the auditor has to report on the physical verification of inventory has been conducted at reasonable intervals by the management; are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported; whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.

Question 29

As an auditor, comment on the RT Ltd. Received ₹ 50 lacs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of ₹ 50 lacs as income in its Profit and Loss Account for the year. What are your views on the accounting treatment of the above receipt of ₹ 50 lacs?

Answer

Accounting treatment of Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. There are two method of accounting. Under one method, the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. Depreciation is charged on reduced value of fixed assets. Under other method, grants related to depreciable assets are treated as deferred income which is recognized in the Profit &Loss account on a systematic and rational basis over the useful life of the assets .

In the given question, accounting treatment of grant received towards part cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report.

Question 30

Write short notes on First in First out (FIFO) method.

Answer

First in First out (FIFO) Method: It is a cost formula used in assigning the cost to inventories which are ordinarily interchangeable. The FIFO formula is based on the assumption that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those which have been most recently purchased or produced. It is not applied where items of inventory are not ordinarily interchangeable.

Question 31

As an auditor, comment on the following:

(a) You are a Principal Auditor of Sri Company Limited which has three branches the accounts of which are subject to audit by qualified branch auditors. One of the branch auditors qualified his report for non-provision of doubtful debts which he considered to be material for the company as a whole. Subsequent to their reporting, but before you could sign the audit report on the accounts of the company as a whole, the management informed you that the debt under the subject-matter of qualification in Branch Auditor's report had been fully recovered.

(b) A Ltd. is a holding company of B Ltd. B Ltd. is going to start a new project estimated to cost ₹ 20 crores. For this A Ltd. made an investment of ₹ 10 crores in the shares of B Ltd. by borrowing the same from financial institution @10% p.a. As on 31st March, 2010 the project was not completed. The Directors of A Ltd. want to capitalize the interest upto 31st March, 2010 on borrowings amounting to ₹ 1 crore and add it to the cost of investments.

(c) A contractor entered into a contract for building roads for ₹ 2 crores. After completing 60% of the contract he came to know that the cost of completing the contract would be ₹ 2.40 crores. The accountant transferred ₹ 0.24 crores i.e., 60% of total loss of ₹ 0.40 crores to Profit and Loss account in the current year.

(d) Finished goods costing worth ₹ 10 lacs were damaged due to floods in July, 2008. These goods were included in the closing stock as on March 31, 2009 at an estimated realisable value of ₹ 4 lacs. These goods, ultimately, could be sold for ₹ 3 lacs only in the accounting year 2009-10. The difference of ₹ 1 lac was debited to prior period expenditure in the accounting year 2009-10.

Answer

(a) Qualification in branch auditor's report-subsequent events: The Branch auditor had qualified on non-provision of a major debt. After his report but before the issue of report by Principal auditor an event happened which has thrown new light on the facts that existed as on the date of balance sheet date. This is a subsequent event within the meaning of SA 560 i.e. event that had taken place between the date of balance sheet date and the date of signing the audit report. In relation to the cases where the component (i.e. branch) is audited by another auditor, the subsequent event would include events that had taken place between the date of audit report of the component and the date of signing the audit report of the entity as a whole by the principal auditor. On becoming aware of the subsequent events, the auditor should consider whether the accounts had been drawn so as to give effect to the facts of subsequent events. Accordingly, the auditor should omit qualification as the debt is no more doubtful in view of its recovery in full. However, the auditor may check that it has in fact been received by a substantial vouching of the subsequent events which had been considered by him to make himself fully satisfied about his report in the matter.

(b) Capitalisation of interest on borrowing cost: AS 16 states that borrowing cost that are directly attributable to the acquisition, construction or production of a qualifying asset, should be capitalized as a part of the cost of that asset. Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, e.g. manufacturing plants, power generation facilities etc. that require a substantial period of time to bring them to a saleable condition.

In the given case interest of ₹ 1 crore should not be capitalized because as per AS 16

(a) Investment of ₹ 10 crores in the shares of B Ltd. By A Ltd. is not a qualifying asset.

(b) Only borrowing cost incurred upto acquisition is allowed to be capitalized which would be nil in the case of investments.

Therefore the intention of company is wrong. As an auditor it should be brought to the knowledge of management and interest of ₹ 1 crore should be shown as expenditure in profit & Loss a/c.

(c) Recognition of Contract Revenue & Expenditure: As per AS 7 when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately irrespective of the stage of completion.

In the given case the revenue that can be recognized for the contract i.e. ₹ 2 crore and the expected expense on the contract is ₹ 2.4 cores. 60% of the contract has been completed. Therefore as per AS 7 whole amount of expected loss i.e. ₹ 0.40 crores should be recognized as an expense immediately irrespective of the stage of completion of the contract.

Therefore the action of accountant of transferring only ₹ 0.24 crores to the profit & loss a/c is wrong. He must transfer whole ₹ 0.40 crore to profit & loss a/c as an expense.

Auditor must advice the accountant to rectify the same and if he fails to do so he should qualify his report.

(d) Prior Period Items: As per AS 5 "Prior Period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."

Prior Period items should be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information become known or the transaction is finally settled.

In the instant case there is no error or omission in prior periods. It is a case of accounting estimates which have changed when the damaged goods have been finally sold.

Thus the difference of ₹ 1 Lac, debited to prior period expenditure in the accounting year 2009-10 is a wrong accounting treatment.

Question 32

How will you verify/vouch the following?

(a) Loss of stock by theft.

(b) Stock lying with subcontractor for fabrication.

(c) Sale of empties.

(d) Expenditure for advertisement in newspaper.

Answer

(a) Loss of Stock by Theft

(i) The most important evidence for verification will be the First Information Report (FIR) filed with the police for this theft.

(ii) The contents of the FIR will be cross checked with the financial books and stock records.

(iii) If no FIR is lodged, then deeper analysis will be required including satisfaction of the reasons for not filing FIR.

(iv) The quantity and value of the stolen stock is not included in the closing stock will be ensured.

(v) Verify whether such stock was insured and whether theft claim was lodged with the insurance company.

(b) Stock lying with sub-contractors for fabrication

(i) The stock lying with the sub contractor for processing should be confirmed by the confirmation letter obtained from the sub contractors.

(ii) The necessity of holding stock by them should be vouched. If the stock is lying with them for long, the reason for the same should be ascertained. The condition of the stock should be confirmed by the management.

(iii) The stock should be valued at cost or net realizable value whichever is less. The processing charges incurred should be added to the cost. The provision for the liability towards unpaid processing charges should be created.

(iv) The stock should be disclosed under the head current assets under the sub head inventory.

(v) Adjustment in accounts should be made for any discrepancies between stock confirmed and stock sent out as per memorandum records.

(c) Sale of Empties: When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturer normally agrees to purchase them back at a reduced price as compared to the one charged for them. Therefore check whether

(i) Separate account of issue and receipt of empties has been prepared.

(ii) In separate maintained a/c check how many empties lies in warehouse and how many are with customers.

(iii) Check how many empties customers may return after the close of the year.

(iv) Check whether proper provision has been made against the contingency of the containers being returned by customers and that for the wear and tear.

(v) Check the amount of sale with entry in cash book.

(vi) See the sold empties are reduced from the stock.

(vii) If the empties are sold on credit, ask for direct confirmation from purchasing party and confirm the sale.

(d) Expenditure for Advertisement in News paper

(i) Vouch the copy of the newspaper sent by the newspaper/ advertisement agency to ensure that advertisement actually appeared in the newspaper.

(ii) See the date of advertisement which appeared in the newspaper should fall in the current accounting year.

(iii) Contents of advertisement should be verified to ascertain that the advertisement was of the entity and was for the business and not of personal nature.

(iv) Ensure the rate charged with the offer received for rates from newspaper and ensure that the size and placement i.e. page is in accordance with the rate charged.

(v) Ensure deduction of TDS and service tax wherever applicable.

(vi) Ensure that it is printed in all issues of the newspaper for which newspaper has charged.

Question 33

Write a short note on - Provisions versus Specific Reserves.

Answer

***P*rovisions versus specific Reserves:** Provisions are amounts charged against revenue to provide for depreciation, renewal or diminution in the value of assets or a known liability the amount of which cannot be determined with substantial accuracy or a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Profit and Loss Account before arriving at the amount of profit.

On the other hand, a specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association, or the directors want to be provided for, such as dividend equalization, replacement of fixed assets, expansion of the organization, Income-tax liability for future foreign exchange fluctuation etc. Though the concerned amounts are carried under the earmarked heads, these are available for distribution as dividend on the recommendation of directors but subject to the approval of shareholders, since these are created by appropriation of profits. To create any specific reserve, existence of profit is essential. Some of the specific reserves may be required under the contractual obligations or legal compulsion, for example: (i) funds for redemption of debentures and (ii) development rebate reserve.

Thus provisions are amounts set apart to meet specific liabilities. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. While to create any specific reserve, existence of profit is essential.

Question 34

How will you vouch/verify the following ?

(a) Advance given to a director of a Company

(b) Repayment of amount of foreign loan for purchase of an asset

(c) Grant received for reimbursement of revenue expenditure

(d) Deferred Tax Liability.

Answer

(a) Advance given to a director of a company

(1) Verify articles of association for powers of the company to grant advances to director.

(2) Refer Section 295 of the Companies Act, 1956 if the company is a public company or a private company being a subsidiary of a public company. According to the section any loan or advance to director requires prior permission of central government.(Directors are often provided with advance money for expense for the purpose of the business of the Company. Such advances are outside the scope of Section 295).

(3) Check the bank book/cash book entries with vouchers.

(4) Study the contract /loan agreement, terms, rate of interest and inquire whether they are prejudicial to the interest of the company.

(5) Check the confirmation received from the director for outstanding advances.

(6) Check interest had been duly charged for the outstanding unless it is an interest free advance.

(7) The loan or advances made to the directors should be distinctly shown in the balance sheet.

(8) Check the related party transaction with director is disclosed in notes to the account (as per AS 18).

(b) Repayment of amount of foreign loan for purchase of an asset

(1) Check the loan agreement, rate of interest, terms of security.

(2) Check the remittances made during the year towards installments of repayments made.

(3) Check the receipted voucher/account confirmation for the balance of outstanding.

(4) The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.

(5) The gain or loss arising on exchange conversion is to be credited or debited to Profit and Loss account in accordance with the Accounting Standard 11 .

(6) Check banker exchange rate chart for correctness of the conversion.

(7) Check RBI or other agencies' permission for remittances outside India.

(c) Grant received for reimbursement of revenue expenditure

(1) Check the amount of receipt, donor details etc. from relevant voucher.

(2) Study the terms of grant for its utilization and check whether they had been complied with.

(3) Check the nature of grant, amounts have been duly disclosed in accounts in accordance with Accounting Standard 12.

(4) Check the provisions of law, if any, affecting foreign contributions if the grant comes from abroad.

(d) Deferred Tax Liability

(1) The deferred tax liability is created when there is timing difference which result in deferred tax payable with reduction in current tax to the same extent. For example, when more depreciation amount is claimed in Income tax profits than in accounting profits, the current tax payable will be less with an liability to pay more tax in future. This is called Deferred Tax Liability.

(2) Check the creation of Deferred Tax Liability and its actual working.

(3) Check how much Deferred Tax Liability is reversed during the year.

(4) Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.

Question 35

As an Auditor, comment on the following:

(a) Sri Limited is a manufacturing company engaged in manufacture of cement. It had three plants already commissioned in its site at Chennai. The company expanded its plant capacity by contracting with a supplier for the purchase and installation of one additional plant. The project was commenced on 1.7.2009 and the new plant commenced commercial operations on 1.1.20010. The new plant was capitalized and shown as Fixed asset as on 31.3.2010 at cost which included, besides other things, the following:

(i) Contract price of plant and equipment and installation costs

(ii) Interest due for the period till 31.3.2010 for the term loan taken from scheduled bank for financing the project which is repayable over five years commencing from 1.7.2010.

(iii) Salaries, welfare expenses of the plant engineers of the company for the period from 1.7.2009 to 31.12.2009 who supervised the contract work.

(b) The Investments of ABC Limited includes 5,000 equity shares of ₹ 100 each in Amudhan Bank Limited. Amudhan Bank Ltd. declared 20% dividend for the year ended 31.3.2009 at its General Meeting held on 30.6.2009. ABC Limited finalised its accounts for the year ended 31.3.2009 on 30.8.2009 and it includes ₹ 1,00,000 being the amount of dividend received by it from Amudhan Bank Ltd. in its other income subsequent to its Balance Sheet date before approval by the Board of Directors.

(c) AS Limited purchased on 1.4.2009 a machinery from a foreign country at a price of $ 1, 50,000 upon terms of credit that the price should be settled within six months from the date of purchase. The company capitalised the Asset and created Liability for the capital goods converting the foreign currency liability to Indian Rupees at a rate of exchange prevailing as on 1.4.2009. When the company settled the liability on 18.7.2009, it had to incur an additional amount of ₹ 6, 75,000 due to change in foreign exchange rate on the date of settlement. It added this additional amount of exchange variation in the capital cost of the asset and charged depreciation upon the enhanced amount of asset value from 18.7.2009.

Answer

(a) Accounting for Fixed Assets and Borrowing Cost: According to AS 10, the cost of fixed asset includes all expenses for bringing into existence and working condition the asset for its intended purpose. Accordingly all expenses attributable to the construction of fourth cement plant can be added to the cost except those which had been not permitted by the AS.

The cost of purchase, installation of asset is directly related to bringing the asset into the working condition for intended use and hence is correctly capitalized.

According to AS 16 on borrowing cost, the interest expenditure on borrowing can be capitalized till the date of the cessation of construction. The capitalization ceases when substantially all activities of construction are completed. Simply, the interest can be capitalized till the completion of the project and it should not be capitalized after commencement. In the instant case of capitalization of interest, the company is partly right in capitalizing it till 31.12.2009 and is wrong for capitalizing it beyond 31.12.2009 till 31.3.2010.

The allocation of common overhead is allowed if they are specifically relatable to project. The salary expenditure of plant engineers may be capitalized for the construction period.

Accordingly, the auditor shall qualify his report for the deviation if not adjusted, taking into account the materiality of the impact on accounts.

(b) **Dividend Recognition :** ABC Limited accounted the dividend income from its investment in Amudhan Bank Limited declared subsequent to its (ABC Limited) balance sheet but before finalization of the accounts.

According to AS 9 on revenue recognition, the dividend income is recognized when the right to receive it occurs viz. the date of declaration.

As such, the date of declaration is the relevant date. The date of declaration being 30.6.2009 falls after the end of the accounting period.

Hence, the company is wrong in accounting an income which does not pertain to the year under reference. This may warrant a qualification in the audit report subject to materiality consideration.

(c) **Effects of Changes in Foreign Exchange rates**: According to AS 11, the foreign currency transactions should be initially recognized at the exchange rate prevailing on the date of transaction. Accordingly, the asset and liability should be accounted at exchange rate prevailing on the date of purchase.

The monetary items should be reported at the exchange rate prevailing on the close of the accounting period. The liability for capital goods purchased is a monetary item.

If during the accounting period, if a monetary liability is settled at a rate different from the rate at which it was initially recognized the exchange difference should be charged to P&L account in the year of settlement.

According to AS 11 (revised), hence, it is necessary to write off ₹ 6.75 lakhs being exchange differences at the date of settlement. It cannot be added to the cost of the capital. Hence, the company is wrong in capitalizing foreign exchange differences between the amounts of initial recognition and settlement and computing depreciation on the wrongly capitalized portion of the asset.

This warrants correction by the company. Else, the auditor may qualify his report upon relevant considerations.

Question 36

As on Auditor, Enunciate the General principles of verification of Assets.

Answer

General principles of verification of Assets : It is not sufficient for the auditors only to verify correctness of the amount of assets shown in the balance sheet, he must verify them by actual inspection or otherwise and establish the existence of assets.

Points requiring auditor's attention for verification are as under:

(i) ***Cost -*** In regard to assets, verification procedure need not generally be extended to determination of the correctness of costs and authority to incur costs unless the items concerned were purchased during the accounting period under review. In such cases the auditor should check the correctness of costs through normal vouching method. He should ensure that adequate distinction has been made between 'revenue' and 'capital' nature of costs.

(ii) ***Ownership –*** Where ownership of assets is evidenced by documents of title etc. as in the case of immovable property, a reference should be made to such documents. If the documents are held by third person the auditor should either obtain a certificate directly from that party or arrange to inspect them at the third party's place of business.

(iii) ***Valuation* - I**t must be ascertained that all assets are valued in accordance with appropriate accounting policy. For the valuation made, the basis must be consistently applied, unless circumstances necessitated a change. Even then a disclosure is required for the change and its monetary effect.

(iv) ***Existence –*** Physical inspection should be done wherever possible. Where physical inspection is not possible, the possibility of obtaining indirect evidence be considered e.g. machinery imported held in customs godown or materials sent to subcontractor for job work or fabrication. In such circumstances certificating of such parties should be obtained and if considered necessary even physical verification may be requested.

(v) ***Presentation in accounts* -** Material assets must be properly disclosed and correctly described in the accounts. It should be seen that the description given to them is clear and complete and is not misleading e.g. stating loans on the assets side of the balance sheet "as dependent upon realization" is just misleading as was held in the case of London and General Bank Ltd. care must be taken to see that disclosures required under the statute or statement issued by ICAI are complied with.

Question 37

As an Auditor, comment on the following:

(a) Lehar Ltd. installed a new water treatment plant at its factory on 1.10.2009. The company estimated that the new plant will become obsolete after 4 years only and hence charged depreciation at a rate higher than that envisaged in Schedule XIV to the

Companies Act. During the year 2009-10, the company therefore had written off 1/4th of the cost.

(b) Fire Ltd. purchased equipment for its power plant from Urja Ltd. during the year 2008-09 at a cost of ₹ 100 lacs. Out of this they paid only 90% and balance 10% was to be paid after one year on satisfactory performance of the equipment. During the Financial year 2009-10, Urja Ltd. waived off the balance 10% amount which was credited to Profit and Loss account by Fire Ltd. as discount received.

Answer

(a) As per AS 6 on Depreciation Accounting, assessment of depreciation and the amount to be charged in respect thereof in an accounting year/period are usually based on the following three factors:-

(i) Historical Cost.

(ii) Expected useful life of the asset.

(iii) Estimated residual value of the asset.

If the management's estimate of the useful life of an asset in shorter than that envisaged under the relevant statute (Companies Act) the depreciation is appropriately computed by applying a higher rate. The depreciation rate provided in Schedule XIV is the minimum rate and a company can charge higher than those prescribed.

Hence, in the instance case decision of Lehar Ltd., to write off the cost of water treatment plant over four years is absolutely correct and as per AS-6.

However, the company has wrongly charged full year's depreciation during 2009-10 instead of half year's depreciation as per requirement of Schedule XIV. The auditor should highlight this to the company and ask to rectify the same.

(b) According to AS 10 on Accounting for Fixed Assets, the cost of an asset may undergo changes subsequent to its acquisition on account of exchange fluctuation, price adjustment, changes in duty or similar factors. Such changes in price /cost needs to be adjusted with the cost of the asset.

In the give case, Fire Ltd., initially accounted for 100% amount i.e., ₹ 100 lacs as cost of fixed asset although they paid only ₹ 90 lacs and kept ₹ 10 lacs as payable to the credit of Urja Ltd. Now since the supplier has waived off the balance amount of ₹ 10 lacs, this should be treated as change in price and needs to be adjusted with the cost of asset as per AS 10.

Therefore, the treatment given by Fire Ltd., in crediting ₹ 10. Lacs as discount to Profit & Loss Account is completely wrong and needs to be corrected. It will have effect on depreciation also and needs adjustment.

The auditor should report the matter if suitable changes are not made in the accounts.

Question 38

Distinguish between Reserves and Provisions.

Answer

Reserves and Provisions

(i) Reserve is an appropriation of profit whereas provision is a charge against Profit.

(ii) Reserves are not intended to meet any liability, contingency or diminution in the value of assets. Provisions are made to provide for depreciation, renewal or a known liability or a disputed claim.

(iii) Reserves cannot be created unless there is a profit except revaluation reserve and capital subsidy. Provisions must be created whether or not there is profit.

(iv) Reserves are generally optional except in certain situations – Capital Redemption reserve, Debenture Redemption Reserve, Declaration of dividend higher than 10% etc. Provisions are not optional and have to be made as per generally accepted accounting principles.

(v) Reserves are shown on the liability side. Provisions for depreciation and provision for doubtful debts are shown as deduction from respective assets. Provision for liability is shown on the liability side.

Question 39

Distinguish between Capital expenditure and deferred revenue expenditure.

Answer

Distinction between capital expenditure and deferred revenue expenditure: They differ in the following manners:

(a) Capital expenditure result in acquisition of new fixed assets or increase in future benefits from existing fixed assets beyond pre-assessed level.

Deferred revenue expenditure are expenditure of a revenue nature which bring in future benefits without creating a tangible or intangible fixed assets or by way of improvement in the existing assets.

(b) Capital expenditure adds to the net worth of the concern.

Deferred revenue expenditure is not considered in calculating net worth

(c) Capital expenditure is shown under the head fixed assets in balance sheet. Deferred revenue expenditure is shown under the head “Miscellaneous expenditure not written off or adjusted”

Question 40

How would you vouch/verify the following? (Answer any two):

(a) Trade Creditors.

(b) Advances to suppliers.

Answer

(a) Trade creditors:

(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 creditors with balances in bought ledger.

(iv) Compare the balances with the confirmation or statement of account received from trade creditors.

(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 creditors are classified and shown in the balance sheet as per requirement of Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) to the Companies Act 1956.

(b) Advances to suppliers

(i) Examine the bought ledgers to ascertain the debit balance of creditors 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 Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) to the Companies Act 1956.

(vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

Question 41

How would you vouch/verify the following? (Answer any two):

(a) Borrowings from Bank.

(b) Work in progress.

(a) Borrowings from a bank: Borrowings from a bank may be either in the form of overdraft limits; or short term or medium term or long term loans. The audit procedures which an auditor may adopt are outlined below:

(i) Ensure that balance as per books of the client and the bank statement tally. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.

(ii) Examine whether borrowings from the bank have been duly authorized.

(iii) Examine documents to ensure that statutory requirements, if any, with regards to creation and registration charges have been met.

(iv) Examine the loan agreement and ensure that the terms therein have been duly complied with.

(v) Ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made.

(b) Work in Progress:

(i) Involve a technical expert in verification and valuation of WIP, if necessary.

(ii) Ensure that cost sheets are duly attested by the works manager.

(iii) Test the correctness of the cost sheet by verification quantities, Cost of material wages and other charges with reference to the record.

(iv) Verify stage of completion with component of cost involved with underlying records.

(v) Compare the unit cost as shown by the cost sheet with standard cost for any large variations.

(vi) Ensure that the allocation of overhead expenses has been made on reasonable basis and is same as used in earlier period.

(vii) Compare the cost sheet with that of the previous year and if there is any large variation, investigate the reason thereof.

Question 42

As an Auditor how would you react to the following situations/comments?

(a) In a company Fixed Assets have been revalued and there has been resulting surplus of ₹ 2,00,000, which is transferred to revaluation reserve. The Company has a Debit

balance in Profit and Loss account ₹ 1,20,000 as accumulated brought forward losses. The company has adjusted this loss balance against Revaluation reserve.

(b) The Central Government sanctioned ₹ 20 lakh as Grant to a Hospital for the purchase of certain equi9pments and paid ₹ 10 lakh as advance. The hospital took ₹ 10 lakh as income in the Profit and Loss account for the year.

Answer

(a) The guidance Note on Treatment of Reserve created on Revaluation of 'Fixed Assets' advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealized gains.

In the given problem ₹ 2 lakhs transferred to revaluation reserve is unrealized gain whereas ₹ 1.20 lakh being debit balance in P & L A/c is actual accumulated loss. This loss cannot be adjusted from unrealized gain raised as revaluation reserve.

(b) As per AS-12, government grant received for specific asset should be treated in either of the following way:

(1) Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in P&L account on a systematic and rational basis over the useful life of the asset.

OR

(2) Grant to be shown as a deduction from gross value of the asset concerned in arriving at its book value and depreciation is charged on reduced value of fixed asset.

Interview of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the P&L account and has distorted the P&L account by treating the capital item as revenue. The audit should accordingly qualify the report.

Question 43

How would you vouch/verify the Trade Marks and Copy Rights.

Answer

Trademark and Copyright: The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fee have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amortized over the period of legal validity or useful commercial life, whichever is short. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS 26 has suggested a useful life of 10 years unless and until there is clear evidence that useful life is longer. The auditor should ensure that the presentation and disclosure requirements of Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) of the Companies Act. 1956 have also been complied with by the company.

Question 44

Write short note on Impairment of Assets.

Answer

Impairment of assets: Besides charging annual depreciation on assets by the reason of normal wear and tear, afflux ion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the assets can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss. The treatment of impairment loss is similar to depreciation except the fact that it can be re-instated in future, if the recoverable amount of the asset exceeds the carrying amount.

The auditor must ensure that provisions of AS 28 “Impairment of assets” are followed.

Question 45

(a) A Limited Company has filed a suit against debtor from whom ₹ 25 lakhs are receivable. A judgement is received from court in favour of the company after the date of Balance Sheet. Discuss auditors' duty in this regard.

(b) While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer.

Answer

(a) (i) Subsequent events are events occurred after balance sheet date but before the date of audit report.

(ii) In case of audit of components, such as branch or division the subsequent events are events after the balance sheet date and before the date of audit report of that component.

(iii) The subsequent events, according to AS 4 and as reproduced in SA 560 are of two types – (a) those which provide further evidence of conditions that existed at the balance sheet date and (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

(iv) Depending upon the type of subsequent events, the auditor should decide on adjustment of accounts based on evidential value gathered for conditions that existed as on the date of balance sheet date or disclosure of the conditions that arose subsequent to the date of balance sheet.

(v) The auditor should perform audit procedures to identify the subsequent events that are relevant for adjustment/disclosure. These procedures would include reading minutes of Board subsequent to accounting period, contacting lawyers for knowing progress of pending Cases, inquiry with the company management, scrutinizing subsequent interim accounts etc.

(vi) The auditor should perform these procedures as near as practicable to the date of his audit report.

(vii) If the management does not account for the subsequent events in the financial statements where they are to be accounted, the auditor should appropriately comment his report by a qualification or disclaimer.

(b) The Auditor while considering advances granted by bank for purchase of machinery has to consider valuation report given by civil engineer to the bank.

SA 620 "Using the Work of an Expert" clearly states while reliance on work done by expert, the auditor should consider:

(i) Professional qualification of experts

(ii) Experience and reputations.

If auditor finds that civil engineer can not be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

Question 46

How would you vouch/verify the following:

(a) Goods lying with third party.

(b) Proposed dividend

Answer

(a) Goods lying with third party

(a) The auditor should check that the materiality of the item under this caption included in stocks.

(b) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(c) He should inquire into the necessity of sub contractor retaining the stock. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(d) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(e) The records, voucher/slips for the regulating the movement of stock into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(f) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(g) The valuation of stocks should be correctly made for including material cost on appropriate stock valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(h) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

(b) Proposed dividend

1. Proposed dividend is to be provided for even though it is proposed and is to be declared after the end of the accounting period in terms of AS 4 and also schedule VI disclosure requirements.
2. The Auditor should check the minutes of the Board for the amount of dividend proposed to be considered for its declaration in general meeting.
3. The auditor should check the amount of paid up share capital and verify the quantum of dividend proposed by checking the calculations.
4. The interim dividend if any paid should be checked and ascertained that the proposed dividend is properly computed by adjustment to it, if the same had been reckoned for the total dividend.
5. Dividend tax payable on proposed dividend should be provided for.
6. The account should be properly disclosed in P&L account and also in balance sheet according to the requirements of Revised Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards) to the Companies Act 1956.

Question 47

Write short note on Physical attendance by auditor during inventory taking.

Answer

Attendance at stock taking

1. The physical verification of stock is the responsibility of the management. The auditor may find it appropriate to attend the stock taking, if the inventory value is material in his opinion.
2. The extent of participation in inventory taking depends upon the internal control system prevailing, results of examination of inventory records and analytical review procedures.
3. When auditor attend inventory taking, he ensure that the instructions given for inventory taking is followed.
4. He test checks few items by himself for their existence and quantum. He selects to test high value items importantly.
5. The physical conditions of stock – like its age, deterioration, obsolescence etc., are looked into by auditor.
6. The auditor reviews stores records and notes down major discrepancies for reconciling them in a subsequent date.
7. The cut off arrangement is also looked into ensure that the entity accounts for stock for which liability had been booked and excludes stick which had been sold.

Question 48

State the information to be disclosed in the financial statements according to the requirements of AS 6.

Answer

***Requirements of AS 6*:** AS 6 requires following information to be disclosed in the financial statements:

(i) Historical cost or other amount substituted for historical cost of each class of depreciating asset;

(ii) Total depreciation for the period for each class of assets.

(iii) The related accumulated depreciation.

It also requires following disclosure of information in the financial statements along with the disclosure of other accounting polices:

(i) Depreciation method used and

(ii) Depreciation rates or the useful life of the assets, if any, if they are different from the principal rates specified in the statute governing the enterprise.

Question 49

As an auditor, comment on the MNR Co. Ltd. did not provide for depreciation during the financial year 2007-08 due to inadequacy of profits. The company declared dividend during the financial year 2008-09 without providing for the previous year's depreciation.

Answer

Payment of dividend without providing for arrears of depreciation: Section 205 (1) of the Companies Act, 1956, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring / paying dividend:

(i) Either out of the profits of that financial year or

(ii) Out of the profits of any other previous years.

In the present case, it would be necessary to make provisions for depreciation in respect of 2007-08 and 2008-09 in the first instance and the balance of profit after providing depreciation including the previous year, could be used for distribution as dividend. Since the company has contravened the provisions of Section 205(1), the auditor should qualify his audit report.

Question 50

How would you vouch/verify "Leasehold property".

Answer

***Lease Hold Property*:** Following are the main steps involved in verification/vouching of lease hold property:

(i) Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions. A lease exceeding the period of one year is not valid unless it has been registered by an instrument. Hence this has to be ensured.

(ii) Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with, e.g. payment of ground rent, insurance premium, maintenance of lease and property in satisfactory state etc.

(iii) Ensure that due provisions for any claims that might arise under the dilapidation clause on the expiry of the lease have been made. If such provision has not been made, the auditor should draw the client's attention to it.

(iv) Ensure that the outlay and legal expenses incurred to acquire lease property have been capitalised. The property must be written off in such a way that it completely wipes off the asset at the end of the lease period.

(v) He should ascertain that the clause entitles the lessee to sub let any part of the leased property and ensure its proper compliance.

Question 51

Write short notes on Verification of credit sales.

Answer

Verification of the credit sales: The credit sales should be verified by reference to copies of invoices issued to customers and, in the process, attention should be paid to the following matters :

(i) that each item of sales relates to the period of account under audit;

(ii) that the goods are those that are normally dealt in by the concern.

(iii) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Despatch Note showing the date and mode of despatch of goods are attached with the invoice.

(iv) that the amount of the invoice has been adjusted in an appropriate account; and

(v) that the sale has been authorised by a responsible official and in token thereof he has initialed the invoice; also that any alteration in the invoice has been attested by the same person.

Question 52

What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance?

Answer

Auditing an account of Bought Ledger : The structure of every account in the Bought Ledger is: opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule VI to the Act. The maximum account due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed alongwith the names of companies (Part I, Schedule VI to the Companies Act, 1956).

Question 53

"Responsibility for properly determining the quantity and value of inventory rests with the management." Comment on this statement.

Answer

"Guidance note on Audit of Inventory" specifies that the responsibility for properly determining the quantity and volume of inventories rests with the management of the entity. Therefore it is the responsibility of the management of the entity to ensure that inventories included in financial statements are physically in existence and represent all owned by the entity.

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the compliance of "Accounting Standard 2: Valuation of Inventory" and adequacy of the method and procedures of physical verification followed by the entity .He is also required to determine whether the procedure for identifying defective, damaged, obsolete and slow moving items are well designed and operate properly that proper books of accounts should be made following the accounting standards

The responsibility of management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents depends on the facts and circumstances of each case.

CARO 2003 also requires specific comment by auditor as to the adequacy and reasonableness of the physical verification of inventory by the management. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for.

Question 54

What procedure an auditor should adopt to test the authenticity of cash at bank.

Answer

Verification of Cash at Bank: While testing the authenticity of cash at bank, the following areas may be considered by the auditor:

(i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

(vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

Question 55

Disclosure requirements of debtors in the financial statements.

Answer

Disclosure Requirements of Debtors in Financial Statements:

1. Classification by Age

(i) Debtors outstanding for a period exceeding 6 months and

(ii) Other debts.

The amount of provision for doubtful debts shall be shown separately. This is called classification by Age.

2. Classification by nature:

(i) Debts considered good and in respect of which the company is fully secured.

(ii) Debts considered good for which the company holds no security other than the debtor's personal security and

(iii) Debts considered doubtful or bad.

3. Classification by party:

(i) Debts due by the Directors or other officers of the company, or any of them severally or jointly with any other person. (The term "officer" includes any Director, Manager, or secretary but not auditor).

(ii) Debts due by Firms or private companies respectively in which any director is a partner or a director or a member, as the case may be.

(iii) Debts due from other companies under the same management along with names of companies concerned.

The maximum amount due, by directors or other officers of the company at any time during the year to be shown by way of a note.

4 Provisions: Provisions shown herein should not ensure the amount of the debts considered doubtful or bad-surplus provided, if any shall be shown as revenue under the head "reserves and surplus" under the heading "Reserve for Doubtful or bad debts".

5. Excluded items: The amounts to be shown under sundry debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations, but shall not include the amounts which are in the nature of loans or advances.

Question 56

Write short notes on of the following:

(a) Audit of sale of Investments

(b) Verification of assets acquired on lease.

Answer

(a) Audit of Sale of Investments:

(i) See that sale of investment has been made on the proper authorisation of Board or other competent authority.

(ii) Ascertain the method of selling investments. It may be either through broker, directly or through a bank. See the broker's sold note.

(iii) See that the difference between the carrying amount and the sales proceeds, net of expenses, is recognised in the Profit & Loss Account. Ensure that when only a part of the holding of an individual investment is sold, the carrying amount is allocated on the basis of average carrying amount of the total holding of the investments.

(iv) See that proper disclosures as required by AS 13 are made as follows:

(1) Interest, dividends, rentals on investments are to be shown in P& L A/c at Gross Value and TDS as advance tax paid.

(2) Showing separately profit & Loss on disposal and changes in carrying amount of current and long term investments.

(b) Verification of Assets acquired on Lease

(i) Examine the terms and conditions of the lease deed.

(ii) If a part of the leasehold property has been sublet, examine the tenant's agreement.

(iii) Verify relevant document to check the cost of property.

(1) In case of acquisition of an asset is on operating lease, lease payment should be recognized as an expense in the statement of profit and loss account on a straight line basis over the lease term, in case of operating lease;

(2) In case of acquisition of an asset is on finance lease, ensure all the substantial risks and rewards to ownership are transferred, considering the indication as prescribed in AS-19, the lessee should recognize the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased assets at the inception of the lease. Ensure contingent rents are recognized as expense in the statement of profit & loss for the period in case of Finance lease.

(iv) Ensure assets acquired under finance lease are segregated from the assets owned.

(v) Ensure that the assets under lease have been properly disclosed as per requirement of Schedule VI

Question 57

What are the factors that are to be considered while designing a confirmation request?

Answer

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:-

(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

Question 58

You are the auditor and examining the book debts of a company. Give some indications which leads to doubt about recovery as uncollectable debts from debtors and advances.

Answer

Indications of Doubtful and Uncollectible Debts

The term 'book debts' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

The following are some of the indications of doubtful and uncollectible debts, loans and advances:

(i) The terms of credit have been repeatedly ignored.

(ii) There is stagnation or lack of healthy turnover in the account.

(iii) Payments are being received but the balance is continuously increasing.

(iv) Payments though being received regularly, are quite small in relation to the total outstanding balance.

(v) An old bill has been partly paid (or not paid), while later bills have been fully settled.

(vi) The cheques received from the debtors have been repeatedly dishonoured.

(vii) The debt is under litigation, arbitration, or dispute.

(viii) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues, e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.

(ix) Amounts due from employees, which have not been repaid on termination of employment.

(x) Collection is barred by statute of limitation.

EXERCISES

1 *As an auditor, how would you react to the following situations?*

(a) *The company entered into "an agreement for sale" to purchase an office space in a commercial complex. The company with the consent of the promoters started operations from the said place upon signing of the said agreement and included under fixed assets, the total consideration payable.*

(b) *Included under sundry creditors was fees payable to the legal counsel for suits filed against the company. The company is not aware of the status of the suits and hence did not want to provide for the same.*

(c) *The company due to liquidity crisis sold and leased back the same vehicles from two different leasing companies on the same terms and conditions. In the notes to accounts the company stated "vehicles taken on lease repayable in 36 instalments of ₹ 36,650 each".*

The company was of the view that since the total monthly instalments payable was disclosed in totality, no qualification was required to be made by the auditor.

2 *State your views on the following:*

(a) *Events occurring after the Balance Sheet date.*

(b) *Verification, valuation and disclosure of fixed assets.*

3 *Write short notes on the following:*

(a) *Intangible assets*

(b) *Analytical review*

(c) *Floating charge*

4 *How will you vouch and/or verify the following?*

(a) *Inventories*

(b) *Sale of assets*

(c) *Bills payable*

(d) *Goodwill*

(e) *Contingent Liabilities*

(f) *Purchase of Quoted Investments.*

5 *State with reasons, how the following items should be allocated to capital and revenue:*

(i) *Repairs to building done shortly after purchase.*

(ii) *Costs of raising a loan.*

6 (a) *What are the general considerations for valuation and verification of assets?*

(b) *What is Depreciation of Fixed Assets and why is it provided? Can a company change the method of providing depreciation?*

7

The Company Audit – I

BASIC CONCEPTS

Appointment and remuneration of auditors (Section 224)

Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed .However, the first auditors of the Company are appointed by the Board of Directors within one month from the date of incorporation of a company.

The **remuneration** of the auditors of a company—

(a) in the case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government, as the case may be;

(aa) in the case of an auditor appointed under section 619 by the Comptroller and Auditor-General of India, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine; and]

(b) subject to clause (a), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

Auditor not to be appointed except with the approval of the company by special resolution in certain cases (Section 224A)

In the case of a company in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by a public financial institution or a Government company or Central Government or any State Government, or any financial or other institution established by any Provincial or State Act in which a State Government holds not less than fifty-one per cent of the subscribed share capital, or a nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment at each annual general meeting of an auditor or auditors shall be made by a special resolution.

Qualifications of auditor (Section 226)

A person shall not be qualified for appointment as an auditor of a company (public or private) unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949; provided that a firm whereof all the partners practising in India are qualified for appointment, as aforesaid, may be appointed by its firm name to be the auditors of a company in which case any partner so practising may act in the name of the firm [Section 226(1)]; and

As per the provisions of the Act, the chartered accountants have exclusive authority to act as the auditors. A chartered accountant either in his individual capacity may act as the auditor or a firm may also act as an auditor provided all partners in the said firm are chartered accountants within the meaning of the Chartered Accountants Act, 1949.

Disqualification of Auditors (Section 226)

Following persons are not qualified for appointment as auditors of a company :

(a) a body corporate;

(b) an officer or an employee of the company;

(c) a person who is a partner, or who is in the employment of an officer or employee of the company;

(d) a person who is indebted to the company for more than ₹ 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than ₹ 1000; and

(e) a person holding any security of that company.

(f) if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.

If an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), he shall be deemed to have automatically vacated his office.

Section 227 describes powers and duties of auditors.

Powers of Auditors

(a) Right of access to books, etc.

(b) Right to require information and explanation from officers

(c) Right to attend general meeting -.

Duties of Auditors

Sub-sections (1A), (2), (3), (4) and (4A) of section 227 of the Companies Act, 1956 specifies the duties of an auditor of a company in a quite comprehensive manner.

"(1A) Without prejudice to the provisions of sub-section (1), the auditor shall enquire:

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

(c) where the company is not an investment company within the meaning of section 372 or a banking company, whether, so much of the assets of the company, as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading."

Sub-sections (2) and (3) of section 227 provide that it is the duty of the auditor to report to the members of the company on the accounts examined by him and on every balance sheet and profit and loss account and every other document declared by the Act to be part of, or annexed to, the balance sheet and the profit and loss account, laid before the company in general meeting during the tenure of his office; also that the report shall confirm the position, envisaged in the under mentioned manner in which the requirements are to be met.

(4A) "The Central Government may, by general or special order, direct that, in the case of such class or description of companies as may be specified in the order, that auditor's report shall also include a statement on such matters as may be specified therein.

Audit Report

Sub-section (2) specifically requires that the auditor should report whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Companies Act, 1956, in the manner so required and that the balance sheet gives a true and fair view of the company's affairs at the end of financial year and the profit and loss account gives a true and fair view of the profit or loss for the financial year.

Sub-section (3) requires that the auditor shall report on the following matters :

(a) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for his audit.

(b) Whether in his opinion, proper books of account as required by law have been kept by the company, so far as appears from his examination of those books and proper returns adequate for the

(c) Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

(bb) Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by section 228(3)(c) and how he has dealt with the same in preparing the auditor's report.

(d) Whether in his opinion, the balance sheet and the profit and loss account comply with the accounting standards referred to in sub-section (3c) of section 211 of the Companies Act, 1956.

(e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company. This clause requires the auditor to highlight in thick type or in italics the observation or comments which have any adverse effect on the functioning of the company. It may be noted that neither auditor's observations nor comments have any adverse effect on the functioning of the company. Instead, those observation or comments are about matters which may have an adverse effect on the functioning of the company. The auditor now have to evaluate his qualifications or adverse comments to make judgement as to which of them deal with matters that have an adverse effect on the functioning of the company within the overall context of audit of financial statement of the company.

(f) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274."

[(g) whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid.]

Power of Central Government to direct special audit in certain cases (Section 233A)

Where the Central Government is of the opinion that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or that the financial position of any company is such as to endanger its solvency; the Central Government may at any time by order direct that a special audit of the company's accounts

Audit of cost accounts in certain cases (233B)

Where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of sub-section (1) of section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor

For details refer to the Companies Act, 1956

Question 1

Comment on the following:

(a) NM & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Various co-operative and term lending institutions held 51% of the paid-up share capital of the company.

(b) Mr. L, a chartered accountant in full-time practice, was acting as the statutory auditor of a public limited company, till it was wound up. Mr. L was appointed as the liquidator for purposes of winding up proceedings.

Answer

(a) Appointment of Auditors

The implication of shareholding of 51% of paid-up capital by various co-operative and term lending institutions is two fold as discussed below:

In terms of Section 224A of the Companies Act, 1956, a company in which not less than 25% of the subscribed share capital is held, whether singly or in any combination, by:

(i) a public financial institution or a Government company or the Central Government or any state government; or

(ii) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or

(iii) a nationalised bank or an insurance company carrying on general insurance business,

the appointment or re-appointment of an auditor in the Annual General Meeting shall be made only by passing a special resolution.

In this case, NM & Co. were appointed as auditors of the public limited company where 51% of the paid-up share capital was held by co-operatives and term lending institutions. Presuming that such institutions are covered by the aforesaid criteria, passing a special resolution was necessary. Hence, the appointment of NM & Co., chartered accountants, was null and void provided such institutions are covered by Section 224A.

Section 619 B read with Section 619 of the Companies Act, 1956 requires that a company in which the central government or any state government or any government company or any government corporation hold either singly or jointly not less than 51% of the paid-up share capital, the auditors of such companies are to be appointed by the central government on the advice of the Comptroller and Auditor General of India.

However, the co-operative and term lending institutions are not covered within the definition of corporation/institution owned by the Central/State Government. Accordingly, the provisions of Section 619 will not apply in this case, although the co-operatives and term lending institutions hold majority share capital.

(b) Appointment of auditor as a liquidator: Regulation 191 of the Chartered Accountants Regulations, 1988 allows a chartered accountant in practice, subject to the control of the Council, to act as a liquidator. But a chartered accountant at the same time cannot act both as liquidator and auditor of the company.

The Institute of Chartered Accountants of India, in order to establish a healthy convention, recommended that in cases where a chartered accountant acts as a liquidator, the statement of accounts to be filed u/s 551(1) of the Companies Act, 1956 should be audited by a qualified chartered accountant other than the chartered accountant who is the liquidator of the company.

The appointment of Mr. L, chartered accountant, to carry out both the functions as a liquidator and as an auditor will not be proper having regard to the concept of auditor's independence. Thus Mr. L, chartered accountant, cannot act both as the liquidator and the auditor.

Question 2

A company had a branch office, which recorded a turnover of ₹ 1,99,000 in the earlier year. The auditor's report of the earlier year had no reference regarding the branch although, the branch audit had not been carried out by the statutory auditor. Comment.

Answer

Reference to branch audit in the audit report: Under Section 228(4) of the Companies Act, 1956, the Central Government has formulated Companies (Branch Audit Exemption) Rules, 1961 to exempt any branch office of a company from being audited having regard to quantum of activity.

These Rules require that, if during the said financial year, the average quantum of activity of the branch does not exceed ₹ 2 lakhs or 2% of the average of total turnover and the earnings from other sources of the company as a whole, whichever is higher, the said branch is exempted.

In the case under review, the turnover is below ₹ 2 lakhs and other information has not been furnished. Accordingly, it may be presumed, exemption may have been granted but still it is necessary that the fact must be mentioned in the audit report.

Since, reference to branch is called for in the auditor's report even if the same has been exempted by the Central Government, the auditor remains responsible. The auditor has, however, no responsibility in respect of the audit of earlier period accounts.

Question 3

(a) An auditor purchased goods worth ₹ 1,500 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers.

(b) *An auditor became aware of a matter regarding a company, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion.*

Answer

(a) **Purchase of goods on credit by the auditor:** Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees.

This provision aims to ensure that the auditor is independent and under no financial obligation to the company.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

(b) Section 231 of the Companies Act, 1956 empowers the auditors of a company to attend any general meeting of the company; to receive all the notices and other communications relating to the general meeting, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Where the auditor has reason to believe that the directors concealed deliberately a serious fact from the shareholders which came to his note after issuance of the audit report, he should exercise this right. Normally speaking, an auditor considers subsequent events only upto the date of issuance of the audit report.

The discovery of a fact after the issuance of the financial statements that existed at the date of the audit report which would have caused the revision of the audit report requires that the auditor may bring this to the notice of shareholders.

Likewise, it may be advisable for the auditor to attend the meeting with a view to bringing to the notice of the shareholders any matter which came to his knowledge subsequent to his signing the report and if it had been known to him at the time of writing his audit report, he would have drawn up the report differently; or where the accounts have been altered after the report was attached to the accounts.

Question 4

'At the AGM of ICI Ltd., Mr. X was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry. State, how the new auditor will be appointed by ICI Ltd.

Answer

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.

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 ICI 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.

Question 5

Write short notes on the following:

(a) Auditor's Lien

(b) Disclaimer of Opinion

Answer

(a) **Auditor's Lien:** In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.

On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non payment of fees, for work done on the books and documents.

The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

(i) Documents retained must belong to the client who owes the money.

(ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.

(iii) The auditor can retain the documents only if he has done work on the documents assigned to him.

(iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under Section 209 of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. However, in both the Act, further provisions are thereunder which books of account could be kept at a different place, pursuant to a Board resolution of which notice must be given to Registrar of Companies.

If in a company meeting, Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar of Companies. If in a company meeting, Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar, the auditor may in such circumstances, exercise the right of lien for non-payment of fees.

However, as per Section 209 he must provide reasonable facility for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints.

His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Audit Documentation also states that, "working papers are the property of the auditor". The auditor may at his discretion make portions of or extracts from his working papers available to his clients.

Thus, documents prepared by the professional accountant solely for the purpose of carrying out his duties as auditor (whether under statutory provisions or otherwise) belong to the professional accountant.

In the case of *Chantrey Martin and Co. v. Martin,* it was held that the following documents were the property of the auditor: working papers and schedules relating to the audit, draft accounts of the company, and the draft tax computation prepared by an employee of the auditor.

It is also clear that the accountant's correspondence with his client (letters written by the client to the accountant and copies of the letters written by the accountant to the client) belong to the accountant. In the case of *Chantrey Martin and Co. v. Martin*, it was also held that the correspondence between the accountant and the taxation authorities with regard to the client's accounts and tax computations was the property of the client since the accountant merely acted as agent of the client.

However, where the accountant communicates with third parties not as an agent, but as a professional man, e.g., as an auditor, the correspondence with third parties would seem to belong to the accountant. According to the statement, where an auditor obtains documents confirming the bank balance or confirming the custody of securities of the client or other similar documents, it is probable that the courts would hold that these documents belong to the auditor.

(b) **Disclaimer of Opinion:** Where an auditor fails to obtain sufficient information to warrant an expression of opinion, and, thus, is unable to form an opinion, he issues a disclaimer of opinion.

Accordingly, the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion.

The necessity of a disclaimer of opinion may arise due to many reasons such as the scope of examination is restricted or in certain circumstances the auditor may not have access to all the books of account for certain reasons, e.g., books are seized by excise authorities or destroyed in fire, etc. It is but natural that the auditor must make all efforts to verify and substantiate the events. In case he is unable to obtain audit evidence even from alternative sources, then the auditor can only state that he is unable to form an opinion.

Question 6

Give your comments and observations on the following:

(i) *KBC & Co. a firm of Chartered Accountants has three partners, K, B & C; K is also in whole time employment elsewhere. The firm is offered the audit of ABC Ltd. and its twenty branches. The firm already holds audit of 40 companies including audit of one foreign company.*

(ii) At the Annual General Meeting of CU Ltd., Mr. L is appointed as the auditor which later is held to be void ab initio. The company holds another general meeting and appoints a new auditor.

(iii) At an Annual General Meeting, Mr. R a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P, could not be proceeded with, due to Mr. P's death.

(iv) MNC Ltd. in which 24 per cent of the subscribed capital is held by a public financial institution at the time of issuing the notice for the Annual General Meeting, appoints RK & Co. as auditors by an ordinary resolution at the Annual General Meeting when the Public Financial Institution increased its Stake in MNC Ltd. to 25 per cent of its subscribed capital.

Answer

(i) Ceiling on Number of Company Audits: According to Section 224(1B) of the Companies Act, 1956 certain chartered accountants cannot hold more than the specified number of company audits. The specified number is to be computed in the following manner:

In the case of firm of chartered accountants, the specified number should be construed as twenty companies (out of which not more than ten may have a paid-up share capital of rupees twenty five lakhs or more) per such partner who is not in whole-time employment elsewhere.

In the firm of KBC & Co., K is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. If B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by KBC & Co., is forty, out of which not more than twenty companies may have a paid-up share capital of rupees twenty five lakhs or more.

Branch audits are not to be counted in computing this specified number. Therefore, it does not matter whether ABC Ltd. is having twenty branches. Audits of the accounts of foreign companies are also not to be included within the specified number as such companies are outside the scope of section 224.

Thus the acceptance of audit of ABC Ltd. and its twenty branches will accordingly be within specified limits.

(Note: Students may note that section 224(1B) has been amended by the Companies (Amendment) Act, 2000 and a provisio has been added whereby this sub-section is not applicable to a private company after 13.12.2000.)

(ii) Observance of provisions of the Companies Act, 1956: Section 224 of the Companies Act, 1956, lays down the necessary details of appointment of an auditor. Accordingly, it is necessary that requirements of Section 224A with regard to passing of special resolution or ceiling on number of audits as laid down in Section 224(1B) amongst others have to be complied with.

In case a company fails to adhere to statutory provisions laid down in the Companies Act, 1956, then in such cases, the appointment of any person as the auditor at the Annual General Meeting would be void *ab initio*. Under the circumstances in view of the fact that the company failed to appoint an auditor, the provisions of Section 224(3) would be attracted and the appointment of the auditor can be made by the Central Government only.

Accordingly, the appointment of a new auditor at the subsequent general meeting will not be valid.

(iii) Reappointment of Retiring Auditor: Section 224(2) of the Companies Act, 1956 dealing with reappointment of auditors specifies that subject to the provisions of sub-section (1B) and section 224A, at any Annual General Meeting a retiring auditor, by whatsoever authority appointed, shall be re-appointed unless, *inter alia*:

"Where notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or dis-qualification of that person or of all those persons, as the case may be, the resolution cannot be proceeded with."

However, it should be noted that even for the re-appointment of a retiring auditor, the passing of a resolution is essential. Section 224 of the Companies Act, 1956, requires that a resolution has to be passed by the company every year. In the absence of a resolution, the retiring auditor is not re-appointed automatically.

Thus, the claim of Mr. R would not hold good.

(iv) Passing of a Special Resolution: Section 224A of the Companies Act, 1956 does not specify the date on which 25% of the subscribed share capital should be held by the specified institutions to require the appointment of the auditors by a special resolution.

The Department of Company Affairs has opined that the material date is the date of the AGM at which the special resolution is required to be passed. In some cases, it is possible that the shareholding of the specified bodies is less than 25% of the subscribed share capital of a company at the time of issuing the notice for the AGM, but exceeds this limit on the date of the AGM. In such a case, it is advisable for the company to adjourn the meeting, issue another notice to the members for appointment of auditors by special resolution and pass the special resolution at the adjourned meeting.

Hence, MNC Ltd. should appoint RK & Co. as auditors in the above mentioned manner.

Question 7

Explain the difference between Unmodified opinion and and Qualified opinion.

Answer

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

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.

Question 8

What will be position of the Auditor in the following cases?

(a) A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September, 2009, which assignment he accepted. Subsequently in January, 2010 he joined B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

(b) K, a chartered accountant, was appointed as auditor of Y Ltd. In the 12th Annual General Meeting of the company in September, 2008. In June, 2009 the company removed him through a resolution in the general meeting and appointed Ram as its auditor.

(c) Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors.

(d) While conducting the audit of a limited company for the year ended 31st March, 2010, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

Answer

(a) Disqualifications of an Auditor: Section 226(3)(c) of the Companies Act, 1956 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (5) of Section 226 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) and (4) of Section 226, he shall be deemed to have vacated his office as an auditor. In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman

Limited, has attracted clause (3) (c) of Section 226 and, therefore, he shall be deemed to have vacated office of the auditor of M/s Laxman Limited.

(b) Removal of an Auditor: The removal of auditor K, a chartered accountant, before the expiry of the term of an auditor's appointment by M/s Y Limited is invalid. Sub-section (7) of Section 224 of the Companies Act, 1956 provides that an auditor may be removed from office before the expiry of his term, by the company only in a general meeting after obtaining the prior approval of the Central Government in that behalf.

However such approval is not required for the removal of the first auditor appointed by the Board of Directors under the proviso to sub-section (5) of Section 224. Since prior approval of the Central Government has not been obtained, the removal of K is not valid and, therefore, K continues to be the auditor. The appointment of Ram in his place is void.

(c) Restricting Scope of Audit: Y may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders.

There is no concept of full or part audit under Section 227 of the Companies Act, 1956. And, remuneration is a matter of arrangement between the auditor and the shareholders. Section 224(8) specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

His duties may not necessarily commensurate with his remuneration. Y, therefore, should not accept the suggestions of the directors regarding the scope of the work to be done. Even if Y accepts the suggestions of the directors regarding the scope of work to be done, it would not reduce his responsibility as an auditor under the law. Under the circumstances, Y is violating the provisions of the Companies Act, 1956.

(d) Right of Access to Minute Books: Section 227 of the Companies Act, 1956 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

Question 9

Comment on the following:

(a) In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.

(b) Due to the resignation of the existing auditor(s), the Board of directors of X Ltd appointed Mr. Hari as the auditor. Is the appointment of Hari as auditor valid?

(c) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?

Answer

(a) Board's Powers to Appoint an Auditor: The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is empowered to fill such a vacancy. Section 224(3) of the Companies Act, 1956, empowers the Central Government to fill up a vacancy in case no auditors are appointed or re-appointed at an annual general meeting (AGM). (It is also opined that the appointment of an auditor having been made by shareholders, sub-section (3) cannot be invoked Thus the auditor could only be appointed by shareholders at general meeting). Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor (s) appointed at the Annual General Meeting refuse to accept the appointment.

(b) Board's Powers to Appoint Auditor(s): The resignation of the existing auditor(s) would give rise to a casual vacancy. As per Section 224(6) (a) of the Act, casual vacancy can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. The rationale behind such a provision is to ensure that resignation is a matter of great concern and, thus, it is necessary that all shareholders must be apprised of reasons connected with resignation in case of a casual vacancy arising on account of resignation. The vacancy shall only be filled by the company in general meeting. Thus the appointment of Mr. Hari as the auditor of the company is not valid.

(c) Restrictions on Powers of Statutory Auditors: Section 227(1) of the Companies Act, 1956 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence' any such resolution even if passed by entire body of shareholders is ultra vires and therefore void. In the case of Newton vs. Birmingham Small Arms Co., it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled under the Companies Act, are inconsistent with the Act.

Question 10

How would you as an auditor distinguish between Reports and Certificates?

Answer

Distinction between Audit Reports and Certificates: The term 'certificate', is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a financial statement, it implies that the contents of that statement can be measured and that the auditor has vouchsafed the exactness of the data. The term certificate is, therefore, used where the auditor verifies certain exact facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain precise figures and is in a position to vouch safe their accuracy as per the examination of documents and books of account.

An auditor's report, on the other hand, is an expression of opinion. When we say that an auditor is reporting, we imply that he is expressing an opinion on the financial statements.

The term report implies that the auditor has examined relevant records in accordance with generally accepted auditing standards and that he is expressing an opinion whether or not the financial statements represent a true and fair view of the state of affairs and of the working results of an enterprise. Since an auditor cannot guarantee that the figures in the balance sheet and profit and loss account are absolutely precise, he cannot certify them. This is primarily because the accounts itself are product of observance of several accounting policies, the selection of which may vary from one professional to another and, thus, he can only have an overall view of the accounts through normal audit procedures. Therefore, the term certificate cannot be used in connection with these, statements.

Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

Question 11

State with reasons your views on the following:

(a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2009-2010. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.

(b) *Mr. Rajendra, a fellow member of the Institute of Chartered Accountants of India, working as Manager of Shrivastav and Co., a Chartered Accountant firm, signed the audit report of Om Ltd. on behalf of Shrivastav & Co.*

Answer

(a) Auditor holding securities of a company : As per sub-section (3)(e) of Section 226, a person holding any security of the company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000 w.e.f. December 13, 2001 is not qualified for appointment as auditor of that company. For the purpose of this section, "security" means an instrument which carries voting rights.

It is further laid down in sub-section (4) of Section 226 that a person is not eligible for appointment as auditor of any company, if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company. Sub-section (5) of Section 226 provides that if an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), he shall be deemed to have automatically vacated his office.

A firm would also be disqualified to be appointed as an auditor even when one partner is disqualified under clause (e) of sub-section (3) of Section 226.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. As such, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd., which is the holding company of Shiva Ltd., even when one partner is disqualified under this clause.

(b) Signature on Audit Report: Section 229 of the Companies Act, 1956 requires that only a person appointed as the auditor of the company or where a firm is so appointed, a partner in the firm practising in India, may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor. Therefore, Mr. Rajendra, a fellow member of the Institute and a manager of M/s Shrivastav & Co., Chartered Accountants, cannot sign on behalf of the firm in view of the specific requirements of the Companies Act, 1956. If any auditor's report or any document of the company is signed or authenticated otherwise than in conformity with the requirements of Section 229, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document shall, if the default is willful, be punishable with a fine.

Question 12

As an auditor, comment on the following situations/statements:

(a) *The first auditors of Health and Wealth Ltd., a Government company, was appointed by the Board of Directors.*

(b) In case the existing auditors reappointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy?

(c) The auditor of Trilok Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.

(d) At the AGM of a company, in which a Nationalised Bank held 25% of the subscribed capital, Krishna & Co., Chartered Accountants, were appointed as auditor by passing an ordinary resolution.

(e) The members of C. Ltd. preferred a complaint against the auditor stating that he has failed to send the auditors report to them.

(f) One of the directors of Hitech Ltd. is attracted by the disqualification under Section 274(1)(g).

Answer

(a) Appointment of the First Auditor by the Board of Directors: Section 224(5) of the Companies Act, 1956 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company". Thus, the first auditor of a company can be appointed by the Board of Directors within one month from the date of registration of the company. However, in the case of a Government Company, the appointment or re-appointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. Hence in the case of M/s Health and Wealth Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Thus, the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd., is null and void.

(b) Refusal by Auditors to Accept the Reappointment: Section 224(3) of the Companies Act, 1956 empowers the Central Government to fill a vacancy in case no auditors are appointed or reappointed at an annual general meeting. Since the appointment of an auditor is complete only on the acceptance of the office by the auditor, it can be deemed that in case an auditor refuses to accept the appointment then in that case no auditor has been appointed and the Central Government may appoint a person to fill the vacancy as provided in Section 224(3). Thus, the non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. As a general principle, the shareholders have to exercise this power in all cases, except in the case of filling a casual vacancy or appointing the first auditors. Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditors appointed at the AGM refuse to accept the appointment.

(c) Comment on Matters Contained under Section 227(1A) of the Companies Act, 1956: Section 227(1A) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in non-reporting on the matters specified in Section 227(1A).

(d) Appointment of Auditor by Passing an Ordinary Resolution: Section 224A of the Companies Act, 1956, provides that in case of a company in which not less than 25% of the subscribed share capital is held whether singly or in any combination, amongst others, by a public financial institution or government company or central or state government or nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment of an auditor or auditors at each annual general meeting shall be made by a special resolution only. In the given case, the nationalised bank held 25% of the subscribed share capital which is equal to the prescribed limit of 25%.

In view of the above provisions, the appointment of Krishna & Co., Chartered Accountants, as auditor of the company is not valid, since as per law, special resolution is required in such circumstances. In such cases, it shall be deemed that no auditor has been appointed and thereupon the Central Government's power to appoint the auditor pursuant to Section 224(3) will become operative.

(e) Dispatch of Auditor's Report to Shareholders: Section 227 of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. In Re Allen Graig and Company (London) Ltd., 1934 it was held that duty of the auditor after having signed the report to be annexed to a balance sheet is confirmed only to forwarding his report to the secretary of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

(f) Disqualification of a Director u/s 274(1)(g) of the Companies Act, 1956: Section 227(3)(f) as inserted by the Companies (Amendment) Act, 2000 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under Section 274(1)(g) of the Companies Act, 1956. To this end, the auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by Section 274(1)(g). Since in this case, one of the director is attracted by disqualification u/s 274(g) of the Act, the auditor shall state in his report u/s 227 about the disqualification of the particular director.

Question 13

White Star Ltd. was incorporated on 1.8.2009 and Mr. T who is related to the Chairman of the Company appointed as auditor by the Board of Directors in their meeting on 4.9.2009. Comment.

Answer

Appointment of First Auditors by the Board: Apparently, there are two issues arising out of this situation, viz., first one relates to appointment of first auditor by the Board of Directors; and second, pertains to relation of such an auditor with the Chairman of the company. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditors, it may be noted as per the provisions of Section 224(5) of the Companies Act, 1956, the first auditor of a company shall be appointed by the Board of Directors within one month of the date of registration of the company. As per the facts given in the case, the Board has failed to appoint the first auditor within one month of the registration of company because the date of incorporation of White Star Ltd. is 1-8-2009 and the date of appointment of auditors by the Board of Directors is 4-9-2009. Therefore, provisio of Section 224(5) becomes operational. Accordingly if the Board fails to appoint the first auditor, the Blue star Ltd. in general meeting has to make the appointment. Thus the appointment of Mr. T is not valid. Under the circumstances, the second issue relating to relationship of auditor with the Chairman becomes redundant.

Question 14

Draft an illustrative Audit Report u/s 227 of the Companies Act, 1956, with a few qualifications. Annexure u/s 227(4A) is not required.

Answer

An illustrative auditor's report on the financial statements in case of a Audit of a complete set of separate general purpose financial statements of a company prepared under the Companies Act, 1956 financial reporting framework. The terms of the audit engagement reflect description of management's responsibility for the financial statements. The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statement. The audit opinion is qualified for the misstatement. In addition to the audit of financial statements; the auditor has other reporting responsibilities required under the Companies Act, 1956 and/or other regulatory requirements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company Limited

Report on the Financial Statements: We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements: Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the Company in accordance with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility: Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

*Basis for Qualified Opinion***:** *ABC Company Limited's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs. XXX in the Balance Sheet as at March 31, 20XX, and ABC's share of XYZ Company's net income of Rs. XXX is included in ABC Company Limited's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX and ABC Company Limited's share of XYZ*

Company's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion: In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects[1] of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;

(b) in the case of the Profit and Loss Account, of the profit/ loss for the year ended on that date; and

(c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the Order.
2. As required by section 227(3) of the Companies Act, 1956, we report that:
   a. we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit except for the matter described in the Basis for Qualified Opinion paragraph;
   b. in our opinion proper books of account as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purposes of our audit have been received from branches not visited by us][2];
   c. the Balance Sheet, Statement of Profit and Loss and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us][3];
   d. *except for the possible effects[4] of the matter described in the Basis for Qualified Opinion paragraph, in our opinion, the Balance Sheet, Statement of Profit and Loss*

[1] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.
[2] To be included if relevant.
[3] To be included if relevant.
[4] Note the use of words "possible effects" as the auditor was unable to obtain sufficient appropriate audit evidence.

and Cash Flow Statement comply with the accounting standards referred to in sub-section (3C) of section 211 of the Act;

e. on the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Act.

f. Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the Company.

For XYZ and Co.

Chartered Accountants

Firm's Registration Number[5]

Signature

(Name of the Member Signing the Audit Report)

(Designation[6])

Membership Number

Place of Signature

Date

Question 15

As an auditor, comment on the following situations/statements:

(a) AAS Ltd. is procuring the packing materials from M/s XY and Co., a partnership firm consisting of Mr. X and Mr. Y. Mr. Y is the Managing Director of AAS Ltd. The total value of purchases made from XY and Co. by AAS Ltd. during the year 2009-10 had been ₹ 38 lakhs.

(b) X Ltd. is good in profits, but suffers temporarily in liquidity. It proposes to declare dividend of 10% in annual general meeting, but the Board proposes to defer payment of

[5] See footnote 13.

[6] Partner or Proprietor, as the case may be.

dividend by two months from the date of annual general meeting by getting a resolution passed in AGM

Answer

(a) **Transactions with Related Parties:** SA 550 "Related Parties" establishes standards on auditor's responsibilities and audit procedures regarding related party transactions. In this case, the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in AS 18, "Related Party Disclosures" has been followed, as Managing Director. Further, the auditor has to ensure compliance with the CARO, 2003 requirements, viz., transaction required to be entered into the Register pursuant to section 301 of the Companies Act, 1956 and having regard to the fact whether such prices were reasonable or not. Accordingly, the auditor has to ensure that the AAS Ltd. has made proper disclosures in financial statements and the matter has been examined and reported in terms of CARO, 2003 also.

(b) **Declaration of Dividends:** As per law, dividend once declared cannot be revoked. However, as per facts of the case, X Ltd. has not declared the dividends so far because Board proposed to recommend declaration of 10% dividend in annual general meeting but in view of liquidity problem it proposes to defer the payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM. As per the question it is clear that the Board has only made a proposal and the same has not been passed by the shareholders. Therefore, in such a case, X Ltd. may declare dividends at a subsequent general meeting.

Note: Students may note that in case dividend has actually been declared in terms of section 205 (A)(1), the penal and other provisions shall become applicable.

Question 16

(a) The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, Vouchers and other records which were taken away by the Income-tax Department in search under section 132 of the I.T. Act, 1961.

(b) E and S were appointed as Joint Auditors of X and Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors.

(c) Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid?

(d) 'B' owes ₹ 1001 to 'C' Ltd., of which he is an auditor. Is his appointment valid? Will it make any difference, if the advance is taken for meeting-out travelling expenses?

Answer

(a) **Reliability of Audit Evidence:** The degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly.

Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

(b) **Responsibilities of Joint Auditors:** In conducting a joint audit, the auditor(s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit. The principles laid down in SA 200, SA 240 and SA 299 need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However, in this case, if it can be assumed that the joint auditors E and S have exercised reasonable care and skill in auditing the accounts of X & Y Ltd. and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence. However, if such concealment could have been discovered by the exercise of reasonable care and skill, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.

(c) **Qualifications of an Auditor:** A person shall be qualified for appointment as an auditor of a company, only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Under the Chartered Accountants Act, 1949, only a Chartered Accountant holding the certificate of practice can engage in public practice. Preksha does not hold a certificate of practice and hence cannot be appointed as an auditor of a company.

(d) **Indebtedness to the Company:** As per Section 226(3)(d) of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding ₹ 1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding ₹ 1000/- then he is not qualified for appointment as an auditor of a company. Accordingly, B's appointment is not valid and he is disqualified as the amount of debt exceeds ₹ 1000. Even if the advance was taken for meeting out travelling expenses particularly before commencement of audit work, his appointment is not valid because in such a case also the auditor shall be indebted to the company. The auditor is entitled to recover fees on a progressive basis only.

Question 17

Explain the various types of companies under Companies (Auditor's Report) Order, 2003 (CARO).

Answer

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.

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

Question 18

Write a short note on Audit enquiry under Section 227(1A).

Answer

Audit enquiry under Section 227(1A): Auditor is required to make an enquiry and report under Section 227(1A) of the Companies Act, 1956, if he is not satisfied in respect of the following matters:

(i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company.

(ii) Whether the transactions which are represented by mere book entries are not prejudicial to the interests of the company.

(iii) Where the company is not an investment company within the meaning of Section 372, or a banking company, whether so much of the assets as consist of shares and debentures and other securities have been sold at a price less than that at which they were purchased by the company.

(iv) Whether loans and advances have been shown by way of deposits.

(v) Whether the personal expenses have been charged to revenue.

(vi) Where it is stated in the books and papers of the company that any shares have been allotted for cash whether the cash has actually been received and if no cash has been received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Question 19

As an auditor, comment on the following situations/statements:

(a) A Ltd. has its Registered Office at New Delhi. During the current accounting year, it has shifted its Corporate Head Office to Indore though it has retained the Registered Office at New Delhi. The Managing Director of the Company wants to shift its books of account to Indore from New Delhi, as he feels that there is no legal bar in doing so.

(b) The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered.

Answer

(a) Place of Books of Account: Section 209 of the Companies Act, 1956 states that every company shall keep at its registered office proper books of account with respect to all sums of money received and spent, all sales and purchases of goods, all assets and liabilities of the company, and the required cost records.

However, all or any of such books of account aforesaid may be kept at any other place in India as the Board of Directors may decide, and if so, the company shall within seven days of the decision file with the Registrar a notice in Form 23 AA in writing giving the full address of that other place.

Therefore, for shifting the books from Delhi to Indore, the Board's Resolution has to be passed, and notice is to be given to the Registrar of Companies within the specified time. The auditor may accordingly, inform the Managing Director that his contention is not in accordance with the legal provisions.

(b) Auditor's Attendance at Annual General Meeting: Section 231 of the Companies Act, 1956 confers right on the auditor to attend the general meeting.

The said section provides that all notices and other communications relating to any general meeting of a company which any member of the company is entitled to have are also to be forwarded to the auditor. Further, it has been provided that the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as an auditor.

Therefore, the section does not cast any duty on the auditor to attend the annual general meeting. The law only confers right on the auditor to receive notices and also attend the meeting if he so desires. Therefore, the complaint filed by the Board of Directors is based on mis-conception of the law.

Question 20

Give your comment on "The Central Government has appointed Mr. Sushil, a retired Finance Director of a reputed company, a non-practising member of ICAI, as a special auditor of MM Ltd., on the ground that the company was not being managed on sound business principles. Mr. Ajay, MD of MM Ltd. feels, that the appointment of Mr. Sushil is not valid as he does not hold a certificate of practice".

Answer

Appointment of Special Auditor: Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.

Amongst others, one of the circumstances specified is in case a company is not being managed in accordance with some business principles or prudent commercial practices. Further the said section also provides that for the purpose, it may appoint a chartered accountant, whether or not the chartered accountant is in practice, or the company's auditor itself to conduct such special audit.

Therefore, the appointment of Mr. Sushil, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Mr. Ajay M.D. is not correct.

Question 21

Write a short note on - Cost Audit.

Answer

Cost Audit: Cost Audit is covered by Section 233B of the Companies Act, 1956. The Central Government may by order direct that audit of cost accounts of a company shall be conducted in the manner, as may be specified in the order by a cost accountant.

The Audit Committee of the Board shall be the first point of reference regarding the appointment of cost auditors. The Audit Committee shall ensure that the cost auditor is free from any disqualifications as specified under section 233B (5) read with section 224 and sub-section (3) or sub-section (4) of section 226 of the Companies Act, 1956.

While a cost auditor shall have prime responsibility to ensure that he does not violate the limits specified under section 224(1-B) of the Companies Act, 1956, the Audit Committee shall also be responsible for such compliance by the cost auditor. The Audit Committee shall obtain a certificate from the cost auditor certifying his/its independence and arm's length relationship with the company.

The company shall e-file its application with the Central Government on www.mca.gov.in portal, in the prescribed Form 23C within ninety days from the date of commencement of each financial year, along with the prescribed fee as per the Companies (Fees on Applications) Rules, 1999 as amended from time-to-time and other documents as per existing practice i.e., (i) certified copy of the Board Resolution proposing appointment of the cost auditor; and (ii) copy of the certificate obtained from the cost auditor regarding compliance of section 224(1B) of the Companies Act, 1956.

On filing the application, the same shall be deemed to be approved by the Central Government, unless contrary is heard within thirty days from the date of filing such application.

If within thirty days from the date of filing such application, the Central Government directs the company to re-submit the said application with such additional information or explanation, as may be specified in that direction, the period of thirty days for deemed approval of the Central Government shall be counted from the date of re-submission by the company.

After expiry of thirty days, as the case may be, the company shall issue formal letter of appointment to the cost auditor, as approved by the Board. Within thirty days of receipt of formal letter of appointment from the company, the cost auditor shall inform the Central Government in the prescribed form, along with a copy of such appointment.

The company shall disclose full particulars of the cost auditor, along with the due date and actual date of filing of the cost audit report by the cost auditor, in its Annual Report for each relevant financial year.

(Note : In those companies where constitution of an Audit Committee of the Board is not required by law, the words "Audit Committee" shall stand substituted by the words "Board of Directors".)

Question 22

(a) *State the matters to be specified in Auditor's Report in terms of provisions of Section 227(3) of the Companies Act, 1956.*

(b) *What are the reporting requirements in Companies (Auditor's Report) Order, 2003 in respect of money raised by public issues?*

Answer

(a) Matters to be reported by auditor under section 227 (3): Under Section 227(3) of the Companies Act, 1956, the report of the auditor shall state -

(i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;

(ii) Whether, in his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examination of those books; whether proper returns adequate for the purposes of his audit have been received from the branches not audited by him;

(iii) Whether the report on the accounts of the branches audited by branch auditors under Section 228 has been forwarded to him and how he had dealt with the same in preparing the auditor's report;

(iv) Whether the company's balance sheet and profit and loss account are in agreement with the books of accounts and returns;

(v) Whether in his opinion the profit and loss account and balance sheet comply with the accounting standards referred to in Section 211(3C);

(vi) In thick type or in italics the observations or comments of auditors which have any adverse effect on the functioning of the company;

(vii) Whether any director is disqualified from being appointed as director under section 274(1)(g);

(viii) Whether the cess payable under Section 441 A had been paid and if not details of amount of cess not so paid.

(b) Money raised by Public Issues: Companies (Auditor's Report) order, 2003 requires that in case the company has made a public issue of any of its securities like shares, preference shares, debentures and other securities, the auditor is required to report upon the disclosure of end-use of the money by the management in the financial statements. The auditor is also required to state whether he has verified the disclosure made by the management in this regard.

Schedule VI to the Act requires that only unutilized amount of any public issue made by the company should be disclosed in the financial statements of a company. In the absence of any legal requirement of such disclosure, it appears that the clause envisages that the companies should disclose the end use of money raised by the public issue in the financial statements by way of notes and the auditor should verify the same.

Normally, the companies do mention the end-use of the money proposed to be raised through the public issues in the prospectus. An examination of the prospectus would provide the auditor an understanding of the proposed end-use of money raised from public. The auditor should verify that the amount of end-use of money disclosed in the financial statements by the management is not significantly different from the proposed and actual end use. The auditor should obtain a representation from the management as to the completeness of the disclosure with regard to the end-use of money raised by public issues. If the auditor is of the opinion that adequate disclosure with regard to end use of money raised by public issue has not been made in the financial statements, the auditor should state the fact in his audit report. If, for any reason, the auditor is not able to verify the end-use of money raised from public issues, he should state that he is not able to comment upon the disclosure of end-use of money by the company since he could not verify the same. He should also mention the reasons which resulted in the auditor's inability to verify the disclosure.

Question 23

X Ltd., to whom Companies (Auditor's Report) Order, 2003 is applicable, has issued 9% Debenture of ₹ 5 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry Creditors and other Current Liabilities of ₹ 2.80 crores. Comment

Answer

Application of Long-Term Funds: The Companies (Auditor's Report) Order, 2003 required the auditor to report whether funds raised on short-term basis have been used by the company for long-term investment and long-term funds have been used to finance short-term assets.

In this case, 'X' Ltd., issued 9% debentures of ₹ 5 crores and out of the proceeds, it used ₹ 2.80 crores for payment of sundry creditors and other current liabilities. The auditor will enquire about the object of issue of debentures and end use of ₹ 5 crores. Further, the auditor should refer to Board's resolution authorizing the utilization of the fund for payment of current liabilities. He will refer to the Cash Flow Statement and would obtain the requisite information and explanations from the management and if he is satisfied that long-term funds have been used for payment of short-term liabilities, he will state in audit report accordingly.

Question 24

Give your comments on the following:

(a) Mr. X, a Director of M/s KP Private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filed the annual accounts and annual return for last three years 2006-07 to 2008-09. Mr. X is of the opinion that he is not disqualified u/s 274(1)(g) of the Companies Act, 1956, and auditor should not mention disqualification remark in his audit report.

(b) Mr. Aditya, a practising chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Singhvi is the Managing Director.

(c) You have been appointed the sole auditor of a company where you were one of the joint auditors for the immediately preceding year and the said joint auditors are not re-appointed.

(d) No Annual General Meeting (AGM) was held for the year ended 31st March, 2010, in XYZ Ltd., Ninu is the auditor for the previous year, whether she is continuing to hold office for current year or not.

Answer

(a) Disqualification of a Director u/s 274(1)(g) of the Companies Act, 1956: Section 227(3)(f) of the Companies Act, 1956 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director u/s 274(1)(g) of the Companies Act, 1956. As per provisions of Section 274(1)(g), if a director is already holding a directorship of a "public company" which has not filed the annual accounts and annual returns for any continuous three financial years shall not be eligible to be appointed as a director of any other public company.

In this case since Mr X is a director of Private Ltd. Company, hence the provisions of section 274(1)(g) are not applicable to him and as such he is not disqualified from directorship of both the companies. Therefore, the auditor shall not report about the disqualification u/s 227(3)(f) of the Companies Act, 1956.

(b) Appointment of a Practising CA as 'Tax Consultant': A chartered accountant appointed as an auditor of a company, should disclose his interest while making the audit report. If this disclosure is not made, it would amount to "misconduct" under the Chartered Accountants Act, 1949.

In this case, Mr. Aditya is a "Tax Consultant" and not a "Statutory Auditor" of ABC Ltd., hence he is not liable to disclose his relationship with Managing Director of the company except as required by Section 349 of the Companies Act, 1956.

(c) Appointment of Sole Auditor: When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. Accordingly, provisions of the Companies Act, 1956 to be complied with are as under:

1. Ascertain that special notice u/s 225(1) of the Companies Act, 1957 was received by the company from a member at least 14 days before the AGM date.
2. Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 190(2) of the Companies Act, 1956.
3. Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.
4. The notice is also sent to the retiring auditor as per Section 225(2) of the Companies Act, 1956.
5. Verify whether any representation, received from the retiring auditor was sent to the members of the company.

6. Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(d) Tenure of Appointment: Section 224(1) provides that an auditor is appointed for a particular period, i.e., from conclusion of one annual general meeting until conclusion of the next annual general meeting. In case the annual general meeting is not held within the period prescribed, the auditor will continue in office till the annual general meeting is actually held and concluded. Therefore, Ninu shall continue to hold office till the conclusion of the annual general meeting.

Question 25

JKT Ltd. having ₹ 40 lacs paid up capital, ₹ 9.50 lacs reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 4.90 crores, ₹ 4.50 crores and Rs. 6 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. Comment.

Answer

Internal Audit System and CARO, 2003: As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies. For other companies, it is applicable if either of the following conditions is satisfied:

a. The company has a paid-up capital and reserves exceeding ₹ 50 lakhs at the commencement of the financial year, or

b. The company has an average annual turnover of ₹ 5 crores or more for a period of 3 years proceeding the current financial year.

In the instant case, the second condition has been fulfilled by JKT Ltd. Hence, the auditor will have to mention in his report the fact of not having such internal audit in his report by the Company.

Question 26

Write a short note on - Statutory Report of a Public Company under Section 165(4).

Answer

Audit of Statutory Report of a Public Company: Under Section 165 of the Companies Act, 1956 every public company limited by shares, or limited by guarantee and having a share capital, has to hold a statutory meeting of its members within a period of not less than one month and nor more than six months from the date at which the company is entitled to commence business. It sets out the following matters:

(i) The total number of shares allotted, distinguishing shares allotted (as fully or partly paid up) otherwise than in cash, and stating in the case of shares partly paid up, the extent to which they are so paid up, and in either case, the consideration for which they have been allotted;

(ii) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(iii) An abstract of the receipts of the company and the payments made there out, up to date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made there out, the particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company, showing separately any commission or discount paid or to be paid on the issue or sale of shares or debentures;

(iv) the names, addresses and occupations of the directors, auditors and also, manager and secretary, if any, and the changes, if any, which have occurred in such names, addresses and occupations since the date of the incorporation of the company;

(v) the particulars of any contract which, or the modification or the proposed modification of which, is to be submitted to the meeting for its approval together in the latter case with the particulars of the modification or proposed modification;

(vi) the extent, if any, to which each underwriting contract, if any, has not been carried out, and the reasons therefore;

(vii) the arrears, if any, due on calls from every director and the manager; and

(viii) the particulars of any commission or brokerage paid or to be paid for issue or sale of shares or debentures to any director or the manager.

The statutory report is to be certified as correct by at least two directors of the company, one of whom should be a managing director, where there is one. The auditors of the company should also certify that part of the report which relates to the shares allotted by the company, the cash received in respect of such shares, and the receipts and payments of the company.

Question 27

(a) Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.

(b) PBS & Associates, a firm of Chartered Accountants, has three partners P, B and S. The firm is already having audit of 60 companies, which includes 2 branch audits of a company. The firm is offered 3 company audits, out of which one is a private company, other is a foreign company and the third one is a public company. Decide and advise whether PBS & Associates will exceed the ceiling prescribed under Section 224(1B) by accepting the above audit assignments?

Answer

(a) Appointment of First Auditor of Company: The appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 224 (5) of the Companies Act, 1956, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company.

In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

(b) Ceiling on number of audits: According to Section 224 (1 B) of the Companies Act, 1956, a Chartered Accountant cannot hold more than the specified number of company audit. This section further states that in case of Chartered Accountant Firm, the specified number is 20 companies per such partner who is not in whole time employment elsewhere. Out of the above 20 companies not more than 10 companies may have a paid up share capital of ₹ 25 lakhs or more. Branch audit, special audit and foreign companies are not to be included or counted within the said specified limit as these companies are outside the scope of Section 224. As per Companies (Amendment) Act, 2000, audit of private companies are not to be counted in computation of ceiling limit.

If Mr. P, B and S do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s PBS & Associates is 60. But as branch audit, audit of foreign company and private company are to be excluded while determining this figure of 60. So the firm can accept the audit of above three companies of which one is a public company as given in the question, which is well within the limit, specified by Section 224 (1 B) of the Companies Act, 1956.

Question 28

Why Central Government permission is required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?

Answer

Permission of Central Government for removal of auditor: Removal of auditor Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest.

Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if auditor has completed his term i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

Question 29

As an Auditor, comment on the following:

(a) Company has debited ₹ 1,75,000 to Delivery Van Account received from a customer against credit sales of ₹ 1,50,000 to him who is now is not able to pay the amount. The Delivery Van has not been registered in the name of the company with R.T.O. till date of Finalisation of accounts.

(b) PQ Ltd. has given donations of ₹ 50,000 each to a charitable school and a trust for blinds, during the year ended 31.3.2010. The average net Profit of the company during last three financial years amounts to ₹ 12 lacs.

(c) AAS Limited had provided for doubtful debts to the extent of ₹ 23 lakhs during the year 2007-08. The amount had since been collected in the year 2009-10. Another debt of ₹ 25 lakhs had been identified to be doubtful during the year 2009-10. The Company made an additional provision of ₹ 2 lakhs during the year. The Profit and Loss account for the year ended 31.3.2010 disclosed in Debit side-provision for doubtful Debts ₹ 2 lakhs.

(d) Alagar Limited is a company engaged in the business of chassis building and bus transportation services. It accounts all expenses and income in Profit and Loss account under various heads explaining clearly the nature of the operations. The auditor of the company requires that the Profit and Loss account should depict the Profit or Loss from the businesses of assembly as well as of operation of bus services separately.

Answer

(a) AS 10 "Accounting For Fixed Assets": As per AS 10 "Accounting for Fixed Assets" When a fixed asset is acquired in exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident.

The delivery van has been acquired in exchange for another assets i.e. receivables. The fair value of delivery van is ₹ 1,75,000 and that of receivable were ₹ 1, 50,000. Here fair market value of the asset given up is more clearly evident. Therefore the delivery van should be valued at ₹ 1, 50,000. Also the delivery van should be recognized as an asset of the company even though it is not yet registered in the name of the company. This is because legal title is not necessary for an asset to exist. What is necessary is control over the asset as per the framework for preparation and presentation of financial statements. Applying substance over form, we find since price has been settled, and the company has control of assets, hence it should be reflected as an asset along with a note to the effect that the registration in the name of the company is pending.

(b) Contribution To Charitable Funds: As per the provisions of Section 293 of the Companies Act, 1956 the Board of Directors of a Public Ltd. Co., with the consent of the Company in general meeting can contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed fifty thousand rupees or five per cent of its average net profits as determined in accordance with the provisions of Sections 349 and 350 during the three financial years immediately preceding, whichever is greater.

In the given case company gave two donations of ₹ 50,000 each to a charitable school and a trust for blinds i.e. ₹ 1,00,000, those are not directly relating to business of the company or the welfare of its employees. According to given situation Board of directors can contribute either (i) ₹ 50,000 or (ii) 5% of average net profit of least 3 financial years i.e. ₹ 60,000 whichever is greater.

Therefore Board of Directors can contribute maximum of ₹ 60,000 to both Charitable institutions with the consent of the company in general meeting. The action of Board of directors is not correct. It has violated the provision of Section 293 of the Companies Act, and as an auditor, this matter should be reported in the auditor's report.

(c) Disclosure of certain ordinary activities under AS 5 : As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

During the relevant year, the company had collected the amount of ₹ 23 lakhs for which provision had already been made earlier in the accounts. The said provision should be reversed to that extent during the relevant year. The company estimates a doubtful debt to the extent of ₹ 25 lakhs in the current year which must be provided for during the relevant year. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 of AS 5 include reversals of provisions. The company had netted off the reversal and additional provision and had shown the net debit of ₹ 2 lakhs in P&L account. This practice does not seem to be good as per AS 5. Company may show the net debit in P&L account but should disclose the facts of write back and additional provision made during the year by way of note. The Company's accounting treatment is wrong and it may warrant audit qualifications.

(d) Segmental reporting: As per AS 17, the company accounts must be presented according to the primary classification based on nature of income and expenses and therefore segment results are to be disclosed accordingly. The result of segment should be disclosed in terms of segment revenue and segment expense.

In the instant case, the company has two business segments namely assembly and transportation. These two segments should be properly identified.

In this case, company should add note to show segment result after computation. It is not necessary that segment-wise details of each and every expenditure and revenue should be specified.

Question 30

Comment on the following:

(a) M/s. Seeman & Co. had been the company auditor for Amudhan Company Limited for the year 2009-10. The company had three branches located at Chennai, Delhi and Mumbai. The audits of branches-Chennai, Delhi were looked after by the company auditors themselves. The audit of Mumbai branch had been done by another auditor M/s Vasan & Co., a local auditor situated at Mumbai. The branch auditor had completed the audit and had given his report too. After this, but before finalization, the company auditor wanted to visit the Mumbai branch and have access to the inventory records maintained at the branch. The management objects to this on the grounds of the company auditor is transgressing the scope of audit areas agreed.

(b) Mr. A was appointed as an auditor of X Ltd. for the year ended 31.3.2009 in the AGM held on 16.8.2008. Mr. A had indebted to the company for a sum of ₹ 2,500 as on 1.4.2008, the opening date of the accounting year which had been the subject to his audit. Upon learning that he might be appointed as the auditor, he repaid the amount on 14.8.2008. Mr. B, a shareholder complained that the appointment of Mr. A as auditor was invalid and he incurred disqualification under Section 226 of the Indian Companies Act, 1956 and his independence had been vitiated in relation to the accounting year of his audit.

(c) The Financial Controller of AS Limited refuses to provide for proposed dividend in books of accounts for the year ended 31.3.2009 on the ground that it is pending approval of shareholders in Annual General Meeting to be held on 16th September 2009.

Answer

(a) Right of access of company auditor for branch records: The audit of the branch of a company is dealt with in Section 228 of the Companies Act, 1956. According to this section, the audits of the branches can be done by the company auditor himself or by another auditor. Even where, the branch accounts are audited, the company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor.

He has also right of access at all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the repot of the branch auditor in framing his main repot. He will disclose how he had dealt with the branch audit report.

In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor.

Applying the above provisions, to the instant case, management's objection that the company auditor is transgressing the scope of audit areas agreed, is absolutely, wrong. The right of company auditor in visiting and accessing the records of branch can not be forfeited. Even where the branch accounts are audited by another local auditor, the company auditor has right to visit the branch and can have access to the books and vouchers of the company maintained at the branch office.

In all other cases, it will be considered as unlawful possession of the books and in such circumstances, he can not exercise such lien.

In the given case, AB & associates retains the books of accounts of Ajanta Ltd., as they have not received their audit fees. They can do so subject to the above provisions of company Law.

(b) **Debt as disqualification for auditor:** According to Section 226 of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding ₹ 1,000 shall be disqualified to be an auditor of such company and he will vacate office when he incurs this qualification subsequent to his appointment.

Though not expressly said, the fact clearly tells that the relevant date for reckoning disqualification is the date of appointment viz the date of resolution passed by the company to effect such appointment.

Where the person has liquidated his debt before appointment date, there is no disqualifications to be construed for his appointment.

In the given case, Mr. A was appointed as an auditor of X Ltd. for the year ended 31-03-2009 in the AGM held on 16-08-2008. He repaid the loan amount of ₹ 2500 fully to the company on 14-08-2008 before the date of his appointment.

In view of the above provision of law, Mr. A's appointment as an auditor is valid and it is as per the provision of the above Section.

(c) **Proposed dividend accounting:** Normally, the dividend is proposed first by Board before adoption of the accounts in AGM. It is the shareholders in AGM who may approve the dividend proposed by BOD. It is also correct that as on the date of balance sheet or subsequent to it, but before approval of the financial statements in AGM, the dividend declaration is a contingent one.

But according to AS 4, Contingencies and Events occurring after the Balance Sheet date, even though certain events occur after balance sheet date, they are included/provided in the accounts because of their special nature or statutory requirement. Schedule VI to the Indian Companies Act, 1956 requires disclosure of proposed dividend specifically.

According to AS 4, the proposed dividend pertaining to the period covered by the financial statements, should be included in the financial statements although they are declared after the approval of the accounts.

In the circumstances, applying the above provisions, the contention of the Financial controller of AS Ltd. is wrong. Hence proposed dividend should be provided in the books of accounts for the year ended 31-03-2009, as the same is a statutory requirement of the law.

Question 31

Give your assertions for the following items appearing in balance sheet of a Limited Company:

			₹
(i)	*Cash in hand*		*10,000*
(ii)	*Investments*		*1,00,000*
(iii)	*Secured Loans*		*10,00,000*
(iv)	*Machinery:*		
	Opening cost	*13,00,000*	
	Less: depreciation		
	Current depreciation	*1,30,000*	*11,70,000*

Answer

(i) Cash in Hand ₹ 10,000

This is the item of current assets, exhibited on the asset side of balance sheet It implies:

(1) that the firm concerned has ₹ 10,000 in hand in valid notes and coins on the balance sheet date.

(2) that the cash was free and available for expenditure to the firm.

(3) that the books of accounts show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

(ii) Investments ₹ 1,00,000

This is also the item to be exhibited on the asset side of balance sheet as per Schedule VI as prescribed by Company Law. This description is not giving us a complete picture of investment. We, as an auditor, must know:

(1) Nature of Investment, type of Investment; whether it is short term or long term investment or trade investment or non-trade investment.

(2) Rate of interest receivable.

(3) Face value or market value of investments as on balance sheet date.

(iii) Secured Loan ₹ 10,00,000

It Implies that the company has secured loan from some parties, worth ₹ 10,00,000. The description does not give us a complete picture. We, as an auditor, must know:

(1) the name of the lender,

(2) the nature of security provided; and

(3) the rate at which interest is payable.

(iv) Machinery ₹ 11,70,000.

(1) The Company owns the Plant and Machinery whose WDV as on date of balance sheet is ₹ 11,70,000. Gross block is ₹ 13,00,000.

(2) The Machinery physically exists.

(3) The asset is being utilized in the business of the company productively.

(4) Charge of depreciation on this asset is ₹ 1,30,000 relates to the year in respect of which the accounts are drawn up.

(5) The amount of depreciation, has been calculated on recognized basis and the calculation is correct.

Question 32

Comment on the following:

(a) During the year 2009-10, it was decided for the first time that the accounts of the branch office of AAS Company Limited be audited by qualified Chartered Accountants other than the company auditor. Accordingly, the Board had appointed branch auditors for the ensuing year. One of the shareholders complained to the Central Government that the appointments was not valid as the Board of Directors do not have power to appoint auditors, be they Company Auditor or Branch Auditors?

(b) The Chief Accountant of AAS Company Limited says that the company, being in loss, would not provide depreciation for the Fixed Assets during this year, it would provide for the arrears of depreciation when it has profits in the future years; there is nothing wrong in this treatment, as according to the Companies Act, 1956, the company is bound to provide for depreciation only when it intends to declare dividend; in the present case, the company does not declare dividend.

(c) Other liabilities in Balance Sheet of AAS Limited include ₹ 7.8 lakhs being the amount of excise duty payable since 1.5.2008 remaining unpaid till 31.3.09. However, the same had been paid by the company on 15.4.2009 upon getting clarification from its advocates that the liability is actually payable by it.

Answer

(a) Appointment of Branch Auditor: Under Section 228 of the Companies Act, 1956, the accounts of the branch may be audited by the company auditor or by a separate branch auditor/s, unless where there is branch audit exemption. When it had been decided that the accounts of the branch may be audited by a person other than company auditor, the shareholders in general meeting should appoint branch auditor. The shareholders in general meeting, instead of appointing branch auditor, may authorize the board of directors to appoint branch auditors.

In the present case, the board has appointed branch auditors without obtaining authorization from the shareholders in general meeting. The board had appointed the auditor where it did not have authority to do so. As such, the appointment is invalid. The shareholder's complaint is right.

The branch auditor should ascertain before accepting the audit whether his appointment is valid.

(b) Non provision of depreciation: According to Section 205 of the Companies Act, 1956, the company cannot declare dividend unless it provided for depreciation. But the true and fair view of the results of the company must be reflected in the accounts as per Section 211 of the Companies Act. Generally Accepted Accounting Principles require the depreciation to be charged for fixed assets so that the revenue matched with the cost of expiration.

The Accountant's view of looking at depreciation as a mere legal requirement for declaration of dividend is partial appreciation of the accounting reality. According to Schedule VI of the Act, the profit and loss account shall separately disclose depreciation. If no provision is made for depreciation, the same should be disclosed by way of note.

Accordingly, if the company persists in not providing the depreciation, the same should be disclosed. Again, the non-provision will be subject of qualification in the auditor's report even if it has been disclosed in notes.

(c) Undisputed Statutory Liability: According to CARO 2003, if any undisputed statutory due like excise duty, income tax etc, is not remitted within due date and is outstanding for more than six months, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the present case, the statutory liability has crystallized and is outstanding for more than six months. It is not a disputed liability. It is an undisputed liability about which the company had some doubts.

The fact that it had been since remitted before finalization of accounts would not render the requirement of disclosure in CARO 2003 report. The fact of subsequent remittance may be added after the disclosure of non-remittance in the CARO 2003 report.

Question 33

Give your comments on the following:

(a) Mr. Budha, Statutory Auditors of Secret Ltd. was not permitted by the Board of Directors to attend general meeting of the company on the ground that his right to attend general meetings is restricted only to those meetings at which the accounts audited by him are to be presented and discussed.

(b) M/s Young & Co., a Chartered Accountant firm, and Statutory Auditors of Old Ltd., is dissolved on 1.2.2009 due to differences of opinion among the partners. The Board of Directors of Old Ltd. in its meeting on 6.2.2009 appointed another firm M/s Sharp & Co. as their new auditors for one year.

(c) Mr. Fat, auditor of Thin Ltd., has his office and residence in the building owned by Thin Ltd. Mr. Fat has been given 10% concession in rent by the company as compared to other tenants.

Answer

(a) According to Section 231 of the Companies Act, 1956 the auditors of a company are eligible and entitled to attend any general meeting of the company and not only those meetings at which the accounts audited by them are to be presented and discussed. However, it is not mandatory for the auditor to attend such meetings.

In the instant case, the board of directors of Secret Ltd., have no right to restrict Mr. Buddha from attending the general meeting and Mr. Buddha has every right to attend such meeting as conferred by Section 231.

Thus, the action of the board of directors is contrary to the provisions of law and curtails the right of the auditor.

(b) Section 224(6)(a) of the Companies Act, 1956 lays down that the Board of Directors may fill any casual vacancy in the office of an auditor provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall be filled in general meeting.

The expression “casual vacancy” has not been defined in that Act. Talking its natural meaning it may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firm etc.

Furthermore Section 224(6)(b) stipulates that any auditor appointed in a casual vacancy shall hold office until the conclusion of the next AGM.

In the instant case the action of the board of directors in appointing M/s Sharp & Co. to fill up the casual vacancy due to dissolution of M/s Young & Co., is correct. However, the board of directors are not correct in giving them appointment for one year. M/s Sharp & Co. can hold office until the conclusion of next AGM only.

(c) As per SA 200, “Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing”, In the case of an audit engagement it is in the public interest and, therefore, required by the Code of Ethics, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism In the instant case Mr. Fat has his office and residence in the building owned by Thin Ltd. who are subject to audit by Mr. Fat. Giving 10% concession in rent may be due to some other reasons other than holding auditor ship of Thin Ltd. It may be due to being very old tenant or due to office and residence in the same building or Mr. Fat might have carried out major renovation and so on.

Thus in the instant case unless and until there is direct proof, giving 10% concession in rent does not affect independence of the auditor in expressing his opinion on the audit of Thin Ltd.

Question 34

Write short notes on the following:

(a) Responsibilities of Joint auditors.

(b) Process of Judgement formation by Auditor.

Answer

(a) Responsibilities of Joint Auditors: As per SA 299, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him. In respect of other works, which are not divided, all the joint auditors are jointly and severally responsible for:

(i) Audit work which is not divided and is carried on jointly by all the joint auditors.

(ii) Decision 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) Matters which are brought to the notice of the joint auditors by any one of them and on which there is agreement among the joint auditors.

(iv) Examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.

(v) Ensuring that the audit report complies with the requirement of the relevant statute.

(b) Process of Judgement formation by auditor: After the audit, the opinion that the auditor expresses is the result of exercise of judgement on facts, evidence and circumstances which he comes across in the course of audit. The judgement is formed on the following basis:-

(i) Identification of the assertions to be examined.

(ii) Evaluation of the assertion as to relative importance.

(iii) Collection of the information or evidence about the assertions to enable him to give an informed opinion.

Evaluation of evidence as valid or invalid, pertinent or not pertinent, sufficient or insufficient.

Formulation of judgement as to the fairness of the assertions under consideration.

Question 35

State the basic elements of the Auditor's Report.

Answer

Basic elements of the Auditor's Report:

As per SA 700(Revised), "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements, ordinarily, in the following layout:

(i) Title;

(ii) Addressee;

(iii) Introductory Paragraph

(vi) Management's Responsibility for the Financial Statements.

(v) Auditor's Responsibility

(vi) Auditor's Opinion

(vii) Other Reporting Responsibilities

(viii) Signature of the Auditor

(ix) Date of Auditor's Report.

(x) Place of signature

Question 36

State the circumstances under which special audit may be called under Section 233 A of the Companies Act, 1956.

Answer

Section 233A of the Companies Act 1956 empowers the Central Government to call for a special audit in the following circumstances:-

(i) If the affairs of the company are not being managed on sound business principles or according to prudent commercial practices, or

(ii) If the company is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains; or

(iii) If the financial position of the company is such as might endanger its solvency.

Question 37

When does an auditor issue unqualified opinion and what does it indicate?

Answer

The auditor should express an unqualified opinion when he concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for preparation and presentation of the financial statements.

An unqualified opinion indicates that:

(i) The financial statements have been prepared using the generally accepted accounting principles and being constantly followed.

(ii) The financial statements comply with relevant statutory requirements and regulations.

(iii) All material matters relevant to proper presentation of the financial information, subject to statutory requirement, if applicable, have been adequately disclosed.

Question 38

Under what circumstances the retiring Auditor cannot be reappointed?

Answer

In the following circumstances, the retiring auditor cannot be reappointed:

(1) A specific resolution has not been passed to reappoint the retiring auditor.

(2) The auditor proposed to be reappointed does not possess the qualification prescribed under section 226.

(3) The proposed auditor suffers from the disqualifications under section 226(3) and 226(4).

(4) He has given to the company notice in writing of his unwillingness to be reappointed.

(5) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.

(6) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 224(1B).

Question 39

Write short note on the following:

(a) Disclaimer of Opinion.

(b) Joint Audit.

Answer

(a) Disclaimer of Opinion: As per SA 500 "Audit Evidence", the auditor must collect sufficient and appropriate audit evidence, on the basis of which he draws his conclusion to form an opinion, on the financial statements. But, if the auditor fails to obtain sufficient information to form an overall opinion on the matter contained in the financial statements, he issues a disclaimer of opinion.

The reasons due to which the auditor is not able to collect the audit evidence are:

(i) Scope of audit is restricted;

(ii) The auditor may not have access to the books of accounts, e.g.:-

(a) Books of A/c's of the company seized by IT authorities.

(b) Sometimes, inventory verifications at locations outside the city bound the scope of duties of the auditor.

In such a case, the auditor must state in his audit report that-

"He is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion".

(b) Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. Further, it states that 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. 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 requirement of relevant statute; and

(v) For ensuring that the audit report complies with the requirements of the relevant statute.

Question 40

Comment on the following situations:

(a) Sri Limited charged depreciation on its plant and machinery comprised in fixed assets at rates different from what had been specified in schedule XIV, to the Companies Act, 1956. The auditor insisted that the rates of depreciation adopted should be mentioned in the notes to the account; else, he would make qualification in his audit report. The Management of the company contended that there is no impact in profits due to its omission to disclose the fact and hence on considerations of principle of materiality, the auditor is wrong in mentioning this omission in his report by way of qualification.

(b) P, the first auditor of XYZ Ltd. resigned as auditors of the Co. Board of Directors appointed Mr. Q as statutory auditors in their place.

Answer

(a) (i) It is permissible for the entity to charge depreciation on its assets at rate different from schedule XIV rates provided those rates are higher than the schedule rates based on technical estimation or otherwise allowed under Section 205 of the Act.

(ii) When the rates adopted are different from the principal rates specified in the schedule, the same need to be disclosed in the notes to the accounting.

(iii) The non-disclosure of rates is a violation of AS 1 which requires the accounting policies to be disclosed in the accounts and also schedule XIV requirement which too requires such disclosure.

(iv) The auditor hence, is right in his approach to qualify the same in his report.

(v) The contention of the management that it does not meddle with the profit is not founded.

(vi) The materiality of an item is not always measured in terms of quantitative factors alone.

(vii) The qualitative factors also reckon the judgment of auditors in opining the true and fair view of accounts.

(viii) If the management does not correct the situation, the auditor is justified in qualifying his audit report.

(b) The first auditor appointment by the Board holds the office till the conclusion of the first annual general meeting. If P, the first auditor resigns, the board of directors has still power to appoint Mr. Q as auditor till conclusion of first annual general meeting. The company at the AGM may remove auditor so appointed and appoint another auditor.

Question 41

XYZ Ltd. has purchased plant and machinery costing ₹ 1 crore in the month of October, 2008 out of working capital limits sanctioned by Bank.

What are reporting requirements by Statutory Auditors of the Company in this regard, keeping in mind the provisions of CARO 2003.

Answer

Annexure to Audit Report includes matters specified in Paragraphs 4 and 5 of the CARO, 2003.

(i) The company has maintained proper records showing full particulars including quantitative details of fixed assets.

(ii) All the assets have been physically verified by the management at regular intervals. No material discrepancies were noticed on such verification.

(iii) If company has disposed off substantial part of plant and machinery the sales of such plant and machinery has not affected going concern status of the company.

Question 42

Write short note on responsibilities of Joint auditors.

Answer

Responsibilities of joint Auditors

SA 299 on Responsibilities of Joint Auditors requires that joint auditors should by mutual discussion divide the audit work among themselves. It further states that each joint auditor is responsible only for the work allocated to him, whether or not he has prepared separate report on the work performed by him.

On the other hand, all joint auditors are jointly and severally responsible:

(i) in respect of the work which is not divided among joint auditors and is carried out by all of them;

(ii) in respect of decision taken by all 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; and

(v) for ensuring that the audit report complies with requirements of the statute.

Question 43

As an auditor comment on the following:

(a) On 31.3.2010 stock taking by Identity Ltd. revealed an inventory of ₹ 50 crores at its godown. Due to a fire on 1st April, 2010, stock worth ₹ 30 crores was destroyed. The salvage value and insurance claim were estimated at ₹ 25 crores before the commencement of audit. No provision was made in the books of company for the year ended 31.3.2010 for ₹ 5 crores.

(b) T Ltd. gave a guarantee to the court for payment of VAT dues of ₹ 15 lakhs for its subsidiary Company Y Ltd. According to the company, since the guarantee was given on behalf of its subsidiary Company, no disclosure was required.

(c) Uranus Ltd. has purchased and installed new machinery during the year in expectation of increased sales. However, no production was made by using the new machine. The directors contend that as the machinery was not used, no depreciation needs to be provided. The company declared an interim dividend during the year under audit.

(d) Mr. D is a director of X Ltd. and Y Ltd. On 30th June, 2009, Mr. D resigned from directorship of Y Ltd. X Ltd. sold goods to Y Ltd., during the entire year at the same price and conditions as to any other customer. X Ltd. discloses only the sales for the first quarter ending 30th June, 2009 as related party transactions.

Answer

(a) SA 560 “Subsequent Events” requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor’s report. However, the exact manner and treatment would depend upon whether the event falls in the category of adjusting event or non-adjusting event.

The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date.

Thus, it will have no effect on items appearing at the balance sheet date because as per AS – 4 “Contingencies and Events Occurring after Balance Sheet Date” have to be adjusted that provide evidence of conditions existing as at the balance sheet date.

AS - 4 requires disclosure of the non-adjusting event, in the report of the approving authority only and no further action needs to be taken by the auditor.

As the company has correctly accounted by not providing provision, the auditor is required to ensure the proper disclosure of abovementioned event.

(b) Disclosure of guarantee given by a company on behalf of its holding Company:

T Ltd, in its books of accounts is required to record a contingent liability of ₹ 15 lakhs for the guarantee given by it for payment of VAT dues of its subsidiary company to the court.

If, the subsidiary fails to meet its obligation, T Ltd would be required to pay ₹ 15 lakhs to the authorities concerned.

AS 29 also states that the existence and amount of guarantees undertaken by an enterprise are generally disclosed in financial statements by way of a note, even though the possibility that the loss will occur, is remote. Thus the amount of any guarantee given by the company on behalf of its subsidiary is required to be stated and where practicable the general nature of such contingent liability if material, be specified.

Accordingly, the views expressed by the company cannot be accepted.

(c) As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising out of use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets.

When the machinery was installed and made ready for production, it means it was intended to be used for the purpose of business. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for depreciation. Thus, depreciation in respect of this machinery ought to have provided in the accounts for the year under audit.

It would be necessary for the purpose of section 205 of the Companies Act, 1956 to provide for depreciation even in respect of assets which are not in use during the financial year, if it declares any dividend.

As the company has declared interim dividend, depreciation under section 205 is to be provided for the year under audit. Thus, the auditor may suitably qualify the report stating that depreciation has not been provided.

(d) As per SA 550 'Related Parties', in examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.

As per paragraph 23 of AS 18 'Related Party Disclosures', transactions of X Ltd for the first quarter with Y Ltd upto 30th June, 2009 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did exist need not to be disclosed as related party transactions. As X Ltd has correctly identified and disclosed the related party transactions, the auditor need not take any further action.

Question 44

Comment on the following:

(a) M/s ANC & Co., a Chartered Accountant firm, has three partners, A, N and C who have no interest in any other partnership firm. The firm has a total of 50 company audits, of which 22 are public companies having paid up Share capital of above ₹ 25 lakhs. Mr. A

retires on 31st August, 2009. The reconstituted firm accepts an audit of private company on 2nd September, 2009.

(b) M/s XYZ & Co., auditors of Goodwill Education Foundation, a recognised nonprofit organisation feels that the standards on auditing need not to be applied as Goodwill Education Foundation is a non-profit making concern.

(c) Nickson Ltd. is a subsidiary of Ajanta Ltd., whose 20% shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nickson Ltd. appointed Mr. P as statutory auditor for the year.

(d) Mr. Amar, a Chartered Accountant, bought a car financed at ₹ 2,00,000 by Chaudhary Finance Ltd., which is a holding company of Charan Ltd. and Das Ltd. He has been the statutory auditor of Das Ltd. and continues to be to even after taking the loan.

Answer

(a) Section 224 (1B) of the Companies Act, 1956 specifies a ceiling of 20 audits per person. In case of an audit firm, the ceiling shall be multiplied by the number of partners. For this purpose, private companies shall be excluded and the ceiling shall be 10 in case of public companies having paid up share capital of ₹ 25 lakhs or more.

The Council of ICAI has specified a ceiling of 30 audit assignments per person, whether in respect of private companies or other companies. In case of an audit firm, the ceiling shall be multiplied by the number of partners. Also the ceiling shall be 10 in case of public companies having paid up share capital of ₹ 25 lakhs or more.

In the given case, after retirement of Mr. A, the firm shall hold audit of 50 companies of which 22 will be public companies having paid up share capital of ₹ 25 lakhs and more. The ceiling as per requirement of the Council of ICAI will be 60 audit assignments (30 x 2 = 60 audits) However, the aggregate ceiling for audit of public companies having paid up share capital of ₹.25 lakhs or more is 20 (10 x 2 partners = 20 audits) in the given case.

A firm can accept the audit of the private company as it shall be within the ceiling specified. But as the firm exceeds the ceiling for audit of public companies having paid up share capital of ₹ 25 lakhs or more, the firm must resign from 2 such companies.

(b) The Preface to Standards on Auditing gives the scope of the Standards on Auditing. As per the Preface, the SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial statements/information of any entity; whether profit oriented or not and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.

Also while discharging their attest function; it is the duty of the Chartered Accountant to ensure that SAs are followed in the audit of financial information covered by their audit reports.

In the given case, even though the client is a non-profit oriented entity the SAs shall apply and the auditor shall be guilty of professional misconduct for failing to discharge his duty in case of non-compliance with SAs.

(c) According to Section 617 of the Companies Act, 1956, a Government company is defined "as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company as thus defined". The auditors of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India.

In the given case Ajanta Ltd is a government company as its 20% shares have been held by Central Govt, 25% by U.P. State Government and 10% by M.P. State Govt. Total 55% shares have been held by Central and State governments. Therefore, it is a Government company.

Nickson Ltd. is a subsidiary company of Ajanta Ltd. Hence Nickson Ltd. covers in the definition of a government company. Hence the Auditor of Nicksons Ltd. can be appointed only by C & AG.

Therefore, appointment of 'P' is invalid and 'P' should not give acceptance to the Directors of Nicksons Ltd.

(d) According to section 226 (4) of the Companies Act, 1956, a person is not eligible for appointment as auditor of any company, If he is disqualified for acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.

Also according to section 226 (5) of the Companies Act, 1956, if an auditor, after his appointment, becomes disqualified under Section 226(3) or (4) he shall be deemed to have vacated his office as such.

In the given case Mr. Amar is disqualified to act as an auditor under section 226 (3) as he is indebted to M/s Chaudhary Finance Ltd. for more than 1,000 ₹ Also according to Section 226(4) he cannot act as an auditor of any subsidiary of Chaudhary Finance Ltd. i.e. he is also disqualified to work in Charan Ltd. & Das Ltd. Therefore he has to vacate his office in Das Ltd. Even though it is a subsidiary of Chaudhary Finance Ltd.

Hence audit work performed by Mr. Amar as an auditor is invalid, he should vacate his office immediately and Das Ltd must have to appoint any other CA as an auditor of the company.

Question 45

Mr. Y was appointed as an auditor of PQR Ltd. for the year ended 31.3.2009 at Annual General Meeting held on 16.08.2008. Mr: Y has been indebted to the company for sum of ₹ 10,000 as on 1.4.2008, the opening date of accounting year which has been subject to his *audit. However, Mr. Y having come to know that he might be appointed as auditor, he repaid the amount on 10.8.2008.One of the shareholders, complains that the appointment of Mr. Y as an auditor was invalid because he incurred disqualification u/s 226 of the Companies Act, 1956. Comment.*

Answer

According to the section 226 of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding ₹ 1000/- shall be disqualified to be an auditor of such company and he should vacate office when he incurs this disqualification subsequent to his appointment. The relevant date for reckoning disqualification is the date of appointment i.e. the date of resolution passed by the company to effect such appointment. Where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for his appointment.

In the given case Mr. Y was given appointment for the year ended 31.3.09 in the AGM held on 16.8.2008, he repaid the loan amount fully to the company on 10.8.2008, before the date of his appointment and hence his appointment is valid and the shareholders complaint is invalid.

Question 46

(a) PQR Company Ltd. -removed their first auditor by passing a resolution in the meeting of the Board of Directors for his removal without obtaining prior approval from the Central Government. Offer your comments in this regard.

(b) R & M Company, a firm of Chartered Accountants, was appointed as statutory auditors of XYZ Company Ltd. Draft an engagement letter accepting the appointment as auditors.

Answer

(a) Removal of first Auditor: As per clause (7) of Section 224, an auditor may be removed before the expiry of his term by the company in general meeting, after obtaining the prior approval of the Central Government in that behalf, except that such approval is not required for the removal of the first auditor appointed by the Board of Directors. Under the proviso to sub section (5) of section 224, the first auditor appointed by the Board of Directors may be removed by merely passing an ordinary resolution in the general meeting.

Conclusion: In the instant case the first auditor appointed by the Board of Directors was removed by a resolution in the meeting of the Board of Directors inspite of the General Meeting as per the requirement of section 224 (5). There is of course no need for approval of the Central government.

Due to contravention of the proviso of sub section (5) of Section 224, the auditor should qualify the audit report.

(b) Engagement Letter for accepting the appointment as an Auditor: As per the SA 210, “Agreeing the Terms of Audit Engagements”, the draft of Engagement Letter is as follows

To the Board of Directors of XYZ Company Limited

You have requested that we audit the financial statements of XYZ Company Limited, which comprise the Balance Sheet as at March 31, 2010, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance][7] acknowledge and understand that they have responsibility:

(a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.[8] This includes:

[7] Use terminology as appropriate in the circumstances.
[8] Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".

- The responsibility for the preparation of financial statements on a going concern basis.
- The responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
- The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.

(b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide us with:

(i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that we may request from [management] for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

R & M Co.
Chartered Accountants

Firm's Registration No.
…………………………
(Signature)

Date : (Name of the Member)

Place : (Designation[9])

Acknowledged on behalf of XYZ Company by
……………………..
(Signature)
Name and Designation
Date

Question 47

Comment as an auditor on the following situations:

(a) Government of India has appointed Mr. M, a retired Finance Director and a non-practising member of the Institute of Chartered Accountants of India, as an auditor to conduct special audit of ABC Ltd. on the ground that the company was not being managed on sound business principles. The Managing Director of the company contends that the appointment of Mr. M is not valid because he does not hold a certificate of practice.

(b) M.N.P.Company Ltd. purchased a machinery for ₹ 1.00 crore. The State Government granted the company a subsidy of ₹ 40 lakhs to meet partial cost of machinery. The company credited the subsidy received from the State Government to its Profit and Loss Account for the year ended March 31, 2010.

(c) Sri & Company, a firm of Chartered Accountants was appointed as statutory auditors of Aaradhana Company Ltd.. Aaradhana Company Ltd. holds 51 % shares in Sarang Company Ltd. Mr. Sri, one of the partners of Sri & Company, owed ₹ 1,500 as on the date of appointment to Sarang Company Ltd. for goods purchased in normal course of business.

[9] Partner or proprietor, as the case may be.

Answer

(a) Appointment of Special Auditor : Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.

Amongst others, one of the circumstances specified is, in case, a company is not being managed in accordance with sound business principles or prudent commercial practices.

Such an audit aims at providing the government with a critical appreciation of the company and its financial position.

The audit may be conducted either by the company's auditor or another Chartered Accountant who may or may not be engaged in a practice, appointed by the Central Government. The auditor appointed has the same power and duties in the matter of special audit as the statutory auditor of a company has, except for the fact that he must report to the Central Government in place of member of the company. .

Conclusion: In view of the above provisions of the Companies Act, 1956, the appointment of Mr. M, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Managing Director is not correct.

(b) Accounting treatment for Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.

Following are two methods of presentation of grants related to specific fixed assets in financial statements as acceptable alternatives.

(i) Under the first alternative the grant is shown in the balance sheet as a deduction from the gross value of the assets concerned. The grant is recognized in profit and loss accounts over the useful life of the depreciable life of asset *by way of a reduced depreciation charge.*

(ii) Under second alternative, it is treated as a deferred income which should be recognized in profit and loss account over useful life of asset in proportion in which depreciation will be charged on the assets concerned. Deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description i.e. Deferred Government Grant.

Conclusion: In the instant case, MNP Company Ltd received a subsidy from government worth ₹ 40 lakhs towards meeting partial cost of machinery. The company credited the same to its profit & loss account.

Accounting treatment of grant received towards partial cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant;

otherwise it is the duty of the auditor to qualify his report bringing out the quantification impact clearly.

(c) **Appointment of the auditor:** Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees.

This provision aims to ensure that the auditor is independent and under no financial obligation to the company.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company.

Sub section(4) of the Section 226 further lays down that a person is not eligible for appointment as auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company. Similarly a firm of auditors acts through its partners hence no partner should be indebted even in his personal capacity to the entity being audited the debt arising from normal course of business of the entity should also be record for indebtedness.

Conclusion: Accordingly, the partner Mr Sri is disqualified to be appointed as auditor of the company as he is indebted to the company for an amount exceeding ₹ 1000. This disqualification is attracted even if it exists on any date during the relevant accounting year.

Due to disqualification of Mr. Sri, Sri & Co., is also disqualified to be appointed as an auditor of Aaradhana Company Ltd.

Question 48

Comment on the following:

(a) *X Ltd. has its Registered Office at Mumbai. During the current accounting year it shifted its Corporate Office to Delhi. The Managing Director of the Company wants to shift company's books of account to Delhi because he holds the view that there is no legal bar in doing so.*

(b) *A partnership firm revalued its fixed assets like land and building. The firm adequately disclosed the revalued amounts in the Balance Sheet.*

Do you, as an auditor, approve the disclosure given by the partnership firm?

(c) *R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director?*

Answer

(a) **Shifting of Books of Account:** As per section 209(1) of The Companies Act 1956, every company shall keep at its registered office proper books of accounts. It is permissible, however, for all or any of the books of accounts to be kept at such place in India as the Board of Directors may decide but, when a decision in this regard is taken, the company must file within seven days of such decision with the Registrar of Companies a notice in writing giving full address of the other place.

Conclusion: In view of the above provisions, X Ltd should maintain its books of account at its registered office at Mumbai. The Managing Director is not allowed to shift its books of account to Delhi unless decision in this behalf is taken by the Board of Directors and a notice is also given to the Registrar of Companies.

(b) Disclosure of revalued fixed assets of a partnership form: As per AS 10 "Accounting for fixed assets", revalued amounts substituted for historical costs of fixed assets, method adopted to compute the revalued amounts, nature of indices used, year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts should be disclosed in the financial statements.

In the instant case, the partnership firm revalued its fixed assets like building and land and adequately disclosed the revalued amounts in the Balance sheet. The firm did not disclose the method adopted by it for arriving at the revalued figures.

Conclusion: The firm had disclosed the revalued amounts in the balance sheet but the method and nature of indices used etc. are not disclosed. Thus, this act of the firm is in contravention with the AS 10 for "Accounting for Fixed Assets'.

Hence, the auditor cannot approve the disclosure given by the partnership firm and shall have to qualify the report.

(c) Ownership and custody of working papers: As per SA-230 "Audit Documentation", the working papers are the property of the auditor, the auditor may, at his discretion make portion of or extracts from his working papers available to the client.

In the instant case the managing director of the company has demanded copies of the working papers from the auditor. He has no right to obtain copies of the working papers from the auditor because they are the property of the auditor. However the auditor may at his discretion make portions of or extracts from the working paper to the managing director of PQR & Company Ltd.

Conclusion: The auditor is not bound to oblige the managing director by supplying copies of the audit working papers.

Question 49

Explain the concept of joint audit. Discuss its advantage and disadvantage.

Answer

Joint Audit: The practices of appointing chartered accountants as joint auditors is quite widespread in big companies and corporations, joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

When more than one auditor is appointed to audit large entities, such auditors are called joint auditors. Joint auditors have a collective responsibility to report on the financial statements. SA 299, "Joint Audit" deals with duties, rights and professional responsibilities of joint auditors. The joint auditors should follow the principles of division of work and coordination while conducting joint audits.

Advantages of Joint Audit

(i) Pooling and sharing of expertise

(ii) Advantage of mutual consultation.

(iii) Lower work load

(iv) Better quality of work performance.

(v) Improved service to the client.

(vi) Displacement of the auditor of the company in a take-over often obviated.

(vii) In respect of multinational companies, the work can be spread using the expertise if the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance.

Disadvantages of Joint Audit

(i) The fees being shared.

(ii) Psychological problem where firms of different standing are associated in the joint audit.

(iii) General superiority complexes of some auditors.

(iv) Problems of coordination of the work.

(v) Areas of work of common concern being neglected.

(vi) Uncertainty about the liability for the work done.

(vii) Lack of clear definition of responsibility.

Question 50

What is Companies (Auditor's Report) Order 2003? Explain the companies which are not covered by the CARO order.

Answer

CARO, 2003: CARO is an additional reporting requirement Order which was issued by the Central Government in consultation with the Institute of Chartered Accountants of India under section 227 (4A) of the Companies Act, 1956. This Order is legally known as Companies Auditor's Report Order, 2003 and it makes obligatory for the statutory Auditor to make a specific statement on certain additional points contained in as 21 Clauses/Paragraph in their audit report.

As per CARO, 2003, the auditor is required to report in relation to fixed assets, inventories, terms and condition of loans and advances, adequacy of internal control system, maintenance of cost records, deposition of statutory dues, default in repayment of dues FI/bank/debenture holders, Disclosure of the end use of money raised by the public’s issues, fraud on or by the company noticed or reported etc. Some of the reporting requirements contained in the Order go beyond the scope of financial audits and involved propriety aspects as well

Companies not Covered by the Order

Companies which are not covered under CARO 2003 are :

(i) a banking company as per the Banking Regulation Act, 1949;

(ii) an insurance company as per the Companies Act, 1956;

(iii) a company licensed to operate under section 25 of the Companies Act, 1956; and

(iv) a private limited company with a paid-up capital and reserves not more than rupees fifty lakh and which does not have outstanding loan exceeding rupees twenty five lakhs from any bank or financial institution and does not have a turnover exceeding rupees five crores at any point of time during the financial year.

Question 51

Discuss :

(a) Ceiling on number of audits in a company to be accepted by an auditor.

(b) Filling of a casual vacancy of auditor in respect of a company audit.

(c) In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".

Answer

(a) Ceiling on number of Audits : According to Section 224 (1B) of the Companies Act, 1956, a Chartered Accountant cannot hold more than the specified number of company audit. This section further states that in case of Chartered Accountant Firm, the specified number is 20 companies per such partner who is not in whole time employment elsewhere. Out of the above 20 companies not more than 10

companies may have a paid up share capital of ₹ 25 lakhs or more. Explanation II after sub-section (IC) of section 224 further amplifies the manner of identifying the audit units for calculating the specified number. Under this explanation, when an auditor is appointed to audit even a part of a company's accounts, the part will be considered as a unit of audit for the purpose of calculation of the ceiling. Each of the joint auditors is considered a part auditor for the purpose. Any joint audit held by an auditor will be included as one audit unit for the purpose of calculating the ceiling of audits. However, audit of a branch of company is not included in the computation of the ceiling. Similarly, audit of corporations which are not companies and foreign companies are also not to be included. Further, it may be noted that even non-profit companies would be counted for the purpose of ceiling. However, guarantee companies not having share capital, special audit and investigation of companies will not be counted for the purpose.

As per Companies (Amendment) Act, 2000, audit of private companies are not to be counted in computation of ceiling limit. Therefore, with this amendment, while computing the ceiling a number of audits; only audit of public companies would be taken into consideration. In other words, an auditor can accept audit of any number of private companies. This, however, is subject to guidelines of the Institute which provide restriction in respect of private companies as well. The Council of ICAI has specified a ceiling of 30 audit assignments per person, whether in respect of private companies or other companies. In case of an audit firm, the ceiling shall be multiplied by the number of partners. Also the ceiling shall be 10 in case of public companies having paid up share capital of ₹ 25 lakhs or more.

(b) Filling of a Casual Vacancy: A casual vacancy in the office of the auditor can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. In case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor. The expression 'casual vacancy' has not been defined in the Act. Taking its natural meaning, it stands for a vacancy created by the auditor ceasing to act after he was validly appointed and the appointment was accepted. This may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firms of auditors, etc. The provision to require the filling of casual vacancy caused by resignation of the auditor by the general meeting is in consonance with the principle of auditor's independence. The process may bring out facts regarding the auditor's resignation to the notice of, and hence scrutiny by the shareholders. Any abuse of authority or financial impropriety by the management that might have contributed to the resignation will be known. If the auditor could be found to be conscientious and honest, the general meeting may even request him to reconsider his decision and take appropriate steps to cure the evils, if any, in the management. The auditor

appointed to a casual vacancy shall hold office till the conclusion of the next annual general meeting.

(c) 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.

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.

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.

Question 52

State the matters which only the shareholders can sanction at a General Meeting.

Answer

Matters to be sanctioned only by the Shareholders

Some of the matters which only the shareholders can sanction at a general meeting

(i) Appointment and fixation of remuneration of auditors in the annual general meeting - section 224 of the Companies Act, 1956.

(ii) Declaration of dividends - Regulation 85, Table A.

(iii) Appointment of relatives of directors etc. to an office or place of profit in the company under section 314 of the Companies Act, 1956.

(iv) Sale, lease or a disposal of the whole of the company's undertaking or a substantial part of it and donations above a certain limits [Section 293(1)].

(v) Rectification of name or adoption of new name where it resembles the name of an existing company with the previous approval of the Central Government.

(vi) Issue of shares at a discount.

(vii) Alteration of share capital.

(viii) Re-issue of redeemed debentures.

(ix) Adoption of statutory report.

(x) Passing of annual accounts and balance sheet, alongwith reports of Board of directors and auditors.

(xi) Appointment of first directors who are liable to retire by rotation.

(xii) Increase or reduction in the number of directors within the limit fixed by the Articles.

(xiii) Appointment of managing/whole-time director.

(xiv) Removal of a director and appointment of a director in his place.

(xv) Approval of appointment of sole selling agents.

(xvi) Winding up a company voluntarily in certain events.

(xvii) Appointment and fixation of remuneration of liquidators in members voluntary winding up.

(xviii) Nomination of a liquidator in creditors voluntary winding up.

Question 53

Discuss CARO 2003 requirement with regard to internal audit system. What are the factors to be considered by the auditor to examine whether the internal audit system is commensurate with the size of the company and the nature of its business?

Answer

Internal Audit System and CARO, 2003:

As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies. For other companies, it is applicable if either of the following conditions is satisfied:

(1) the paid-up capital and reserves of the company are more than rupees fifty lakhs as at the commencement of the financial year; or

(2) average annual turnover exceeds rupees five crores for a period of three consecutive financial years immediately preceding the financial year concerned.

The following are some of the factors to be considered to ensure that the internal audit system is commensurate with the size of the company and the nature of its business:

(i) Size of the internal audit department.

(ii) The qualifications of the persons who undertake the internal audit work

(iii) Reporting officer of the internal auditor.

(iv) Areas covered by the internal auditor.

(v) Technical assistance of the internal auditor.

(vi) Reports submitted by the internal auditor or other evidence of his work: It is important that the auditor should satisfy himself that not merely does an internal audit system exist but also that it is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) Follow-up: It is not sufficient that the internal audit system should point out errors in operation or deficiencies in the internal control system. It is equally necessarys that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

EXERCISES

1 Comment on the following:

(a) The company had also appointed a Cost Auditor and therefore, the management had requested your firm not to review the cost records.

(b) The management requested your firm not to comment on valuation of Inventory and realisability of certain debtors, as they had been covered in the Directors Report

(c) While conducting the audit of a company for the year ended 31st March, 2010 the auditor called for he General Ledger for the year ended 31 March 2007 for some reference. He would not get that ledger as the booked of accounts of that year were already destroyed as per the instructions of the Executive Director of the Company.

(d) While conducting the audit of a limited company for the year ended 31st March, 2010, the auditor called for the ledger for ascertaining the details of a particular account. The ledger could not be made available to him as it was destroyed due to space constraint as per the instruction of the Executive Director of the company.

2 What are the provisions of the Companies Act, 1956 with regard to the remuneration of an auditor?

3 How is the Auditor's remuneration required to the disclosed in the company's Profit and Loss Account?

4 "Auditor's report implies an expression of opinion by the auditor." Discuss the statement.

8

The Company Audit – II

BASIC CONCEPTS

The Chapter deals with the provisions relating to company accounts, some specific items of financial statements relating to companies and audit thereof.. The important sections outlined herein are as follows:

Section 53 Service of documents on members by company.

Section 56 Matters to be stated and reports to be set out in prospectus

Section 60A Shelf prospectus

Section 60B Information memorandum

Section 69 Prohibition of allotment unless minimum subscription received

Section 73 Allotment of shares and debentures to be dealt in on stock exchange

Section 75 Return as to allotments.

Section 76 Power to pay certain commissions and prohibition of payment of all other commissions, discounts, etc

Section 77A Power of company to purchase its own securities.

Section 77B Prohibition for buy-back in certain circumstances.

Section 78 Application of premiums received on issue of shares.

Section 79 Power to issue shares at a discount

Section 79A Issue of sweat equity shares

Section 80A Redemption of irredeemable preference shares, etc.

Section 81 Further issue of capital

Section 93 Payment of dividend in proportion to amount paid-up.

Section 94 Power of limited company to alter its share capital.

Section 94 A Share capital to stand increased where an order is made under section 81(4)

Section 100 Special resolution for reduction of share capital.

Section 108 Transfer not to be registered except on production of instrument of transfer.

Section 109A Nomination of shares.

Section 109B Transmission of shares.

Section 110 Application for transfer.

Section 111 Power to refuse registration and appeal against refusal.

Section 117A Debenture trust deed.

Section 117B Appointment of debenture trustees and duties of debenture trustees.

Section 166 Annual general meeting

Section 198 Overall maximum managerial remuneration and managerial remuneration in case of absence or inadequacy of profits.

Section 205 Dividend to be paid only out of profits.

Section 205A Unpaid dividend to be transferred to special dividend account.

Section 205 B Payment of unpaid or unclaimed dividend.

Section 205C Establishment of Investor Education and Protection Fund.

Section 206 Dividend not to be paid except to registered shareholders or to their order or to their bankers.

Section 206A Right to dividend, rights shares and bonus shares to be held in abeyance pending registration of transfer of shares.

Section 207 Penalty for failure to distribute dividends within thirty days

Section 208 Power of company to pay interest out of capital in certain cases.

Section 209 Books of account to be kept by company.

Section 209 A Inspection of books of account, etc., of companies.

Section 210 Annual accounts and balance sheet.

Section 210A Constitution of National Advisory Committee on Accounting Standards

Section 211 Form and contents of balance sheet and profit and loss account (under Schedule VI as notified by Ministry of Corporate Affairs vide *Notification [F. NO. 2/6/2008-C.L-V], Dated 30-3-2011.*

Section 212 Balance sheet of holding company to include certain particulars as to its subsidiaries.

Section 215 Authentication of balance sheet and profit and loss account.

Section 217 Board's report.

Section 222 Construction of references to documents annexed to accounts.

Section 227 Powers and duties of auditors

Section 291 General powers of Board.

Section 292 Certain powers to be exercised by Board only at meeting.

Section 293 Restrictions on powers of Board.

Section 293(A) Prohibitions and restrictions regarding political contributions.

Section 294 Appointment of sole selling agents to require approval of company in general meeting.

Section 295 Loans to directors, etc.

Section 297 Board's sanction to be required for certain contracts in which particular directors are interested.

Section 299 Disclosure of interests by director.

Section 300 Interested director not to participate or vote in Board's proceedings.

Section 301 Register of contracts, companies and firms in which directors are interested.

Section 309 Remuneration of directors.

Section 314 Director, etc., not to hold office or place of profit.

Section 370 Loans, etc., to companies under the same management.

Section 372 Purchase by company of shares, etc., of other companies.

Section 541 Liability where proper accounts not kept.

For details refer to the Companies Act, 1956

Question 1

Comment on the following:

(a) The surplus arising from a change in the basis of accounting was set off by X Ltd., against a non-recurring loss.

(b) Z Ltd. gave a guarantee to the Court for payment of excise dues of ₹ 10 lakhs for one of its subsidiaries. According to the company, since the guarantee was given on behalf of its subsidiary, no disclosure was required.

Answer

(a) Adjustment and disclosure of surplus on account of changes in the basis of accounting and non-recurring losses

AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" states that any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.

Transactions which are of a abnormal on non-recurring nature, may also be considered material, even though *prima facie*, they do not appear to be material.

Materiality is an important and relevant consideration in determining whether or not such exclusion/non-disclosure will distort the true and fair view of the financial statements. Thus, it would be important that users must know the quantum of non-recurring loss. In offsetting and aggregating items care need to be taken to ensure that material items are not offset against each other.

Accordingly, it would not be prudent to set off the surplus emanating from a 'change in the basis of accounting' against a 'non-recurring loss'. Accordingly, it would be better to disclose surplus on account of change in the basis of accounting and non-recurring loss separately.

(b) Disclosure of guarantee given by a company on behalf of its subsidiary: Z Ltd., in its books of account is required to record a contingent liability of ₹ 10 lakhs for the guarantee given by it for payment of excise dues of its subsidiary, to the Court. In the event, the subsidiary failed to meet its obligation, Z Ltd. would be required to pay ₹ 10 lakhs to the authorities concerned.

AS 4 also states that the existence and amount of guarantees undertaken by an enterprise are generally disclosed in financial statements by way of a note, even though the possibility that the loss will occur, is remote.

Thus, the amount of any guarantee given by a company on behalf of its subsidiary is required to be stated and where practicable, the general nature of such contingent liability, if material, be specified. Accordingly, the views expressed by the company cannot be accepted.

Question 2

Comment on the "Credit for the profit arising out of a hire-purchase sale was fully adjusted in the year of sale".

Answer

Adjustment of profit arising on hire-purchase sale transaction: The nature of a hire-purchase transaction makes it absolutely clear that a person does not become owner till the last instalment has been paid.

As per AS 9 on "Revenue Recognition", credit for the amount of profit arising from hire purchase sales is not taken into account until the instalments of sales price have been realised.

Therefore it is distributed proportionately over the hire purchase period. Accordingly, in the instance case, credit for the amount of profit arising from hire purchase sale is not to be taken into account until the last instalment of sales price have been realised. It is not proper to take the entire difference between the total hire purchase consideration and the cash value of the relevant asset to the profit and loss account at the time of delivery of goods. Instead this difference is recognised in various accounting periods proportionately on the basis of hire purchase consideration outstanding during the accounting period. Accordingly, in cases where profit arising on a hire purchase sale has been adjusted fully in the year of sale, a provision equal to the amount of profit which has not accrued should be created. The amount of provision so made should also be deducted from the "hire purchase debtors" for purposes of disclosure in the balance sheet.

Question 3

Comment on the "Interest on share capital was paid to the shareholders as the company had a long gestation period before it could become operational".

Answer

Payment of interest out of capital: Section 208 of the Companies Act, 1956 permits payment of interest to shareholders out of capital, where there is a long gestation period. Payment of interest on capital is, however, capitalised as part of cost of construction of the project. The auditor should ensure that following conditions have been complied whenever such interest has been paid:

(i) Payment is authorised by the Articles or by special resolution of shareholders in general meeting;

(ii) Payment is approved by the Central Government;

(iii) It is paid only for the period determined by the Central Government not exceeding six months after the half-year in which the project has been completed.

(iv) The rate shall not exceed 12% p.a. or such other rate as may be prescribed by the Government.

(v) The payment of interest shall not operate as a reduction of the amount paid-up on the shares in respect of which it is paid.

Question 4

As an auditor comment on the following situations:

(a) A company had acquired a 10 Tonner delivery van valued at ₹ 6.5 lakhs on instalment basis from a dealer. During the year, the company paid ₹ 1.5 lakhs being the instalment for the year and provided depreciation on the said amount paid.

(b) A sum of ₹ 15,000 per month has been paid as remuneration to a Director, who is not in the whole-time employment of the company.

(c) A company received a subsidy of ₹ 1 crore for establishing an undertaking in the backward/notified area.

Answer

(a) Purchase of van on instalment basis: The delivery van was purchased at ₹ 6.5 lakhs on instalment basis and accordingly, the property passed on to the purchaser immediately whereas in the case of hire-purchase basis, property in goods passes only after payment of last instalment.

Therefore, the gross book value of the delivery van will be ₹ 6.5 lakhs. Depreciation should, thus, be provided on ₹ 6.5 lakhs and not on the instalment amount of ₹ 1.5 lakhs paid. Under the circumstances, the auditor will have to qualify the audit report.

(b) Remuneration paid to a Director: Under section 309 (4) of the Companies Act, 1956, a Director who is not in the whole-time employment of the company, may be paid on a monthly/quarterly/annual basis with the approval of the Central Government or by way of commission if the company passes a special resolution.

However, the remuneration so paid shall not exceed: (i) 1% of the net profits of the company if the company has a managing or whole-time director or a manager; or (ii) 3% of the net profits of the company in any other case. However, company with the approval of the Central Government in general meeting may approve payment exceeding these specified percentages.

Therefore, the auditor has to examine whether the sum paid confirm to the above norms and requirements. In case, the payment has not been so approved and sanctioned, the Directors who have approved payment of the said ₹15,000 p.m. would have to personally reimburse the amount or the amount in excess paid. A qualification is also called for in the audit report as well.

(c) Subsidy received by the company: The Company had received a subsidy of ₹ 1 crore, for establishing an undertaking in the backward/notified area.

The accounting treatment of such subsidy shall depend upon the nature and purpose for which it has been given. As per AS 12 on "Accounting for Government Grants", the grant given for acquisition of fixed assets is in the nature of promoter's contribution.

As per facts of the case, the grant has been given with reference to the total investment in the undertaking by way of contribution towards its total capital outlay for the establishment of the undertaking which is having similar characteristics to those of promoter's contribution.

In such cases, no repayment is ordinarily expected and thus the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Accordingly, the amount of ₹1 crore should be kept in a special reserve account and treated as a part of shareholders' funds.

Question 5

"The interest of a director in a transaction, entered into by the company has not been disclosed in the records maintained by the company". Comment.

Answer

Non-disclosure of interest of directors in records maintained by the company

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.

Question 6

Write a short note on - the Sweat Equity Shares.

Answer

Sweat Equity Shares: The Companies (Amendment) Act, 1999 recognised that in the wake of globalisation of corporate sector, the employees will have to be rewarded suitably to share in the growth of a company.

By insertion of new section 79A, the employees may be compensated in the form of 'Sweat Equity Shares". "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

(i) the issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;

(ii) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(iii) not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;

(iv) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

However, in the case of a company where equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the prescribed guidelines.

Question 7

As an auditor, what would you do in the following situations?

(a) One customer from whom ₹ 5 lacs are recoverable for credit sales gives a motor car in full settlement of the dues. The directors estimate that the market value of the motor car transferred is ₹ 5.25 lacs. As on the date of the balance sheet the car has not been registered in the name of the auditee.

(b) The company had borrowed ₹ 100 lacs from ICICI, which it is unable to repay on the due date. The accrued unpaid interest on the same is ₹ 25 lacs. There is a stipulation that on default in repayment, there would be a penal interest payable, which would amount to ₹ 10 lacs. The company has applied to ICICI for rescheduling the repayment and waiver of a part of the accrued interest and the penal interest. As on the date of audit, the said application is still pending.

Based on this application, the management does not wish to provide for the accrued interest and the penal interest.

Answer

(a) Determination of cost in case of exchange of assets: An enterprise may acquire an asset through exchange process. In the instant case, the company has acquired a motor car from a customer in exchange of amount due from him.

However, the motor car has not been registered in the name of the company on the date of the balance sheet. Having regard to the principle of substance over form, the auditor should see that the transaction is recorded though the car is not registered in the name of the auditee. As far as determination of the cost is concerned, AS 10 broadly lays down the following principle:

"When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration." *(Para 11.1)*

Consequently, it shall be more appropriate to record the cost of motor car at ₹ 5 lacs since the value of asset given up is more clearly evident than the fair value of assets acquired i.e. motor car which happens to be estimation on the part of directors. Accordingly, the customer's account should also be credited by ₹ 5 lacs.

Note: However, directors may revalue the asset and write up the value of motor car to ₹ 5.25 lacs. Then ₹ 25,000 should be transferred to Revaluation Reserve.

(b) Non-provision of Interest: The non-provision of accrued unpaid interest amounting to ₹ 25 lacs as also the penal interest amounting to 10 lacs payable to ICICI by the management is not the proper accounting treatment since the company has been unable to repay on the due date and penal interest is also payable in case of default as per terms of the contract.

The contention of the management is not tenable simply because application for rescheduling the repayment and waiver of a part of the accrued interest and the penal interest has been made to the ICICI.

In any case, a company has to follow accrual system of accounting as per section 209(3)(d) of the Companies Act, 1956. As a matter of fact, the auditor must ensure that provisions for the entire amount of accrued interest as also the penal interest has been made since the same has not been waived on the date of audit.

Since the management does not wish to provide the above amounts, the auditor shall have to qualify the audit report as per the Institute's statement on the subject. The qualification paragraph must bring out clearly the quantitative impact of non-provision of interest on the profits.

Question 8

State briefly, how you will audit the following in a joint stock company:

(a) Issue of shares for consideration other than cash.

(b) Buy-back of shares by the company.

(c) Splitting of one share of the face value of ₹ 10 into 10 shares of ₹ 1 each.

Answer

(a) Issue of shares for consideration other than cash

(i) Study of the contract pursuant to which the issue is made to determine how many shares are agreed to be issued and for what value and the nature and other details of the consideration.

(ii) Examination of the prospectus to see the substance of the contract and the relevant terms of the issue including the mode of payment of the purchase consideration in case of an issue to a vendor of the business or pay-ability of commission to the underwriters or pay-ability of the preliminary expenses.

(iii) Examination of the Board's minutes to see the adoption of the relevant contract, the decision to issue shares for a consideration other than cash and the actual allotment of shares.

(iv) Verification of the filing of the copy of the contract or the relevant terms of the contract where the contracts is not in writing with the Registrar of Companies within a period of 30 days after the date of the allotment. [as per section 75(1B) of the Companies Act, 1956.]

(v) Ensuring that proper accounting entry has been passed to record the acquisition of the assets or the business or payment of the expenses (any of these may constitute the consideration) on the one hand and the issue of shares on the other. Incidentally, if any premium or discount is involved, ensure that appropriate adjustment entry has been passed therefore.

Sometimes, in view of the nature of transaction, it may be difficult to know whether an allotment is for cash or for a consideration other than cash, for instance, allotment of shares in adjustment of a debt owed by the company. In such a case, if the allotment is made in adjustment of a bonafide debt payable in money at once, the allotment should be considered as against cash.

This position should be kept in view when inquiring into matters stated in section 227(1A). Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.

(b) Buy-back of shares by the company

(i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

(ii) Check authorisation in the Articles of Association which is a prerequisite of any buyback.

(iii) Examine special resolution passed in the general meeting authorising buyback.

(iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free serves but in case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity capital in that financial year.

(v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.

(vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.

(vii) Buy-back should be completed within 12 months from the date of passing the special resolution.

(viii) Ascertain that declaration of solvency in Form No.4A was filed with the SEBI and/or the Registrar of Companies before making buy-back but subsequent the passing of the special resolution.

(ix) See that SEBI (buy-back of securities) Regulations, 1998 have been followed by listed company.

(c) Splitting of shares of face value from ₹ 10 to ₹ 1 per share

(i) Confirm that alteration was authorised by articles.

(ii) Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

(iii) Verify also with reference to Form No.5 filed with the ROC.

(iv) Verify that alteration had been effected in copies of Memorandum Articles, etc.

(v) Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

Question 9

Explain the difference between Reserves and Provision.

Answer

Reserves and Provisions

Reserves: Reserve denotes retained profits. In other words, certain sum or sums are set apart out of the profits earned for specific or general purposes, and this constitutes reserve (or reserves).

These reserves are not available for dividend purposes in the year concerned. However, subject to decision of the Board of Directors, there can be appropriation out of reserves created in the past for dividend purposes, provided such reserves are not capital reserves.

If there is no profit, no reserve can be created and, basically, reserves are at the disposal of the undertaking; they are not required to be maintained for meeting possible losses or expenses. The term "reserve" has been negatively defined in Part III of erstwhile Schedule VI (applicable upto financial year 2010-2011) to the Companies Act, 1956 as not including any amount written off or retained by way of providing for diminution, renewals or diminution in value of assets or retained by way of providing for any known liability.

Requirements of Revised Schedule VI:

As per the revised version of Schedule VI, Reserves and Surplus have to be presented in the following manner:

"I. Equity and Liabilities:

1. Shareholders' Funds:

(a) Share Capital

(b) Reserves and Surplus

(c) ____________________"

- Reserves and Surplus shall be classified as:
  - (a) Capital Reserves;
  - (b) Capital Redemption Reserve;
  - (c) Securities Premium Reserve;
  - (d) Debenture Redemption Reserve;
  - (e) Revaluation Reserve;
  - (f) Share Options Outstanding Account;
  - (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
  - (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

  (Additions and deductions since last balance sheet to be shown under each of the specified heads)
- A reserve specifically represented by earmarked investments shall be termed as a 'fund';
- Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Provision: Provision, on the other hand, represents a charge for an estimated expense or loss or for shrinkage in the cost of an asset or the accrual of a liability.

Except for provision for dividend which is appropriation of profits, provisions are meant to meet expected losses and expenses for which the amount is uncertain.

Profit cannot be ascertained unless the necessary provisions are first made. Part III of Old Schedule VI to the Companies Act, 1956 has defined "provision" to mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. Amounts provided for depreciation, renewals or diminution in value of assets are expenses and losses.

Hence, the character of provision is of an expense or loss which must be charged against the revenue so as to arrive at the true and fair profit or loss. Since reserve is retained profit, it is necessarily an appropriation of profit obtained after charging all the expenses and losses including provisions. It, therefore, cannot include anything which is properly chargeable as expense or loss, i.e., provision.

However, if amounts are provided in excess of the needs, the excess should be treated as reserve. For example, the company may provide for depreciation at the rate of 25% as against the statutory rate of 15%. The excess of depreciation to the extent of 10% would be treated as reserve even though the entire 25% has been a charge to the profit and loss account. For creation of reserve, existence of profit is a must while provision is necessary even where there is a loss so as to correctly reflect the operating results of the enterprise.

Requirements of Revised Schedule VI:

As per the revised version of Schedule VI, the Current Liabilities and Provisions have to be presented as follows:

"Non-current liabilities

(a) ____________________

(b) ____________________

(c) ____________________

(d) ***Long-term provisions"***

"Current liabilities

(a) Short-term borrowings

(b) Trade payables

(c) Other current liabilities

(d) Short-term provisions"

General Instructions under Revised Schedule VI

- ***Long-term provisions:*** The amounts shall be classified as: (a) Provision for employee benefits; (b) Others (specify nature).
- ***Short-term borrowings:*** Short-term borrowings shall be classified as:
  (a) Loans repayable on demand: (i) from banks; (ii) from other parties.
  (b) Loans and advances from related parties.

(c) Deposits.

(d) Other loans and advances (specify nature).

- Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.
- ***Other current liabilities:*** The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends

(g) ***Application money*** received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium ,if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of share out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'

(a) Unpaid matured deposits and interest accrued thereon

(b) Unpaid matured debentures and interest accrued thereon

(c) Other payables (specify nature);

- **Short-term provisions:**

The amounts shall be classified as: (a) Provision for employee benefits; (b) Others (specify nature).

Question 10

In carrying out the "Share Transfer Audit" of your client, what aspects would be required to be examined by you as an auditor?

Answer

The following aspects are required to be examined by the auditor in conducting the share transfer audit:

(i) Inspection of the Articles of Association regarding the prescribed form of transfer and other provisions, particularly the time limits laid down by the Articles or law.

(ii) Notification by transferor of the lodgment made by the transferee and inspects the objections received, if any. Also see, where calls due or not paid, whether transfer can be refused under the articles and whether any transfer was so refused.

(iii) Examining in the case of particularly partly-paid shares, where the application for registration was made by the transferor, a notice was sent to the transferee and registration was effected only on receipt of 'non-objection' received from him.

(iv) Scrutiny of transfer forms, noting specially:

(a) That in every case, the application for transfer was made in the prescribed form and the prescribed authority (contemplated in Clause 1A of Section 108) had stamped the date on which it was presented to it; also that it was delivered to the company:

(i) In case of 'quoted' shares before the Register of Members were closed for the first time subsequent to the transfer within twelve months from the date of presentation of the application to the prescribed authority whichever is later.

(ii) In any other case within two months from the date of such presentation.

(b) That each transfer form is properly executed and bears the proper stamp duty.

(c) That the name of the company is correctly stated on the form.

(d) That where the consideration for transfer appears to be inadequate, an inquiry was made by the company for ascertaining the reasons therefore. (This is not necessary if the transfer form bears the seal of the Collector of Stamps.)

(e) That the alterations, if any, have been suitably initiated; and

(f) That the name and address of the transferee have been recorded completely and fully for purposes of correspondence.

(v) Comparison of the signatures of each transferor on the transfer form with his signature on the original application for shares or on the transfer form (if the shares were acquired on a transfer).

(vi) Ascertaining that none of the transferees is disqualified from holding shares in the company.

(vii) Vouching the entries in the Shares Transfer Journal by reference to the transfer forms, noting in each case:

(a) the name of transferor;

(b) the name and address of the transferee;

(c) the number and class of shares transferred; and

(d) the distinctive numbers, if any, of the shares transferred.

(viii) Verification of postings from the Share Journal to the Register of Members.

(ix) Inspection of each transfer as to names, addresses, occupations, form of document, description, number (in words), distinctive number of shares, stamp, date, signature, witnesses, etc.

(x) Check whether the transfer to firms, etc. has been rejected or not and whether notes of trust has been entered in the share register.

(xi) Noting transferor's name, etc. and class, number and distinctive number of shares, as stated in the transfers, with old certificates and Register of Members. See that old certificates were cancelled.

(xii) Inspection of the power of attorney and specimen signatures if transfer executed by an agent.

(xiii) Inspection of letters of indemnity for lost certificates and ensuring that duplicate certificates have been issued on proper authority.

(xiv) Where part of the shares have been transferred, the issue of balance certificates to the transferors should be seen and confirm that the distinctive number of shares have been correctly stated.

(xv) Refer to the minute's book to ensure that all transfers recorded in the share transfer journal have been approved by the Board.

(xvi) Checking of counterfoils of new certificates.

(xvii) Reconciliation of the amount of transfer fees collected with the total number of transfers lodged and verifying that the amount of transfer fees have been accounted for.

(xiii) Reconciliation of the total number of shares of different classes issued by the company with the total amount of capital issue and its sub-divisions by extracting balances of shares held by different members from the Register of members.

(xix) Ensuring that provisions of Section 113 regarding registration of share certificate have been complied with.

(xx) Ensuring that, in case of transfers, registration whereof was refused, the notice of refusal was sent to the transferor and the transferee within a period of two months giving reasons for such refusal (Section 111).

(xxi) Ensuring that, in case of any share transactions by directors, corresponding entries have been made in the Register of Directors' shareholding.

Question 11

Explain 'Option on Share Capital'.

Answer

Option on Share Capital: Part I of Old Schedule VI to the Companies Act, 1956 requires disclosure of the particulars of any option on unissued share capital. An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for share in the company if he so chooses. Such options generally arise under the following circumstances:

(i) Under the promoter's agreements, subsequently ratified by the company;

(ii) Collaboration agreement;

(iii) Loan agreements, debenture deeds (Refer to Section 81 of the Companies Act, 1956);

(iv) Other contracts, such as for supply of capital goods and/or merchandise.

Requirements of Revised Schedule VI:
As per the revised version of Schedule VI, Share Capital has to be presented in the following manner: ***"I. Equity and Liabilities:*** *1. Shareholders' Funds:* *(a) Share Capital* *(b) Reserves and Surplus* *(c) Money Received under Share Warrants* *2. Share Application Money Pending Allotment"*
General Instructions for Share Capital under Revised Schedule VI
• A company shall disclose the following in the notes to accounts: • Share Capital, i.e., for each class of share capital (different classes of preference shares to be treated separately): (a) the number and amount of shares authorized; (b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid; (c) par value per share; (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

	(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital; (f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate; (g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held; (h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts; (i) For the period of five years immediately preceding the date as at which the Balance Sheet is prepared: ***(a)*** Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash; ***(b)*** Aggregate number and class of shares allotted as fully paid up by way of bonus shares; ***(c)*** Aggregate number and class of shares bought back (j) Terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date; (k) Calls unpaid (showing aggregate value of calls unpaid by directors and officers); (l) Forfeited shares (amount originally paid up)
•	***Share Application Money Pending Allotment*** now appears as a separate category after the heading Shareholders' Funds.

Question 12

Give your comments and observations on the following:

(a) A company has not provided depreciation on machinery on the plea that the machinery has been maintained in excellent condition and is as good as new.

(b) A company, whose accounting year ends on 31st March, 2009 has placed an order with Globe Machinery Limited, Bombay for a machinery costing ₹ 20 lakhs against cash payment during the month of June, 2009. The company has added a foot-note to the Balance Sheet as at 31st March, 2009 showing separately that a capital contract has been entered into which requires the payment of ₹ 20 lakhs in cash.

(c) *A company has scrapped a semi-automatic part of a machine (not entirely written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to a more suitable place in the factory, which involved the building of a new foundation in addition to the cost of dismantling and re-erection. The company wants to charge the whole expenditure to revenue.*

(d) *A company has made additions to its factory buildings by its own workmen, at a cost of ₹ 4,50,000 for wages and materials. The lowest estimate from an outside contractor to carry out the same work was for ₹ 6,00,000. The directors contend that as they were fully entitled to employ an outside contractor, it is reasonable to debit the Factory Building Account with ₹ 6,00,000.*

Answer

(a) Non-Provision of Depreciation: The machinery is as good as new. The plea of the management of the company not to provide for depreciation on its assets in a particular year on account of the reason that the company has maintained the machinery in an excellent way during the year is not acceptable because as per the definition of depreciation given in AS 6 on "Depreciation Accounting", "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".

Thus, depreciation also arises due to efflux of time and, therefore, depreciation should be provided irrespective of whether the assets were maintained very well during the year. Hence, the mere fact that the assets have been maintained excellently during the year is not an acceptable ground for the management not to provide for depreciation.

(b) Payment on Account of Capital Contract: The placement of an order for the purchase of a machinery against cash, to be delivered in the next year is a capital commitment and, thus, as such there is no necessity for making a provision in the year of order.

However, the capital commitment for which no provision is made, the company will have to comply with the disclosure requirements and, thus, a note is to be added to the Notes to the Accounts stating that a capital contract has been entered into which would require the payment of ₹ 20 lakhs in cash. It is just nothing but a contingent liability on capital account. Therefore, the treatment accorded by the company is correct.

(c) Treatment of Expenditure Incurred on Machinery: The written down value of the semi-automatic part is required to be written off to the revenue. The whole expenditure incurred in purchasing the fully automatic part and in repositioning the machine is required to be treated as capital expenditure since the amount incurred has increased the earning capacity of the machine.

A clear distinction shall have to be made as to the nature of expenditure which leads to benefits in the future periods by increasing the earning capacity of the machine. In the instant case, it is clear that such expenditure can not be treated revenue at any cost because of the enhanced earning capacity of the machine in the future. In fact, the output of the machine has almost doubled and the machine has been moved to a more suitable place. Therefore, the company's contention to charge whole expenditure to revenue is not justifiable.

(d) Additions to Factory Buildings: The contention of the Board to debit the Factory Building Account by ₹ 6,00,000 is incorrect. Despite the fact that addition to factory buildings have been made at a cost of ₹ 4,50,000. In the case of a fixed asset which is held for the purpose of earning income and not for resale, it would be improper to value the asset in excess of the amount which has been paid for it. The additions made to the factory buildings must appear in the balance sheet at a figure not exceeding its actual cost to the company.

AS 10 on "Accounting for Fixed Assets", makes clear that gross book of self-constructed fixed assets should be computed on the basis actual cost incurred/allocated. Even internal profits, if any, are eliminated in arising at such costs. Hence the Board's contention is not correct.

Question 13

Write a short note on- the Audit of Capital Reserve.

Answer

Audit of Capital Reserve: A capital reserve is a reserve which is not available for distinction as dividend. The auditor should examine that the head 'capital reserves' does not include any amounts as are regarded as free for distribution as dividend. In the case of a company, if there is a capital profit on reissue of forfeited shares, it is to be shown under capital reserves.

The following are the duties for the Auditor in connection with the capital profit, which are not normally available for distribution to the shareholders unless:

(a) The Articles of the company permit such a distribution,

(b) It has been realised in cash.

(c) The assets value remaining after distribution of the profit will be not less than the book value so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.

Revaluation reserve is also not available for dividends. Further, the bonus share cannot be issued by capitalisation of revaluation reserve. If any company does so, the auditor should qualify his report.

It may however, be noted that revalued capital profits are distributable in the same way as other profits and that it is not necessary to comply condition (a) and (b) above. This is because AS 10 requires that any profit on sale of fixed asset has to be routed through the profit and loss account. A clear distinction should be made between capital profits and capital receipts. The latter cannot be distributed by way of dividend at all.

Auditor should also ensure that following presentation and disclosure requirements of Revised Schedule VI to the Companies Act, 1956 have been complied with.

Requirements of Revised Schedule VI:
As per the revised version of Schedule VI, Reserves and Surplus have to be presented in the following manner: ***"I. Equity and Liabilities:*** *1. Shareholders' Funds:* *(a) Share Capital* *(b) Reserves and Surplus* *(c) ________________________________"* • Reserves and Surplus shall be classified as: (a) Capital Reserves; (b) Capital Redemption Reserve; (c) Securities Premium Reserve; (d) Debenture Redemption Reserve; (e) Revaluation Reserve; (f) Share Options Outstanding Account; (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof); (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc. (Additions and deductions since last balance sheet to be shown under each of the specified heads) • A reserve specifically represented by earmarked investments shall be termed as a 'fund'; • Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Question 14

As a Company Auditor how would you react to the following situations?

(a) A publishing company undertook repair and overhauling of its machinery at a cost of ₹ 250 lakhs to maintain them in good condition and capitalised the amount as it is more than 25% of the original cost of the machinery

(b) Inventories of a Car manufacturing company include the value of items, required for the manufacture of a model which was removed from the production line five years back, at cost price.

(c) Interest on loan borrowed to purchase machinery which has been installed two years back is still debited to Machinery Account.

(d) Sale value of scrap items adjusted against Miscellaneous Expenditure

(e) Insurance claim of ₹ 2 lakhs received stands included under Miscellaneous Income.

(f) ₹ 5 lakhs paid by a pharmacy company to the legal advisor defending the patent of a product treated as Capital Expenditure.

Answer

(a) Amount incurred to repair and overhaul the machinery: The money spent on the repair and overhaul of the machinery can be treated as capital expenditure, irrespective of the amount, only if it results in increasing the earning capacity or reduction in the cost of production. In this case, neither the earning capacity has increased nor there is any reduction in the cost of production.

In the absence of both these criteria, it is to be treated as revenue expenditure. The mere fact that maintenance expenditure is more than 25% of the original cost of the machinery would not change its nature, i.e. in revenue expenditure.

If any expenditure of a revenue nature is treated as capital, then it would have the effect of inflating the profit for the year. Consequently, the auditor would be required to qualify his report.

(b) Inventory valuation: AS 2 on "Valuation of Inventories" provides that the cost of inventories may not be recoverable if those inventories are damaged, have become wholly or partially obsolete, or if their selling prices have declined.

Accordingly, the auditor should examine whether appropriate allowance has been made for the defective, damaged, obsolete and slow-moving inventories in determining the net realisable value.

In this case, items required for the manufacture of a model which has been withdrawn from the production line five years ago are included in the stock at cost price resulting in overstatement of inventory and profit. As it appears from the facts given that the net realisable value of these items is likely to much lower than the cost at which these are being shown in the books of account.

Accordingly, it becomes necessary to write down the inventory to ‘net realisable value’ if the items of inventories become wholly or partially obsolete. Under the circumstance, the auditor should qualify the report appropriately.

(c) **Borrowing costs:** AS 16 on “Borrowing Costs” permits capitalisation of borrowing costs in case certain conditions are fulfilled, viz., costs are directly attributable to the acquisition, construction or production of an qualifying asset.

A qualifying asset is one which necessarily takes a substantial period of time to get ready for its intended use or sale. As such, interest on loan borrowed to purchase the machinery which has already been installed two years back should not be debited to machinery account since this would result in the overstatement of the value of machinery and profit.

The auditor would be required to qualify the report bringing out quantitative impact on the assets and profit.

(d) **Treatment of revenue of scrap items:** Sale value of scrap is an item of miscellaneous income and adjusting such income against miscellaneous expenditure is not proper.

AS 5 on, “Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies” requires that when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Therefore, requirements in regard to the profit and loss account of a company, it should disclose clearly credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.

The auditor should see that the revenue has been disclosed properly in the financial statement since such an adjustment would fail to explain the performance of the company.

(e) **Amount received on account of Insurance claim:** The principle laid down in AS 5 that even those items of income and expense which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance may be disclosed separately.

However, money received from the insurance company is against a specific loss. It has to be adjusted against the loss. The auditor should check the adjustment of the amount received in short of the value of actual loss as per the insurance policy.

In respect of claim against an asset, the profit and loss account should be debited with the shortfall of the claim against the book value. If the claim was lodged in the previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

(f) **Legal expenses incurred by the company:** Legal expenses of ₹ 5 lakhs incurred to defend the patent of a product of the pharmacy company is revenue expenditure pertaining to the asset since by this expenditure neither any endurable benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased.

Payment of legal fees is normally revenue expenditure irrespective of the amount involved unless same is incurred to bring any new asset into existence. Hence, treating such expenditure as capital expenditure is incorrect. This would result in overstatement of the value of asset and profit and calls for qualification in the audit report.

Question 15

As an auditor comment on the following situations/statements:

(a) The sale and purchases of investments of A Ltd., was controlled through a committee. Shri B sold some of the investments without discussing the same with the other members of the committee as they were out of station and Shri B believed that its price would fall and the company would suffer a loss if it is not sold. A Ltd. earned a profit of ₹ 1 lakh from such sale.

(b) The company due to liquidity crises sold and leased back the same vehicles from leasing companies. In the notes to accounts, the company stated 'Vehicles taken on lease repayable in 46 instalments of ₹ 26,650 each'.

(c) No depreciation provided on a machinery costing ₹ 50 lakhs imported three years back, since it is yet to be put into use.

(d) A portion of Share Premium utilised to declare 40% dividend.

Answer

(a) **Sale of Investments without Proper Authorisation:** There should be proper authority for sale of investments. Detailed records regarding disposal of investments should be maintained along with proper documentation.

In the instant case, Mr. B had sold the investments without discussing the matter with the other committee members. This matter, therefore, needs to be addressed by the auditor as purchase and sale can only be authorised by the Committee.

The fact that Mr. B believed that the prices would fall and the company would suffer a loss if the investments are not sold is not good enough for Mr. B to act as per his discretion. A profit of ₹ 1 lakh from such sale is also not a sufficient reason to act since one cannot rule out the possibility of earning higher profits. The formation of the Committee by A Ltd, to control sale and purchase of investments is, perhaps, one of the best aspects of internal control system to eliminate the possibility of manipulation, if any, in sale and purchase of investments. The statutory auditor may however, examine whether there have been any other instances involving non-observance of internal control system and procedures. In any case, the Committee must approve the transaction and authorise the same from the view point of the statutory auditor.

(b) **Sale and Leaseback of Vehicles:** Under a lease agreement, the lessee acquires the right to use an asset for an agreed period of time in consideration for payment of rent to the lessor. The legal ownership of the asset remains with the lessor.

In the instant case, the company had sold vehicles to two leasing companies to meet its liquidity crises and took them back on lease. In the notes to the accounts it had disclosed about instalments payable to different leasing companies, but without disclosing the true nature of the transaction as covered by AS 19, “Leases”.

The transaction entered into by the company is a classic case of sale and leaseback transaction. In case of such transactions, the sale price of assets and lease rentals normally do not represent fair value since the same are negotiated as a package. In case such a transaction is an operating lease and it is clear that the rentals and the sale price are established at fair value, then in effect it is a normal sale transaction and any profit or loss is normally recognised immediately.

If the sale price is below fair value, any profit or loss is recognised immediately, except that, if the loss is compensated by future rentals at below market price, it is deferred and amortized in proportion to the rental payments over the useful life of the asset.

If the sale price is above fair value, the excess over fair value is deferred and amortized over the useful life or the asset.

Therefore, it would be important for the auditor to determine whether the amount of instalments payable is fair having regard to sale price of assets. In case the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income.

Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

Further, disclosure shall have to be made separately of such transaction in terms of AS 5.

The auditor should, therefore, suitably qualify his report since proper disclosures have not been made as per the requirement of accounting standards.

(c) **Non-provision of depreciation:** As per AS 6 on "Depreciation Accounting", 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.

Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the machinery has been imported by one entity, it means it was intended to be used for the purpose of business.

Depreciation in respect of this machinery ought to have been provided in the accounts for all the previous years. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

Further Part-II of erstwhile Schedule VI (applicable upto financial year 2010-2011) to the Companies Act required that if no provision is made for depreciation, the fact that no provision has been made and quantum of arrears of depreciation computed in accordance with Section 205(2) of the Companies Act should be disclosed. Provision of depreciation is essential to show a true and fair picture of financial statement.

Thus, the auditor should ensure compliance with all these requirements.

(d) Utilisation of Share Premium: Section 78 of the Companies Act, 1956 deals with application of premium received on issues of shares. Section 78(1) required creation of Securities Premium Account and states that the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the premium account were paid-up share capital of the company. Sec. 78(2) lays down that the securities premium account may be applied by the company:

(a) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

Thus, it is clear from the above that share premium can be utilised only for specific purposes. Further, section 205 of the Companies Act, 1956 also specifies the sources from which dividends can be paid and requires the same to be only paid out of past profits, general reserve or any other free reserve. Hence, declaration of dividends out of share premium is not proper and, consequently, the auditor shall have to qualify the audit report

Question 16

“No cost accounting records are maintained though the company is required to maintain the same”. Comment.

Answer

Non-maintenance of Cost Records: Section 209(1)(d) of the Companies Act, 1956 requires that every company shall maintain books of accounts containing particulars relating to the utilisation of material or labour or to other items of cost if such class of companies are notified by the Central Government.

As per the CARO, 2003, where maintenance of cost records has been prescribed by the Central Government, auditor of the company is specifically required to state whether such accounts and records as prescribed have been made and maintained.

Though the auditor is not required to conduct detailed audit but the auditor is expected to conduct a general review of the cost records to determine whether the prescribed accounts and records are *prima facie* complete. Therefore whether cost audit is ordered or not the auditor should report upon the non-maintenance of the cost records.

Question 17

Comment on the following:

(a) ABC Ltd. has not deposited provident fund contributions of ₹ 20 lakhs to the authorities, but accounted in the books.

(b) Asian Overseas Oil Ltd.'s oil wells were damaged in Iraqi war in November, 2009. Claim preferred with the Insurance Companies for total loss. Pending the settlement by the Insurance Companies for total loss. Pending the settlement by the Insurance Companies neither any provision nor any disclosure has been made in 2009-10 accounts.

(c) Sundry debtors of a company as a 31-3-10 include ₹ 10 lakhs from M/s Unreliable Traders, who have been declared as insolvent on 4-4-2010.

(d) Directors of Speedway Ltd. declared a final dividend of 30% for 2008-09 in their meeting held on 11-8-2009.

(e) During the year under audit, A Ltd. credited to the Profit & Loss Account, the entire profit of 5 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit

(f) In spite of the internal control weakness commented upon by the audit manager, no further tests need to be carried out, as the purchase and sales figure as a percentage of gross profit was same as in the previous year. The audit manager's comments were in regard to control over purchases and sales.

Answer

(a) Non-Deposit of Provident Fund Dues: The auditor's report under CARO, 2003 has to specifically state whether the company is regular in depositing provident fund dues with the appropriate authority and, if not, the extent of arrears of provident fund shall be indicated by the auditor. The auditor may also ascertain the period since which dues have not been paid. In this case, the failure of ABC Ltd. to deposit provident fund of ₹ 20 lakhs will be reported by the auditor in CARO, 2003 issued u/s 227(4A) of the Companies

Act, 1956. In indicating the arrears, the period to which the arrears relate should preferably be also given.

(b) Non-Provision of Losses: Part-III of erstwhile Schedule VI (applicable upto financial year 2010-2011) to the Companies Act, 1956 required that a company shall make provision for all those known liabilities, the amount of which cannot be ascertained with substantial accuracy. Under the new Schedule VI (applicable for financial year 2011-2012 and onwards), the provisions have to be disclosed as long term and short term provisions with their nature being specified. It should be noted that the term provision need to construed from AS 29 on Provisions, Contingent Liabilities and Contingent Assets, issued by ICAI. As per AS 29, provisions which can be reliably measured and are probable to result in outflow of resources embodying economic benefits should be provided for in the financial statements.

This is a case of non provision of loss in the accounts resulting in overstatement of profit in the accounts for 2009-10. The company must estimate the loss and provide the same in the accounts so as to reflect a true and fair view of the state of affairs of the company. While estimating the amount for provision, the company may take into amount the probable amount of recovery from the claim lodged by it.

In any case, a proper disclosure explaining the loss incurred and the subsequent position relating to that has also not been made by the company. Under the circumstances, the auditor shall have to issue a qualified report.

(c) Non-provision of Sundry Debtors 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. In this case, the debtors 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. 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.

(d) Declaration of Final Dividend by the Board of Directors: As per provisions of the law, the final dividend of a company shall be declared only by the shareholders based on the recommendation of Board of Directors. The Board can only propose the dividend which shall become final only after approval by shareholders at the AGM.

The Board is empowered to declare the interim dividend only. Hence in the given case, the action of Speedway Ltd.’s directors is not in accordance with the law and the auditor should have qualified his report to this effect. The auditor were also required to confirm whether the provision for the same has been made under Part II of erstwhile Schedule VI (applicable upto financial year 2010-2011) to the Companies Act, 1956. Under the new

Schedule VI (applicable from financial year 2011-2012 and onwards), the only disclosure of proposed dividend required is in Notes to Accounts.

(e) Declaration of Dividend out of Capital Profit: Profit of ₹ 5 lakhs on the sale of land is a capital profit in case it represents the excess of sale value over the original cost of the asset. The question whether such a profit can be distributed as dividend has been considered in legal cases, viz., *Lubbock v. The British Bank of South America Ltd.* And *Foster v. The New Trinidad Lake Asphalte Co. Ltd*. Based on the Court judgements, it is argued that capital profits can be distributed by a company only if certain conditions are fulfilled. However, Accounting Standard 10 on "Accounting for Fixed Assets" requires that any gain arising from disposal of fixed assets should be recognised in the profit and loss account. Moreover, section 205 of the Companies Act, 1956 does not make any distinction between capital profit and other profit. Thus, all profits which can properly be taken to the profit and loss account are 'profit' for the purposes of section 205 and are distributable. Therefore, the directors can declare dividend out of the above profit.

(f) Performing Appropriate Audit Procedures Due to Weaknesses in Internal Control System: The audit manager's observation that internal control over purchases and sales were weak after evaluating the system should be quite pertinent for the auditor.

However, the auditor's judgement that no further tests need to be carried out since purchase and sale as a percentage of gross profit were same as in the previous year cannot be accepted since the same percentage may be a coincidence.

As a matter of fact, while performing analytical procedures when no deviations are reported, it is necessary to investigate such a situation in more detailed manner to ascertain the reasons for same percentage. It is quite possible that the absolute figures might have changed in the same proportion. In fact, such a state of affairs calls for conducting further audit tests in detail since there might have been attempts by the management to manipulate figures.

Therefore, the audit team would have to rely more on test of details of transactions and balances than on drawing their conclusions on analytical procedures.

In fact, the auditor should carry out substantive tests in more detail to ensure that transactions are genuine and valid and, thus, supported by sufficient and appropriate evidence.

Question 18

Ganga-Kaveri Project Ltd. was incorporated on 1.7.2009. During the year ended 31.3.2010 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore the Chief Accountant of the company contends that for the relevant year there was no need to prepare a statement of profit or loss or any other statement except a Balance Sheet as at 31.3.2010. Comment.

Answer

Preparation of Financial Statements: As per facts of the case, Ganga-Kaveri Project Ltd. did not carry any manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery, etc. Section 210 (3) of the Companies Act, 1956 requires preparation of the profit and loss account from the period beginning with the incorporation of the company.

Though the company did not carry any manufacturing or trading activity but the company has carried on certain activities like construction of factory shed, acquisition of plant and machinery. etc. In such a case, it is necessary to provide for depreciation and other expenses.

The mere fact that there was no manufacturing or trading activity cannot be the basis for not preparing the profit and loss account. Therefore, the contention of the Chief Accountant is not correct.

Question 19

Write a short note on Disclosure requirements of bank balances of a limited company.

Answer

Disclosure Requirements for Bank Balance: As per Part I of erstwhile Schedule VI (applicable upto financial year 2010-2011) to the Companies Act, 1956, the disclosure requirements for bank balance were as under:

(i) Bank balance with scheduled bank.

(ii) Bank balance with banks other than scheduled banks.

The other particulars are to be stated are as under:

(a) Balances lying with scheduled banks in current accounts, call accounts, deposit accounts.

(b) Where the balance is with non-scheduled bank, the name of the banker, balances lying with such bankers on current accounts, call accounts and deposit accounts, the maximum amount outstanding with them during the year should be specified.

(c) the nature of the interest, if any, of any director or his relative [or the managing agent/secretaries and treasurers of any associate of the latter] in each of the bankers (other than Scheduled Banks) referred to in (*b*) above.]

Under the new Schedule VI (applicable from financial year 2011-2012 and onwards), the following disclosure requirements are mandated:

General Instructions for Current Assets under Revised Schedule VI:
• ***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.

Question 20

Z Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31st March, 2010:

	Amount ₹ in lacs
Securities Premium Account	*80*
Capital Reserve	*60*
General Reserve	*90*

The company had an accumulated loss of ₹ 40 lacs on the same date, which it has disclosed under the head "Profit and Loss Account" on the assets side of the Balance Sheet. Comment.

Answer

Debit Balance of Profit and Loss Account: Part I of erstwhile Schedule VI (applicable upto financial year 2010-2011) to the Companies Act, 1956 required that the debit balance of Profit and Loss Account shall be shown as deduction from the uncommitted reserves, if any. Hence, the accumulated loss of ₹ 40 lakhs should be deducted from the General Reserve of ₹ 90 lakhs, and the net amount of ₹ 50 lakhs should be shown as General Reserve on the Liabilities side of the Balance Sheet. Securities Premium Account and Capital Reserves are not uncommitted reserves and, thus, these shall also be shown on the liabilities side of the balance sheet under the heading of "Reserves and Surplus". In the present case, the disclosure requirements of erstwhile Schedule VI to the Act have not been followed and, accordingly, the auditor should modify his report

Requirements of New Schedule VI (applicable for the financial year 2011-2012 and onwards):

Reserves and Surplus shall be classified as:

(a) Capital Reserves;

(b) Capital Redemption Reserve;

(c) Securities Premium Reserve;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account;

(g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

A reserve specifically represented by earmarked investments shall be termed as a 'fund';

Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Question 21

Write a short note on - Capital Redemption Reserve.

Answer

Capital Redemption Reserve: As per Section 80 of the Companies Act, 1956 where preference shares are redeemed otherwise than out of a fresh issue, these shall be out of profits, otherwise available for dividends, be transferred to a reserve fund called Capital Redemption Reserve Account, an amount equal to the nominal value of the shares redeemed. The provisions of the Companies Act, 1956, relating to the reduction of share capital of a company shall apply as if the Capital Redemption Reserve account were paid up share capital of the company. The Capital Redemption Reserve Account may be applied by the company in paying up in issued share of the company to be issued to members of the company as fully paid up bonus shares. Capital Redemption Reserve should be disclosed under the head "Reserves & Surplus" on the Liabilities side of the Balance Sheet as per Part-I of Schedule VI to the Companies Act, 1956.

Question 22

M/s Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2008-09 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2007-08 was less charged by ₹ 75 lacs on account of arithmetical error on the part of Insurance Company. M/s Bonafide Ltd.

paid the said sum of ₹ 75 lacs during the accounting year 2008-09 by debiting the same to Prior Period Expenses. Comment.

Answer

Prior Period Expenses: Accounting Standard 5 defines the prior period items as income or expenses which arise in the current period as a result of errors or omission in the preparation of the financial statements of one or more prior period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts or oversight. In this case, there has been arithmetical mistake of ₹ 75 lacs in computing the amount of premium.

Though in this case there was no error or omission on the part of M/s Bonafide Ltd. and the error was on the part of the Insurance Company. But it is the management of the enterprise which is responsible for preparation of financial statements. Thus, the expenditure of ₹ 75 lacs pertains to prior period and to be debited to Prior Period Expenses. Therefore, the accounting treatment accorded by the management is appropriate. The auditor should, however, ensure that the nature of mistake, i.e., insurance premium as well as amount of ₹ 75 lacs has been disclosed separately in such a manner that its impact on the current profit or loss can be perceived.

Question 23

As an auditor, comment on the following situations/statements:

(a) The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately.

(b) The register of members of AP Ltd. has not been written up-to-date and as a result, the balances in the register do not agree with the amount of issued Share Capital.

Answer

(a) Disclosure of Surplus on Sale of Investments: AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the statement on profit and loss account. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

(b) Maintenance of Statutory Register: Register of members is a statutory book, which should be maintained by every company. The auditor should ascertain whether the company updates the register and then examine whether it is in agreement with the amount of issued capital. Because in the audit of share capital, it constitutes one of the internal documentary evidence. The auditor may also consider applying alternative audit procedures because if the company fails to update the register and the auditor fails to obtain sufficient appropriate audit evidence, the auditor may qualify his report.

Question 24

What are the special considerations in an audit of a Limited Company?

Answer

Special Consideration in and Audit of Limited Company

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 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.

Question 25

How will you vouch and/or verify Re-issue of Forfeited Shares?

Answer

Re - issue of forfeited shares

(i) The auditor should ascertain that the board of directors has the authority under the Articles of Association of the company to reissue forfeited shares. Check the relevant resolution of the Board of Directors.

(ii) Vouch the amounts collected from persons to whom the shares have been allotted and verify the entries recorded from re-allotment. Auditor should check the total amount received on the shares including received prior to forfeiture, is not less than the par value of shares.

(iii) Verify that computation of surplus amount arising on the reissue of shares credited to Capital Reserve Account and

(iv) Where partly paid shares are forfeited for non-payment of call, and re-issued as fully paid, the reissue is considered as an allotment at a discount and compliance of the provisions of Section 79 is essential.

Question 26

Board of Directors of Natraj Ltd. wants to transfer an amount of ₹ 31.50 lacs lying in unpaid dividend account to their Profit and Loss account on the plea that it is 3 years old and no shareholder is expected to turn up and claim the same. Comment.

Answer

According to Section 205A, of the Companies Act, 1956 it is compulsory for a company to transfer the amount of dividend, which remains unpaid or unclaimed within 30 days of the declaration, to a special bank A/c to be opened in any scheduled bank.

Furthermore, if the money so transferred to the unpaid dividend remains unclaimed for a period of seven years from the date of such transfer, such money should be transferred to Investor Education and Protection Fund established under Section 205C of the Act.

In the instant case, action of the company in transferring the amount after 3 years from unpaid dividend A/c to Profit & Loss Account is non-compliance of the section and may invite imprisonment and/or fine.

The auditor should advise the board of directors of Natraj Ltd., not to transfer the said amount to its Profit & Loss Account in violation of Section 205A and if the board of directors does not agree, he should qualify his report.

Question 27

Strong Ltd. holding 60% of the equity shares in Weak Ltd. purchased goods worth ₹ 50 Lakhs from Weak Ltd. during the financial year 2006-07. The Managing Director of Strong Ltd. is of the opinion that it is normal business activity and there is no need to disclose the same in the final accounts of the Company. Comment.

Answer

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 one 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. 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.

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.

In the instant case since there is related party transaction the contention of Managing Director of strong Ltd is not correct and the auditor should insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor as per SA 550 "Related Parties", should express a qualified opinion.

Question 28

Explain the Director's responsibility statement in brief.

Answer

The report of board of directors on annual accounts shall also include a 'Director's Responsibility statement' indicating therein:

(i) That applicable accounting standards have been followed while preparing annual accounts and material departure, if any, have been explained.

(ii) That the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for the period.

(iii) That the directors have taken proper care for maintenance of adequate accounting records in accordance with the provisions of the Companies Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

(iv) That the accounts have been prepared on a going concern basis.

Question 29

TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, have also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. Comment.

Answer

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.

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.

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.

Question 30

Briefly mention five important items which you would examine while verifying payment of interest out of capital during construction.

Answer

Payment of interest out of capital during construction should be verified as follows:

(i) Ascertain that payment is authorised by the articles or special resolution.

(ii) Verify that prior sanction of the Central Government has been obtained.

(iii) Verify that interest has been paid only for the period authorized by the Central Government.

(iv) Verify that rate of interest does not exceeds such rate as notified by the Central Government.

(v) Verify that interest paid has been added to the cost of assets created out of capital.

Question 31

Discuss in brief the power of Company purchases its own Securities.

Answer

Power of Company to Purchase its Own Securities:

The Companies (Amendment) Act, 1999 contains elaborate provisions enabling a company to buy-back its own securities. The work security includes both equity and preference shares. As per section 77A, a company may purchase its own shares or other specified securities ("buy-back") out of-

(i) Its free reserves; or

(ii) The securities premium account; or

(iii) The proceeds of any earlier issue other than from issue of shares made specifically for buy-back purposes.

No company shall purchase its own shares or other specified securities unless-

(a) The buy-back is authorized by its Articles;

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

(c) The buy-back is or less than twenty-five per cent, of the total paid-up capital (equity shares and preference shares) and free reserves of the company;

(d) The debt equity ratio is not more than 2:1 after such buy back.

(e) All the shares and other securities are fully paid up.

(f) Every buy back shall be completed within 12 months from the date of passing the special resolution.

(g) The company shall not make further issue of same kind of shares.

The company, after buy-back file with the Registration and SEBI, a return containing such particulars relating to buy-back within 30 days.

New Schedule VI (applicable from financial year 2011-2012 and onwards) Requirements:

Under the head "Share Capital", a company is required to disclose for the period of five years immediately preceding the date as at which the Balance Sheet is prepared, the aggregate number and class of shares bought back

Question 32

Write short note on payment of interest out of capital during construction.

Answer

Payment of Interest out of Capital during construction: As in Section 208, a company which has raised money by issue of shares to meet the cost of construction of any work or building or provision of any plant which cannot be made profitable for a long time, can pay interest on paid up capital for a period and subject to conditions specified in Sub section (2) and (7) of Section 208.

Accordingly, the payment of interest should be verified as follows:

1. Assertion that the payment is authorized by the articles or by a special resolution.
2. Previous approval of Central Government has been obtained.

3. Confirm that the interest has been paid only for such period as has been authorized by the Central Government and does not extend beyond the half year next following during which the construction was completed or the plant was provided.
4. Verify that the rate of interest shall in no case exceed such rate as the Central government may by notification in the official gazette, direct.
5. Check that the amount of interest paid has been added to the costs of assets created out of capital.

Question 33

State clearly provisions of the Companies Act, 1956 with regard to issue of shares at a discount.

Answer

***Issue of Shares at a Discount*:** According to Section 79 of the Companies Act, 1956, a company can issue shares at a discount on the following conditions:

(i) The issue should be authorised by an ordinary resolution of the company sanctioned by the Central Government.

(ii) No such issue of shares at discount can be sanctioned by the Central Government in case the maximum rate of discount should exceed 10% unless the Central Government is of the opinion that a higher rate for discount is justified by the special circumstances of the case

(iii) The issue should be made within two months of the sanction by the Central Government and not earlier than one year after the date of commencement of business.

(iv) The issue should be a class already issued by the company.

(v) It is the duty of the auditor to confirm that the conditions given above have been complied with by the company at the time the allotment was made.

Question 34

Comment on the following situations:

(a) XYZ (Pvt.) Ltd. has paid up Capital and Reserves of. ₹ 60 lacs and secured Loans of Nationalized Banks having sanctioned limit of ₹ 28 lacs and outstanding balance of ₹ 23 lacs. The turnover of the company is ₹ 5.10 crores for the year ended 31.3.2009. A customer returns goods worth 40 lacs on 2.4.2009, out of sales made during the year ended 31.3.2009. The management of CO. is of the opinion that CARO, 2003 is not applicable to the company.

(b) C Ltd. declared dividend amounting to ₹ 5 lacs out of Profits for the year ended 31.3.2009.

Subsequently, it was noticed that company had failed to make provisions for outstanding expanses of ₹ 7.80 lacs and Closing stock was also over valued, which was not reported by auditors of the company. Management of C Ltd. helds auditors responsible for this situation.

Answer

(a) Company (Auditor's Report) Order 2003 is applicable to a private limited company if all the following 3 conditions are fulfilled at any point of time -

(i) Paid up capital and reserves are more than ₹ 50.00 Lacs

(ii) Outstanding loan from bank or financial institution is more than ₹ 25.00 Lacs.

(iii) Turnover exceeds ₹ 5 Crores.

In the above case, the paid up capital and reserves are more than ₹ 50 lacs, cash credit limit exceeds ₹ 25 lac (because the Order will apply if on any day during the financial year the loan exceeds ₹ 25 lacs and not the year end balance), and the company's turnover exceeds ₹ 5 crores . Hence CARO 2003 will be applicable to the company. The contention of the management that out of sales, goods worth ₹ 40 lacs has been returned by the customer is not tenable. Sales return of next year cannot be reversed or adjusted during the previous year.

(b) **Failure to detect untrue and incorrect financial position of a company:** In the given case, profit of the company has been inflated by non provisioning of outstanding expenses and by overvaluation of closing stock by ₹ 7.80 lacs and subsequently dividend of ₹ 5 lacs has been paid. Thus it can be said that dividend has been paid out "inflated profit" and not out of "real profit". It was the duty of auditor to ascertain whether the Balance Sheet & P & L A/c of the company show a true and fair view of the financial position and revenue earning capacity. For that he has to exercise proper audit procedure of substantive test (i.e. vouching and verification) and valuation of P & L A/c & Balance Sheet items, particularly, whether provision for all outstanding expenses has been made or not, whether closing stock has been properly valued as per AS-2. If not, he should issue qualified report or adverse report. If he failed to do so, he will be held as guilty of gross negligence.

The facts of the case are similar to the established judgement on "The Leeds Estate Building & Investment Co. Ltd vs Shepherd (1887)", where, it was held, that it was an auditor's duty to ascertain that the accounts, he certifies, are correct and that if he fails in his duty, he is liable for damages for dividends wrongly paid by the company out of capital.

Question 35

As an auditor, how will you verify application and allotment money received on shares issued for cash?

Answer

Verification of application and allotment money received on Shares Issued for Cash shall be carried out as under:

On Application Verify the amount received along with the applications for shares in the following manner:

(i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;

(ii) ***Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;***

(iii) ***Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;***

(iv) ***Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.***

On Allotment

(i) ***Examine Director's Minutes Book to verify approval of allotments.***

(ii) ***Compare copies of letters of allotment with entries in the Application and Allotment Book.***

(iii) ***Trace entries in the Cash book into the Application and Allotment Book for the verification of amounts collected on allotment.***

(iv) ***Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.***

(v) ***Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.***

Question 36

How would you vouch/verify the following?

(a) Reduction in Share Capital.

(b) Receipt of Capital subsidy.

Answer

(a) Reduction in Share Capital

(i) Verify that the meeting of the shareholders was properly convened and the proposal of reduction of share capital was passed by Special Resolution and also that the proposal was circularised in advance among the members

(ii) Verify that the reduction of share capital is authorised by the Articles of Association and the procedure prescribed by the Articles has been followed.

(iii) Examine the order of the Tribunal confirming the reduction of share capital and see that a copy of the order and the minutes have been registered and filed with the Registrar of Companies.

(iv) Inspect Registrar's Certificate as regards reduction of capital.

(v) Vouch the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also seeing that the requirements of Schedule VI, Part I, have been complied with.

(vi) Confirm that revaluation of assets have been properly disclosed in Balance Sheet.

(vii) Verify the adjustment made in the member's accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.

(viii) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(ix) Verify that the Memorandum of Association of the company has been suitably altered.

(b) Receipt of Capital Subsidy

(i) Refer to office copy of application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to use of subsidy.

(iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up an industrial unit at a specified area/location.

(iv) Check the relevant entries in the books for receipt of subsidy.

(v) Ensure that compliance requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for and also compliance with the disclosure requirements.

Question 37

Write short note on the reissue of redeemed debentures.

Answer

Re-issue of redeemed debentures : A company may issue debentures previously redeemed, either by reissuing the debentures or by issuing others in their place unless the articles or a contract or resolution, recorded at a General Meeting, or terms of issue or same other act of the company expressly or impliedly manifest the intention that, on redemption, the debentures shall be cancelled. However, the re-issue of redeemed debentures or the issue of others in their place are treated as a new issue for the purpose of stamp duty and the rights and privileges attaching to the debentures that re-issued shall be the same as if the debentures had never been redeemed. On these considerations, it is necessary for the auditor to verify the re-issue of debentures in the same manner as those issued for the first time.

Question 38

How an auditor can audit allotment of debentures?

Answer

Allotment of Debentures

Following are the steps to be taken by an auditor while doing the audit of allotment of debentures :

(i) Verify that the Prospectus or the Statement in lieu of Prospectus had been duly filed with the Registrar before the date of allotment.

(ii) Check the applications for debentures with the Application and Allotment Book to verify that the name, address of the applicants and the number of debentures applied for are correctly recorded.

(iii) Verify the allotment of debentures by reference to the Directors' Minute Book.

(iv) Vouch the amounts collected as are entered in the Cash Book with the counterfoils of receipts issued to the applicants; also trace the amounts into the Application and Allotment Book.

(v) Check postings of allotments of debentures and the amounts received in respect thereof from the Application and Allotment Book, into the Debentures Register.

(vi) Verify the entries on the counterfoils of debentures issued with the Debentures Register.

(vii) Extract balances in the Debentures Register in respect of amounts paid by the debenture holders and agree their total with the balance in the Debentures Account in the General Ledger.

(viii) Examine a copy of the Debenture Trust Deed and note the conditions including creation of Debenture Redemption Reserve contained therein as to issue and repayment.

(ix) If the debentures are covered by a mortgage or charge, it should be verified that the charge has been correctly recorded in the Register of Mortgages and Charges and that it has also been registered with the Registrar of Companies. Further, that the charge is clearly disclosed in the Balance Sheet.

(x) Compliance with SEBI Guidelines should also be seen.

(xi) Where debentures have been issued as fully paid up to vendors as a part of the purchase consideration, the contract in this regard should be referred to.

Question 39

What are the duties of an auditor in case of reduction of capital?

Answer

Reduction of Capital

The duties of the auditor in this regard are following :

(i) Verify that the meeting of the shareholders was properly convened and the proposal of reduction of share capital was passed by Special Resolution and also that the proposal was circularised in advance among the members.

(ii) Verify that the reduction of share capital is authorised by the Articles of Association and the procedure prescribed by the Article has been followed.

(iii) Examine the order of the Tribunal confirming the reduction of share capital and see that a copy of the order and the minutes have been registered and filed with the Registrar of Companies.

(iv) Inspect Registrar's Certificate as regards reduction of capital.

(v) Vouch the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also seeing that the requirements of Schedule VI, Part I, have been complied with.

(vi) Confirm that revaluation of assets have been properly disclosed in Balance Sheet.

(vii) Verify the adjustment made in the member's accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.

(viii) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(ix) Verify that the Memorandum of Association of the company has been suitably altered.

Question 40

Discuss the audit procedure for verification of payment of dividends.

Answer

Verification of Dividends

The procedure for the verification of payment of dividends is stated below:

(i) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.

(ii) Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 205 of the Companies Act, 1956 and that the transfer to reserves is according to rules framed by the Central Government in this respect [vide Section 205(2A)]. It may be noted that now there exists a requirement to transfer profits to reserves upon 10 per cent of the profits of that year. However, if the rate of dividend does not exceed 10 per cent no such transfer is necessary. If the company proposes to pay the dividend out of past profits, see that either this is in accordance with the rules framed by the Central Government in this behalf or the consent of the Government has been obtained. [vide Section 205A(3)].

(iii) Inspect the shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.

(iv) If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.

(v) Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members. Test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the

number of the shares held. Verify the casts and cross cast of the different columns.

(vi) Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.

(vii) Examine the dividend warrants in respect of previous years presented during the year for payment and verify that by their payment any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.

(viii) According to section 205A, as it is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within thirty days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account of .Company Limited/Company (Pvt.) Limited". Such an account is to be opened only in a scheduled bank. The transfer must be made within 7 days from the date of expiry of thirty days.

The expression "dividend which remains unpaid" means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

(ix) In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred to Investor Education and Protection Fund established under section 205C of the Act.

EXERCISES

1 *As an auditor how you would react to the following situations?*

(a) Calls in Arrears included an amount of ₹ 20,000 due from Directors of the company. The Articles of Association provided for charging interest on calls in arrears. The company did not provide interest on the amount due from Directors.

(b) One of the manufacturing unit of B Ltd. equal to 40% of the total assets was destroyed in a fire for which there was no insurance cover. The chief accountant of the company contends that the destruction of the unit took place only after the date of the Balance Sheet and therefore there was no need to make disclosure of loss in the annual accounts as at the Balance Sheet date

(c) A public limited company has issued Debentures which are guaranteed by the Government of India both as to the repayment of the principal and interest but not secured by any charge on the assets of the company and disclosed the same as 'Secured Loans' in the Balance sheet.

2 *You client has sought your opinion to correctly account for and/or disclose the following matters. State your views with reasons for the same:*

(a) The amount payable to suppliers of machinery under deferred payment arrangement has been shown as current liabilities. The company accepted the bills drawn by the supplier and offered its other fixed assets as a collateral security.

(b) The debit balance in the profit and loss account is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet.

(c) Sundry debtors include charges made for returnable packing cases.

(d) The value of land and building was not separately disclosed. Also a major repair of the roof amounting to ₹ 1, 00,000 was carried out during the year/, without which the building would have become unusable.

(e) Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under Sundry Creditors.

3 Explain the points to be considered while vouching Shares issued at a discount.

9

Special Audits

BASIC CONCEPTS

Special Audits

The following are the major points that must be kept in mind while performing the audit:

1. Constitution of the organisation
   a Examine the constitution of the organisation.
   b. Examine the bye laws or rules and regulations or trust deed.
   c. Examine the powers of the members of the management and other officers.
   d. Examine the minute books of managing committee and of members general meeting as the case may be.
2. Evaluate the internal Control System in the organisation.
3. Examine the accounting policies followed and the accounting records maintained.
4. Check the various receipts of the organisation in the form of fees, rent, income on investment, donations and grants.
5. Check the various expenditure of the organisation like to staff, common expenses.
6. Verification of assets and liabilities.

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 authorised 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.

(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, authorising such expenditure.

(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.

(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, or in 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.

(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 organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Role of C&AG in the Audit of a Government company: The auditor of a government company is appointed by the C&AG. The C&AG have powers under section 619(3) of the Companies Act, 1956 as follows:

(i) to direct the manner in which the company's accounts shall be audited by the auditor and to give such auditor instructions in regard to any matter relating to the performance of his functions as such;

(ii) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf; and for the purposes of such audit, to require information or additional information to be furnished to person or persons so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may, by general or special order; direct.

In addition, the C&AG have a right to comment upon or supplement the audit report in such manner as he thinks fit.

Question 1

Mention the special steps involved in the audit of an Educational Institution.

Answer

The special steps involved in the audit of an educational institution are the following:

(i) Examine the Trust Deed or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Stock Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

Question 2

Write a short note on- Performance Audit.

Answer

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.

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.

Question 3

Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only ₹ 500 per month from a student for his lodging/boarding.

Answer

1. General
   - (i) Study the constitution under which the charitable institution has been set up whether under the Society Registration Act, as a trust or as a company limited by guarantee. Verify whether it is managed as contemplated by the law and rules and regulations made thereunder.
   - (ii) Examine the internal control structure particularly with reference to admission to hostel, expenses incurred on different kinds of activities.
   - (iii) Verify the broad nature of expenses likely to be incurred with reference to the previous year's annual audited accounts.
2. Verification of the receipts
   - (i) Check the amounts received on account of, monthly rentals, etc., and receipts issued for the same.
   - (ii) Ascertain that there is adequate internal control over the issue of official receipts, custody of unused receipt books, printing of receipt books, etc.
   - (iii) Cross - tally the rent received along with the number of students (from the student register) staying in the hostel during the year.
   - (v) Check the amounts received from additional services rendered like guest fees, receipts for breakage, fines, penalties, etc
3. Verification of expenses
   - (i) Check the day-to-day administration expenses incurred along with the necessary vouchers, supporting for the same like salary registers, repairs register, etc.;

(ii) Verify whether the expenses incurred are in conformity with the budgets prepared internally or filed with the relevant authorities.

(iii) Check the amount spent on provisions of hostel facilities with reference to bills, etc.

(iv) See that whenever heavy expenditure has been incurred on renovation of the hostel, computer centre, etc. the same is accounted for properly.(if such facilities are being provided by the hostel)

4. Verify investments made from surplus funds as well as existing investments by physically verifying the same and that they are in the name of the institution and that there is no charge/pledge against the same.

5. Verify all capital expenditure and expenditure on repairs, etc., incurred with the vouchers and also whether proper tenders, etc., were invited for the same. See that all furniture, glass, cutlery, kitchen utensils, liner, etc. are adequately depreciated.

6. *Library Facilities*: See that proper library register are maintained. The system regarding issue and receipt of books is in order. Late fee fines and money received on account of lost book is accounted for properly. Obsolete books are written off only after proper authorisation. Expenses incurred on newspapers and weekly magazines as compared to Journals and periodicals have been accounted for properly.

7. Check the provision of other additional facilities like computer facilities, etc. Ensure that proper registers are maintained for charging fees, based on monthly or hourly basis. In case such facility is extended to each room, whether the charges are payable on lump-sum basis or on actual usage basis. Also ensure that amounts spent have been allocated properly.

8. Verify whether the institution is eligible for income tax exemption and if not, whether provision for taxation has been made.

Question 4

Mention the special points in the case of an audit of the entity from Incomplete Records.

Answer

The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor.

An auditor may face the situation of incomplete records under the following circumstances:

(i) Where records are kept on single entry basis; or

(ii) Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditor's examination due to similar reasons.

Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete, but may still contain useful information for the auditor.

On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system.

In any case, the following steps would be required to conduct an audit:

(i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained.

(ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.

(iii) Check that all entries on the payment side of cash book are posted in the ledger.

(iv) Confirming that all entries appearing in bank account are posted in the ledger.

(v) Analyse personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonored, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtor's accounts.

Similarly, it would be necessary to analyse the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonored, etc., to relevant accounts.

From an auditor's view point, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures.

Question 5

(a) An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:

(i) Audit against Rules and Orders

(ii) Audit of Sanctions

(iii) Audit against Provision of Funds

(iv) Propriety Audit

(v) Performance Audit

(b) What role is played by Comptroller and Auditor General of India in the audit of a Government company?

Answer

(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 authorised 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.

(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, authorising such expenditure.

(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.

(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, or in 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.

(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 organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

(b) Role of C&AG in the Audit of a Government company: The auditor of a government company is appointed by the C&AG. The C&AG have powers under section 619(3) of the Companies Act, 1956 as follows:

(i) to direct the manner in which the company's accounts shall be audited by the auditor and to give such auditor instructions in regard to any matter relating to the performance of his functions as such;

(ii) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf; and for the purposes of such audit, to require information or additional information to be furnished to person or persons so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may, by general or special order; direct.

In addition, the C&AG have a right to comment upon or supplement the audit report in such manner as he thinks fit.

Question 6

Draft an Audit Programme to audit the accounts of a Recreation Club with facilities for indoor games and in-house eating.

Answer

(i) Examine the constitution, powers of governing body and relevant rules relating to preparation and finalisation of accounts. In case, it is constituted as a company limited by guarantee, application of provisions of the Companies Act, 1956 should also be seen.

(ii) Vouch the receipt on account of entrance fees with members applications, counterfoils issued to them, and minutes of the Managing Committee.

(iii) Vouch Members' subscription with the counterfoils of receipts issued to them. Trace receipts for a selected period to the Register of members; reconcile the amount of total subscription due with the amount collected and the outstanding. Check totals of various columns of the Register of Members and tally them across. See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery. The amount considered irrecoverable, if any should be written off.

(iv) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscription received in advance have been correctly adjusted.

(v) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests as well as with the fees chargeable for the special service rendered such as billiards, tennis, etc. Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

(vi) Vouch purchase of sports items, furniture, crockery, etc., and trace their entries into the respective stock registers. Vouch purchases of food-stuffs, cigars, wines, etc. and test their sale price so as to confirm that the normal rates of profit have been earned on their sales.

The stock of unsold provisions and stores, at the end of the year should be verified physically and its valuation checked.

(vii) Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.

(viii) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts, also ascertain that the arrangements for their safe custody are satisfactory, check the accrual of income therefrom and provision of income tax thereon. .

Question 7

Explain the audit procedure for conducting the audit of a Non-Governmental Organisation (NGO).

Answer

Audit Procedure for Conducting the Audit of Non-Governmental Organisation : NGO's can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives. Non-Governmental Organisations are generally incorporated as societies under the Societies Registration, Act, 1860 or as a trust under the India Trust Act, 1882, or under any other law corresponding to these Acts enforced in any part of India. NGO's can also be incorporated as a company under section 25 of the Companies Act, 1956. While planning the audit of a Non-Governmental Organisation (NGO), the auditor may concentrate on the following;

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.

(ii) Reviewing the legal form of the organisation and its Memorandum of Association, Articles of Association, rules and Regulations.

(iii) Reviewing the NGO's Organisation chart, Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and Formats, budgetary policies, if any.

(iv) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(v) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material is omitted:

(i) *Corpus fund: The* contributions/grants received towards corpus are vouched with reference to the letters from the donor(s). The interest income is checked with investment Register and physical investments in hand.

(ii) *Reserves:* Vouch transfers from projects/programmes with donor's letters and board resolutions of NGO. Also check transfers and adjustments made during the year.

(iii) *Ear-marked Funds:* Check requirements of donors' institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

(iv) *Project/Agency Balances:* Vouch disbursements and expenditures as per agreements with donors for each of the balances.

(v) *Loans:* Vouch loans with loan agreements receipt counter –foil issued.

(vi) *Fixed Assets:* Vouch all acquisitions/sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/agreements for the grants. For immovable property, check title, etc.

(vii) *Investments:* Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis-investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) *Cash in Hand:* Physically verify the cash in hand and imprest balance, at the close of the year and whether it tallies with the books of accounts.

(ix) *Bank Balance:* Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(x) *Stock in Hand:* Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) *Programme and Project Expenses :* Verify agreement with donor/contributor (s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) *Establishment Expenses:* Verify that provident fund, life insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(i) *Contribution and Grants for projects and programmes:* Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) *Receipts from Fund arising programmes:* Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) *Membership Fees:* Check fees received with membership register; ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) *Subscription:* Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/circulars/periodicals. Check the receipts with subscription rate schedule.

(v) *Interest and Dividends:* Check the interest and dividends received and receivable with investments held during the year.

Question 8

Explain in detail the duties of Comptroller and Auditor General of India.

Answer

Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under:

(i) *Compile and submit Accounts of Union and States* - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) General Provisions Relating to Audit - It shall be the duty of the C&AG –

  (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

  (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

  (c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) *Audit of Receipts and Expenditure* - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) *Audit of Grants or Loans* - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) *Audit of Receipts of Union or States* - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) *Audit of Accounts of Stores and Stock* - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and stock kept in any office or department of the Union or of a State.

(vii) *Audit of Government Companies and Corporations* - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 1956.

Question 9

Mention any eight special points which you as an auditor would look into while auditing the books of a partnership firm.

Answer

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:

(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.

Question 10

Describe the salient features of Financial Administration of Local Bodies.

Answer

Salient Features of Financial Administration of Local Bodies

(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.

Question 11

What are the special steps involved in conducting the audit of an Educational Institution?

Answer

The special steps involved in the audit of an educational institution are the following:

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Stock Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

Question 12

With reference to Government Audit, what do you understand by "Audit of Commercial Accounts"?

Answer

Audit of Commercial Accounts: The government also engages in commercial activities and for the purpose it may incorporate following types of entities:

(i) Departmental enterprises engaged in commercial and trading operations, which are governed by the same regulations as other Government departments such as defence factories, mints, etc.

(ii) Statutory corporations created by specific statues such as LIC, Air India, etc.

(iii) Government companies, set up under the Companies Act, 1956.

All aforesaid entities are required to maintain accounts on commercial basis. The audit of departmental entities is done in the same manner as any Government department, where commercial accounts are kept. Audit of statutory corporations depends on the nature of the statute governing the corporation. In respect of government companies, the relevant provisions of Companies Act, 1956 are applicable. As per section 619 of the Companies Act, 1956 the statutory auditor of a Government company shall be appointed or re-appointed by the CAG. Such an auditor must be a chartered accountant. Further, the Companies Act, 1956, provides that the CAG shall have the powers:

(i) to direct the manner in which the company's accounts shall be audited by the auditor, and to give the auditor instructions in regard to any matter relating to the performance of his functions; and

(ii) to conduct a supplementary or test audit of the company's accounts by such person, as he may authorise in this behalf, and for the purposes of such audit to require information or additional information to be furnished to any person or persons, so authorised on such matters by such person or persons, and in such form as the CAG may direct.

The statutory auditor shall submit a copy of his audit report to the CAG, who shall have the right to comment upon or supplement the audit report in such manner he may think fit.

Any such comments upon or supplement to the audit report shall be placed before the company, at the same time, and in the same manner, as the audit report. Thus, it is seen that there is a two layer audit of a Government company, by the statutory auditors, being qualified chartered accountants, and by the CAG. The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

Question13

What special steps will you take into consideration in auditing the accounts of a hotel?

Answer

The business of running a hotel is very much dissimilar to running an industrial unit for manufacturing of products. It is a service-oriented industry. The business is characterized by handling of large amounts of liquid cash, stock of foods providing a variety of services, and keeping watch on customers to ensure that they do not leave hotel without settling the dues. In view of these, the following matters require special attention by the auditor.

(i) *Internal Control:* Pilferage is one of the greatest problems in any hotel and it is extremely important to have a proper internal control to minimize the leakage. The following points should be checked:

(a) Effectiveness of arrangement regarding receipts and disbursements of cash.

(b) Procedure for purchase and stocking of various commodities and provisions.

(c) Procedure regarding billing of the customers in respect of room service, telephone, laundry, etc.

(d) System regarding recording and physical custody of edibles, wines, cigarettes, crockery and cutlery, linen, furniture, carpets, etc.

(e) Ensure that are trading accounts are prepared preferably weekly, for each sales point. A scrutiny of the percentage of profit should be made, and any deviation from the norms is to be investigated.

(ii) *Room Sales and Cash Collections*

(a) There are various sales points scattered in a hotel and sales are both for cash and credit. The control over cash is very important. The charge for room sales is made from the guest register, and tests are to be carried out to ensure that the correct numbers of guests are charged for the exact period of stay. Any difference between the rate charged to the guests and standard room rent is to be investigated to see that it is properly authorized.

(b) The total sales reported with the total bills issued at each sales point have to be reconciled.

(c) Special care must be taken in respect of bills issued to customers who are staying in the hotel, because they may not be required to pay the bills immediately in cash but at a future date or by credit cards. Billing is to be done room-wise. It must be ensured that all customers pay their bills on leaving the hotel or within specified dates.

(iii) *Stock:* the stocks in a hotel are all saleable item like food and beverages. Therefore, following may be noted in this regard:

(a) All movement and transfer of stocks must be properly documented.

(b) Areas where stocks are kept must be kept locked and the key retained by the departmental manager.

(c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(d) Many hotels use specialized professional valuers to count and value the stocks on a continuous basis throughout the year.

(e) The auditor should ensure that all stocks are valued at the year end and that he should himself be present at the year end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories

(iv) *Fixed Assets:* The fixed assets should be properly depreciated, and the Fixed Assets Register should be updated.

(v) *Casual Labour*: In case the hotel employs a casual labour, the auditor should consider, whether adequate records have been maintained in this respect and there is no manipulation taking place. The wages payment of the casual labour must also be checked thoroughly.

(vi) The compliance with all statutory provisions, and compliance with the Foreign Exchange Regulations must also be verified by the auditor, especially because hotels offer facility of conversion of foreign exchange to rupees.

(vii) Other special aspects are to be verified as under

(a) Consumption shown in various physical stock accounts must be traced to the customers' bills to ensure that all issues to the customers have been billed.

(b) All payments to the foreign collaborator, it any, are to be checked.

(c) Expenses and receipts are to be compared with figures of the previous year, having regard to the average occupancy of visitors and changes in rates.

(d) Special receipts on account of letting out of auditorium, banquet hall, spaces for shops, boutiques, and special shows should be verified with the arrangements made.

(e) In depth check should be carried out on the customers' ledgers to verify that all charges have been properly made and recovered.

(f) The occupancy rate should be worked out, and compared with other similar hotels, and with previous year. Material deviations should be investigated.

(g) Expenses for painting, decoration, renovation of building, etc. are to be properly checked.

(h) It is common that hotels get their bookings done through travel agents. The auditor should ensure that the money is recovered from the travel agents as per credit terms allowed. Commission paid to travel agents should be checked by reference to the agreement on that behalf.

(i) Apart from control over stock of edibles, control over issue and physical stock of linen crockery, cutlery, glassware, silver, toilet items, etc. should be verified.

(j) The auditor should verify the restaurant bills with reference to KOT (Kitchen order Ticket).

(k) The auditor should ensure that all taxes have been included in the client's bills.

(l) Computation and payment of salaries and wages vis-a-vis number of employees must be checked.

Question14

(a) An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

(b) What special steps will you take into consideration in auditing the receipts from entry fees of an amusement part? Mention any four point's specific to the issue.

Answer

(a) Receipt of Donations

(1) *Internal Control System*: Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(2) *Custody of Receipt Books*: Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

(3) *Receipt of Cheques*: Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(4) *Bank Reconciliation*: Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(5) *Cash Receipts*: Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-

checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(6) Foreign Contributions, if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of donations to different NGOs

(1) *Mode of Sending Remittance*: All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

(2) *Confirming Receipt of Remittance*: All remittances are supported by receipts and acknowledgements.

(3) *Identity:* Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(4) *Direct Confirmation Procedure:* Send confirmation letters to entities to whom donations have been paid.

(5) *Donation Utilisation*: Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(6) *System of NGOs' Selection*: System for selecting NGO to whom donations have been sent.

(b) Audit of receipts from Entry Fees of an Amusement Park

(1) Evaluate the internal control system regarding entry and collection for entry tickets including rotation of staff.

(2) Ensure that tickets are pre numbered.

(3) Ensure that the deposit of cash collected into the bank account very same next day.

(4) Compute analytical ratios in respect of the receipts pattern i.e. on week ends, holidays, etc. and make comparisons to draw conclusions.

Question 15

How the audit is advantageous to Sole Trader?

Answer

Advantages of Audit to a Sole Trader: Although sole traders are not required by any law (except u/s 44AD, 44AE, 44AB and other provisions of the Income-tax Act, 1961) to have their accounts audited, yet it has become customary for many of them who derive their large incomes from numerous sources and whose expenditure is vast and varied to get their accounts audited. Also, sole traders, get their financial statements audited due to regulatory requirements, such as stock brokers or on a specific instructions of the bank for approval of loans, etc. The sole trader can determine the scope of the audit as well as the conditions under which it will be carried out. For example, he can stipulate that only a partial audit shall be carried out or certain parts of the accounts shall not be checked. It will also be decided that the audit will be carried out continuously or at the end of the year. Thus, the duties and the nature of auditor's work will depend upon the agreement that he has entered into with the sole trader. But he must obtain clear instructions from his clients in writing as to what he is expected to do. The following are some of the advantages that can be derived from an audit of this nature:

(i) The individual is assured of having his accounts properly maintained and his expenditure vouched.

(ii) He is also assured of not being defrauded by the accountant and his agents. Even if they have done some defalcations, etc.; these may be discovered by the auditors.

(iii) The audited accounts are reliable and are generally accepted by the Income-tax Department and hence, individuals do not feel any difficulty for taxation assessments, etc.

(iv) The audited accounts of a deceased are very helpful for executors and administrators.

Question 16

What special steps are involved in audit of a Cinema Hall?

Answer

Special steps involved in audit of a Cinema Hall

(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) stock 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 at appropriate rates which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

Question 17

What are the focus points in doing propriety audits by C&A G as regards government expenditure?

Answer

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.

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.

Question 18

Mention any ten special points to be examined by you in the audit of Income and Expenditure of a Charitable institution running a hospital.

Answer

While auditing the Income and Expenditure Account of a charitable institution running a hospital, following special points may be examined:

(i) Verify the register of patients with duplicate copy of bills and patients admission record to see that bills have been properly and correctly prepared for all the services, tests and treatments.

(ii) Check cash collections from patients by tracing the receipt issued into cash book.

(iii) Check receipt of interest, rent, dividend etc., with receipt counterfoil into cash book and bank book and ensure that all such income has been duly accounted for.

(iv) Check collection of subscription, donations from the receipt issued, correspondence etc., into cash book.

(v) Verify that all grants from government and other bodies have been duly accounted for and have been applied in the manner as specified.

(vi) Verify all recurring nature of revenue expenditure, with necessary evidence like bill, authority, period etc.

(vii) Examine the internal check as regards the receipt and issue of stores, medicines, linen etc., to ensure that these have been properly recorded and issued/consumed only on proper authorisation.

(viii) See that depreciation has been written off in respect of all the assets at appropriate rate and method as in the earlier year.

(ix) Verify the receipts from supply of food and canteen receipts and compare the same with previous year as regards number of patients.

(x) Ensure that all outstanding liabilities have been adequately provided for and similarly all accrued incomes and receipts have been duly accounted for.

(xi) Obtain inventory of stock and stores as at the end of the year and physically check a percentage of items.

Question 19

Write short notes on Audit against Rules and Orders.

Answer

Audit against Rules and Orders: Audit against rules and order aims to ensure that expenditure conforms to relevant laws, rules, regulations and orders. It is the function of audit to carry out examination of the various rules, orders and regulations to see that:

(i) They are not inconsistent with any provisions of the constitution or any law made thereunder.

(ii) They are consistent with the essential requirements of audit and accounts as determined by C&AG.

(iii) They do not come in conflict with the orders of, or rule made by, any higher authority.

(iv) In case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Question 20

Draft an audit programme for conducting audit of accounts of a Local Body.

Answer

(a) Audit of local bodies

(i) The Local Fund Audit Wing of the State Govt. is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure authenticity of his appointment.

(ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; upon whether value is being fully received on money *spent.* His objective should be to detect errors and fraud and misuse of resources.

(iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Question 21

You are approached by a partnership firm to list out the advantages that will accrue to them, if the accounts are audited. State five important advantages.

Answer

Advantages of audit of accounts of a partnership firm: Advantages are as follows (any five):

(i) Audited accounts provide a convenient and reliable means of settling accounts between the partners and thereby possibility of dispute among them is mitigated.

(ii) On the retirement/death of a partner, audited accounts constitutes a reliable evidence for computing the amount due to the retiring partner or representative of deceased partner.

(iii) Audited accounts are generally accepted by the Income tax authorities for computing the assessable income.

(iv) Audited accounts are relied upon by banks for advancing loan.

(v) Audited accounts can be helpful in the negotiation for sale or admission of a new partner.

(vi) It is an effective safeguard against any undue advantage being taken by a working partner as against the non working partners.

Question 22

State any five special points which you, as an auditor, would look into while examining the income and collection of fund by an NGO engaged in providing relief work for flood victims.

Answer

Five special points to be looked into are:-

(i) Grant donations and contributions received from various Government, other NGO, industry and public should be checked with reference to the grant letter, bank statements and ensured that they are properly accounted and banked.

(ii) Foreign contribution received should be checked with reference to the correspondence receipt issued, bank statement, conversion into local currency. It should be ensured that all such contributions are as per RBI guidelines and be kept in separate bank account.

(iii) In the case of any fund raising cultural or sports program, verify the internal control system, mode of receipt and the authority accountable. Ensure that all collections are duly receipted and deposited in the bank promptly.

(iv) Check the fee received from members with the register of members.

(v) Check interest and dividend received from investments with investment held.

Question 23

Write short notes on Power of CAG Under Section 619(3) in relation to audit of Government Company.

Answer

Power of CAG under section 619 (3) : In the case of audit of government company the Comptroller and Auditor General of India have the following powers under section 619 (3) of the Companies Act, 1956.

(i) To direct the manner in which the company's account shall be audited by the auditor and to give such instructions in regard to any matter relating to the performance of his function as auditor.

(ii) To conduct a supplementary or test audit of the company's account by such person or persons as he may authorize in this behalf; and for the purpose of such audit, to require information or additional information to be furnished to person or persons so authorized, on such matters, by such person or persons and in such form, as the CAG may be general or special order, direct.

Question 24

What steps would you take in to consideration in Auditing the receipts from patients of a Hospital?

Answer

1. Examine the internal check system as regards the receipts of bills from the patients.
2. Vouch the register of patients with copy of bills issued to them.
3. Verify bills for a selected period with the patient's attendance record to see that the bills have been correctly repaired.
4. See that bills have been issued to all the patients according to the rules of the hospital.
5. Check cash collections as entered in the cash book with the receipts, counterfoils and other evidence.
6. Compare the total income with the amount budgeted for the same and report to the management for significant variations which have been taken place.

Question 25

Powers of C & AG in connection with the performance of his duties.

Answer

Powers of Comptroller and Auditor General in connection with the performance of his duties:

(i) To inspect any an office of accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.

(ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(iii) To put such questions or make such observations as he may consider necessary to the person in-charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine.

Question 26

What are the special audit points to be considered by the auditor during the audit of a Hospital?

Answer

(a) Audit of Hospital: The audit points to be considered by the auditor during the audit of a Hospital are stated below:-

(i) Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(iii) See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(iv) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) ***Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).***

(vi) ***Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.***

(vii) ***Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.***

(viii) ***Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.***

(ix) ***Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.***

(x) ***See that depreciation has been written off against all the assets at the appropriate rates.***

(xi) ***Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.***

(xii) ***Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.***

EXERCISES

1 *Mention the special points to be examined by the auditor in the audit of a Charitable Institution running a dispensary in a small village which charges ₹ 1 per patient per visit irrespective of the disease.*

2 *What considerations are to be kept in mind while conducting audit of the leasing transactions of a Leasing Company?*

3 *As an auditor, how will you react to an expenditure incurred by a government department which was sanctioned by a fellow officer of the competent authority as the concerned officer was on leave. State your views, if you were entrusted to carry out an audit of receipt of the said assessing department.*

4 *Discuss the provision of the Constitution of India to safeguard the independence of the Comptroller and auditor General of India.*