INTERMEDIATE (IPC) COURSE

PRACTICE MANUAL

PAPER : 6

AUDITING AND ASSURANCE

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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A WORD ABOUT PRACTICE MANUAL

Auditing is, perhaps, one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit engagements. A good knowledge of the subject would provide a strong foundation to students while pursuing the Chartered Accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoying experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting and corporate laws in a meaningful manner. Such learning would only help a student to become a better professional.

Bringing out a series of subject-wise Practice Manuals is one of the quality services provided by the Institute. These Practice Manuals are highly useful to the students preparing for the examinations, since they are able to get answers for all important questions relating to a subject at one place and that too, grouped chapter-wise. It covers a wide range of practical questions and questions based on practical application of Standards on Auditing, Guidance Notes, Accounting Standards, relevant provisions of the Companies Act, 2013, CARO 2016, etc. The students are expected to cover the entire syllabus and also do the practice on their own while going through the Practice Manual.

This Practice Manual aims to provide guidance as to the manner of writing an answer in the examination and is divided into nine chapters. Care has been taken to present the chapters in the same sequence as prescribed in the syllabus to facilitate easy understanding by the students. Main features of Practice Manual 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.

The Practice Manual will serve as a useful and handy reference guide while preparing for the Examination. Further, it will enhance the understanding about the pattern of questions set and the manner of answering such questions. It will enable solving the problems in the best possible manner and guide the students to improve their performance in the examinations. It will also help them to work upon their grey areas and plan a strategy to tackle theoretical as well as practical problems.

The Practice Manual has been revised in view of latest Engagement and Quality Control Standards, Notified Sections along with its relevant Rules, significant Notification/Circulars issued by MCA inclusive of the Companies Act, 2013 and Schedules thereto, CARO 2016, etc. The changes have been inserted in the bold and italics for convenience of the students.

It is important to note that till the time Engagement and Quality Control Standards, Guidance Notes, etc. bare documents get updated from Auditing and Assurance Standard Board and other Competent Authority in pursuance of the Companies Act, 2013, students are required to understand the basic nature of the provision and quote the same along with the new corresponding provisions.

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
		May 2011		Nov. 2011		May 2012		Nov.2012		May 2013		Nov. 2013		May 2014		Nov. 2014		May 2015		Nov. 2015			
Chapter No.	Chapter Name	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M	Q	M		
Chapter-1	Nature of Auditing	4(b)	**8**	6(a) 6(b)	**6** **5**	1(a) 6(b)	**5** **8**	4(b)	**8**	3(b)	**8**	1(b)	**5**	1(a) 2(v)	**5** **2**	2(b) 7(b)	**2** **4**	1(a) 1(c) 2(viii) 6(b)	**5** **5** **2** **6**	1(d) 2(vii) 6(c)	**5** **2** **4**	**95**	**9.5**
Chapter-2	Basic Concepts in Auditing	2(a) 2(b)	**6** **10**	7(b)	**4**	4(a)	**8**	2(a) 2(b)	**6** **10**	1(b)(ii) 2(vi) 7(v)	**5** **2** **4**	1(a) 2(g) (h)	**5,** **2** **2**	2(ii)	**2**	7(c)	**4**	2(v) 5(c) 7(a) 7(b)	**2** **4** **4** **4**	4(a) 4(b)	**6** **6**	**96**	**9.6**
Chapter-3	Preparation for an Audit	6(a)	**8**	1(a) 7(a) 7(e)	**5** **4** **4**	7(b) 7(c) 7(d) 7(e)	**4** **4** **4** **4**	6(a)	**8**	1(b)(i) 3(a) 7(i)	**5** **8** **4**	2(c) (f) 7(b) (c)	**2,** **2,** **4,** **4**	2(vi) 5(a)	**2** **8**	1(c) 2(vi), (ix), (x) 4(a) 7(d)	**5** **2** **2** **2** **6** **4**	2(vii) 7(c) 7(d)	**2** **4** **4**	2(ii) 5(c) 6(a) 6(d) 7(e)	**2** **4** **4** **4** **4**	**133**	**13.3**
Chapter-4	Internal Control	7(c) 7(d)	**4** **4**	2(a) 4(a)	**8** **8**	2(a)	**8**	7(c) 7(d)	**4** **4**	2(iv) 4(a) 7(iii) (iv)	**2** **4** **4** **4**	2(b) 3(a)	**2** **8**	2(vii) 7(c), (d)	**2** **4** **4**			2(iv) 2(vi) 5(b)	**2** **2** **6**	6(b)	**4**	**88**	**8.8**
Chapter-5	Vouching	6(b) 7(a) 7(e)	**8** **4** **4**	1(b)	**5**	3(a)	**6**	6(b) 7(a) 7(e)	**8** **4** **4**	2(i) 4(b) (i)	**2** **4**	4(a) (c) (d)	**12**	1(b) 2(iii) 2(ix) 3(a), (c), (d)	**5** **2** **2** **4** **4** **4**	3(c), (d) 6(c)	**4** **4** **4**	3(a) 3(b) 3(d)	**4** **4** **4**	3(a) 3(b) 3(c) 5(b) 7(a) 7(b)	**4** **4** **4** **6** **4** **4**	**136**	**13.6**

														7(a)	**4**								
Chapter-6	Verification of Assets and Liabilities	1(c)	**5**	1(d) 6(c) 7(c) 7 (d)	**5** **5** **4,** **4**	1(c) 4(b) 7(a)	**5** **8** **4**	1(c)	**5**	4(b) (ii)(iii) 7(ii)	**4** **4** **4**	4(b)	**4**	3(b) 6(a)	**4** **8**	1(b) 2(iii) 3(a), (b) 6(b)	**5** **2** **4** **4** **4**	3(c)	**4**	3(d) 4(c)	**4** **4**	**104**	**10.4**
Chapter-7	The Company Audit - I	1(b) 1(d) 3(b) 7(b)	**5** **5** **6** **4**	1(c) 7(b)	**5** **8**	1(d) 3(b) 3(c) 6(a)	**5** **6** **4** **8**	1(b) 1(d) 3(b) 7(b)	**5** **5** **6** **4**	2(ii), (v), (vii) (ix) 5(a), (b)	**2x4=** **8** **8** **4**	2(a), (d), (e) (j), 5(a) (b)	**2** **2** **2** **2** **5** **6**	1(d) 2(i), (iv), (x) 7(e)	**5** **2** **2** **2** **4**	1(a) 2(i), (iv), (vii), (viii) 4(b) 7(e)	**5** **2** **2** **2** **2** **6** **4**	1(b) 2(ii) 2(iii) 2(ix) 2(x) 4(c) 7(e)	**5** **2** **2** **2** **2** **4** **4**	2(i) 2(iii) 2(iv) 2(v) 2(vi) 2(viii) 2(ix) 2(x) 5(a) 7(c)	**2** **2** **2** **2** **2** **2** **2** **2** **6** **4**	**200**	**20**
Chapter-8	The Company Audit - II	1(a) 5(b)	**5** **8**	2(b) 3(b)	**8** **5**	1(b) 2(b)	**5** **8**	1(a) 5(b)	**5** **8**	5(c)	**4**	5(c) 7(e)	**5** **4**	1(c) 2(viii) 7(b)	**5** **2** **4**	4(c)	**4**					**80**	**8**
Chapter-9	Special Audits	3(a) 5(a)	**10** **8**			5(a)	**8**	3(a) 5(a)	**10** **8**	6(a) 6(b)	**8** **8**	6(a) 6(b) 7(a)	**8** **8** **4**	5(b) 6(b)	**8** **8**	6(a) 7(a)	**8** **4**	2(i) 6(a) 6(c)	**2** **6** **4**			**120**	**12**
	Standards on Auditing and Guidance Notes & Accounting Standards	4(a)	**8**	3(a) 5(a) 5(b)	**8** **8** **8**	5(b)	**8**	4(a)	**8**	1(a) 2(iii) (viii) (x)	**10** **2,** **2,** **2**	1 (c) (d) 2(i), 3(b) 7(d)	**5** **5** **2** **8** **4**	4(a), (b), (c)	**5** **5** **6**	1(d) 2(v) 5(a), (b)	**5** **2** **8** **8**	1(d) 4(a) 4(b) 5(a)	**5** **6** **6** **6**	1(a) 1(b) 1(c) 7(d)	**5** **5** **5** **4**	**169**	**16.9**

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

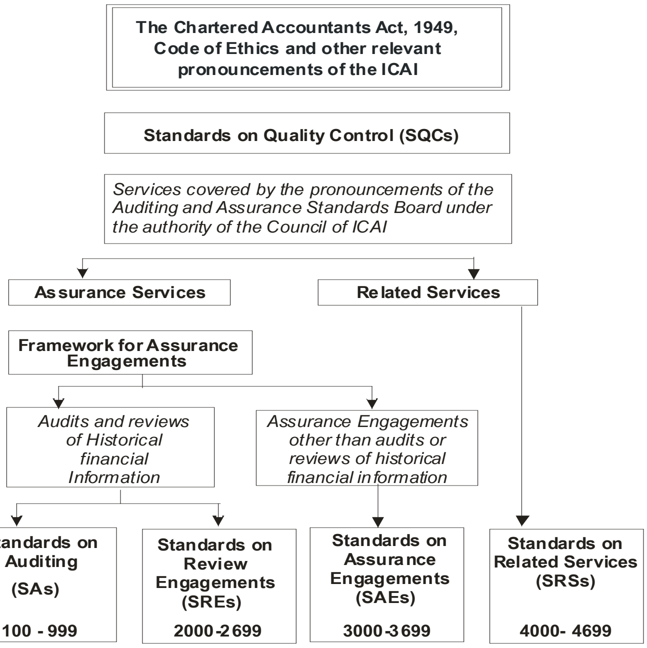
1 Nature of Auditing

BASIC CONCEPTS	
Definition	"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 Statement of Profit and Loss 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 Statement of 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. (***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 read with SA 200(Revised) and SA 220. But in general abovementioned principles are basic principles only.)
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) Detection of Fraud after Completion of Statutory Audit: 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) Factors Causing Risk Under Statutory Audit: 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-

(i) Errors in posting,

(ii) Errors in Casting,

(iii) Errors in carrying forward,

(iv) 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 Statement of Profit and Loss (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

Conditions Which Increases the Risk of Fraud or Error: In planning and performing an 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 auditor's 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 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. 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-

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

(ii) 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.

(iii) 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.

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

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

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

(vii) 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

Standards on Auditing: 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. The 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 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.

Further, as per sub-section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 8

State briefly the qualities of an Auditor.

Answer

Qualities of an Auditor: 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, 2013, 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

Give your comment on the following:

(a) *Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2015-16. The closing inventory of the company as on 31.3.2015 amounting to ₹ 100 lacs continued as it is and became closing inventory as on 31.3.2016. The auditors of the company propose to exclude from their audit programme the audit of closing inventory 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) *Statement of Profit and Loss*

Travelling Expenditure ₹ 50,000

(ii) *Balance Sheet*

Trade receivable ₹ 2,00,000

Answer

(a) Verification of Inventory: As per SA 510 "Initial Audit Engagements – Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by predecessor 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 including the other relevant documents relating to the prior period financial statements such as supporting schedules to 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 inventory 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 inventory 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 inventory 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 Statement of Profit and Loss.

(ii) Trade receivable ₹ 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 notes 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 management's use of the going concern assumption in the preparation and presentation of the financial statements.

Question 11

State the matters which the statutory Auditor should look into before framing an opinion on accounts on finalisation of audit of accounts. Discuss overall 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 12

Write a short note 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.

As per sub section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

Question 13

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

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 wishes 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 read with SA 200 and SA 220. But in general abovementioned principles are basic principles only.)

Question 14

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.
- 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 15

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 16

Discuss the types of audits required under law.

Answer

Types of 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, 2013;

(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 17

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.

Question 18

Comment on the following:

(a) Selling and distribution cost included in the cost of inventories.

(b) Computer software which is the integral part of the related hardware can be treated as intangible assets or fixed assets?

(c) Define shortly arm's length transaction.

Answer

(a) As per AS-2 on Valuation of Inventories, in determining the cost of inventories, it is appropriate to exclude selling and distribution costs and recognise them as expenses in the period in which they are incurred. Therefore, it is not appropriate to include selling and distribution cost in the cost of inventories.

(b) As per AS-26 on Intangible Assets, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. Therefore, computer software which is the integral part of the related hardware should be treated as fixed asset.

(c) Arm's length transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Question 19

Discuss with reference to SAs:

(a) The auditor shall communicate all significant findings with those charged with Governance.

(b) Factors affecting form, contents and extent of audit.

(c) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

(d) What are the auditor's responsibilities in respect of corresponding figures?

Answer

(a) Communication of Findings with Those Charged with Governance: As per SA-260 "Communication with Those Charged with Governance", the auditor shall communicate the following significant findings from the audit, with those charged with governance-

(i) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(ii) Significant difficulties, if any, encountered during the audit;

(iii) Unless all of those charged with governance are involved in managing the entity:

(1) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

(2) Written representations the auditor is requesting; and

(iv) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

(b) Factors Affecting Form, Contents and Extent of audit: As per SA-230 on "Audit Documentation", the form, content and extent of audit documentation depend on the following factors-

(i) The size and complexity of the entity.

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

(iii) The identified risks of material misstatement.

(iv) The significance of the audit evidence obtained.

(v) The nature and extent of exceptions identified.

(vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.

(vii) The audit methodology and tools used.

(c) Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling", sampling risk is 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 tests of details, that a material misstatement does not exists 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 test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatements 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.

(d) Auditor's Responsibilities in Respect of Corresponding Figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether-

(i) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(ii) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 "Subsequent Events".

As required by SA 580, "Written Representations", the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's Statement of Profit and Loss.

Question 20

Write short notes on the following:

(a) Identification of significant related party transaction outside business.

(b) Self-revealing errors and four illustrations thereof.

Answer

(a) Identification of Significant Related Party Transaction Outside Business: As per SA 550 on "Related Parties", for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

(i) Inspect the underlying contracts or agreements, if any, and evaluate whether:

(1) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

(2) The terms of the transactions are consistent with management's explanations; and

(3) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

(ii) Obtain audit evidence that the transactions have been appropriately authorized and approved.

(b) Self-revealing Errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts.

A few illustrations of such errors are given hereunder, showing how they become apparent-

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(ii)	Wrong totaling of the Purchase Register.	Control Account (e.g., the Sundry Creditors Account) balances and the aggregate of the balances in the personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

Question 21

With reference of SA 250, give some examples or matters indicating to the auditor about non compliance of laws & regulations by management.

Answer

Non-compliance of Laws and Regulations by Management: As per SA 250 on "Consideration of Laws and Regulation in an Audit of Financial Statements", the following are examples or matters indicating to the auditor about non-compliance with laws and regulations by management-

(i) Investigations by regulatory organisations and government departments or payment of fines or penalties.

(ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees.

(iii) Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.

(iv) Purchasing at prices significantly above or below market price.

(v) Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.

(vi) Unusual payments towards legal and retainership fees.

(vii) Unusual transactions with companies registered in tax havens.

(viii) Payments for goods or services made other than to the country from which the goods or services originated.

(ix) Payments without proper exchange control documentation.

(x) Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.

(xi) Unauthorised transactions or improperly recorded transactions.

(xii) Adverse media comment.

Question 22

Discuss the following:

(a) "Statements" and "Guidance Notes" of ICAI- whether mandatory or recommendatory?

(b) Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements.

(c) The discipline of behavioural science is closely linked with the subject of auditing.

Answer

(a) Statements and Guidance Notes of ICAI –whether Mandatory or Recommendatory:

(i) Statements: The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute to ensure that statements are followed and complied with.

(ii) Guidance Notes: 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

(b) Inquiring from Management to Evaluate Subsequent Event: As per SA 560 "Subsequent Events", in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-

(i) Whether new commitments, borrowings or guarantees have been entered into.

(ii) Whether sales or acquisitions of assets have occurred or are planned.

(iii) 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.

(iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.

(v) Whether there have been any developments regarding contingencies.

(vi) Whether any unusual accounting adjustments have been made or are contemplated.

(vii) 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.

(viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.

(ix) Whether any events have occurred that are relevant to the recoverability of assets.

(c) The Discipline of Behavioural Science is Closely Linked with the Subject of Auditing: The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

Question 23

Discuss with reference to SAs:

(a) What do you mean by "Written Representations"? As an auditor, how you will deal if management does not provide requested written representations?

(b) "Operating Conditions" that may cast doubt about going concern assumption.

(c) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement?

Answer

(a) Written Representations: As per SA 580, "Written Representation" is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. These representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Requested Written Representations not provided by Management: If management does not provide one or more of the requested written representations, the auditor shall-

(i) discuss the matter with management;

(ii) re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(iii) take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

(b) Operating Conditions Casting Doubt About Going Concern Assumption: The following are examples of operating events or conditions that, may cast significant doubt about the going concern assumption-

(i) Management intentions to liquidate the entity or to cease operations.

(ii) Loss of key management without replacement.

(iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).

(iv) Labour difficulties.

(v) Shortages of important supplies.

(vi) Emergence of a highly successful competitor.

(c) Professional Skepticism: As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while obtaining reasonable assurance, the auditor is responsible for maintaining 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. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

Question 24

Write a short note on Defalcation of cash with examples.

Answer

Defalcation of Cash: Defalcation of cash has been found to perpetrate generally in the following ways -

(i) By inflating cash payments.

Examples of inflation of payments:

(1) Making payments against fictitious vouchers.

(2) Making payments against vouchers, the amounts whereof have been inflated.

(3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.

(4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(ii) By suppressing cash receipts. Few Techniques of how receipts are suppressed are:

(1) 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, money 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.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts etc. to customer' accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts e.g. sale of scrap, quarters allotted to the employees etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(iii) By casting wrong totals in the cash book.

Question 25

(a) Mention any four information which assists the auditor in accepting and continuing of relationship with the client as per SA 220.

(b) State the significant difficulties encountered during audit with reference to SA-260 (communication with those charged with governance).

(c) The auditor may exercise his judgement to identify which risks are significant risks. Explain the above in context of SA-315.

Answer

(a) Information which assist the Auditor in accepting and continuing of relationship with Client: As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:

(i) The integrity of the principal owners, key management and those charged with governance of the entity;

(ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;

(iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and

(iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

(b) Significant Difficulties Encountered During the Audit: As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

- *Significant delays in management providing required information.*
- *An unnecessarily brief time within which to complete the audit.*

- *Extensive unexpected effort required to obtain sufficient appropriate audit evidence.*
- *The unavailability of expected information.*
- *Restrictions imposed on the auditor by management.*
- *Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.*

(c) Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following-

(i) Whether the risk is a risk of fraud;

(ii) Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention;

(iii) The complexity of transactions;

(iv) Whether the risk involves significant transactions with related parties;

(v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Question 26

What are the objectives and functions of Auditing and Assurance Standards Board (AASB)?

Answer

Objectives and Functions of the Auditing and Assurance Standards Board: The following are the objectives and functions of the Auditing and Assurance Standards Board-

(i) To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.

(ii) To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.

(iii) To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.

(iv) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.

(v) To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.

(vi) To formulate General Clarifications, where necessary, on issues arising from Standards.

(vii) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

Question 27

State with reasons (in short) whether the following statement is correct or incorrect:

The basic objective of audit does not change with reference to nature, size or form of an entity.

Answer

Correct: An audit is an 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. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

Question 28

Discuss the following:

(a) Advantages of independent audit.

(b) Is detection of fraud and error duty of an auditor?

Answer

(a) ***Advantages of Independent Audit:*** *The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below-*

(i) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(ii) It acts as a moral check on the employees from committing defalcations or embezzlement.

(iii) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(iv) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property by fire or some other calamity.

(v) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

(vi) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

(vii) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(viii) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(ix) Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

(b) ***Detection of Fraud and Error - Duty of an Auditor:*** *As per SA-240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", 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. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an* *active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability. Broadly, the general principles laid down in this regard are:*

(i) 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. As described in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", 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.

(ii) 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.

(iii) 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.

(iv) 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. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

It may be concluded from the above that detection of fraud and error is not the duty of the auditor provided that he complies with the requirements given in Standards on Auditing, maintains professional skepticism throughout the audit and is not grossly negligent in the performance of his duties as an auditor.

Question 29

Write a short note on Fraudulent financial reporting.

Answer

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

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

Fraudulent financial reporting may be accomplished by the following:

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

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

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

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

Question 30

With reference to SA 320, indicate the factors which may affect the identification of an appropriate bench mark in determining materiality for the financial statement as a whole.

Answer

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

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

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

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

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

(v) The relative volatility of the benchmark.

Exercise

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.

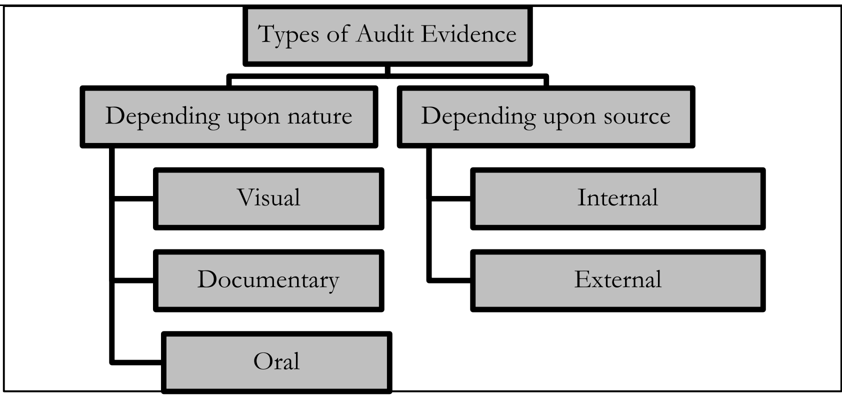
2. *State with reasons your views on the following:*

Mr. X, a partner of X & Co., Chartered Accountants died of a heart attack on 30.03.16 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

<table>
<tr><th colspan="2">BASIC CONCEPTS</th></tr>
<tr><td>Auditor's Independence</td><td>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.</td></tr>
<tr><td>True and Fair</td><td>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.</td></tr>
<tr><td>Audit Evidence</td><td>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.</td></tr>
<tr><td>Types of Audit Evidence</td><td>


</td></tr>
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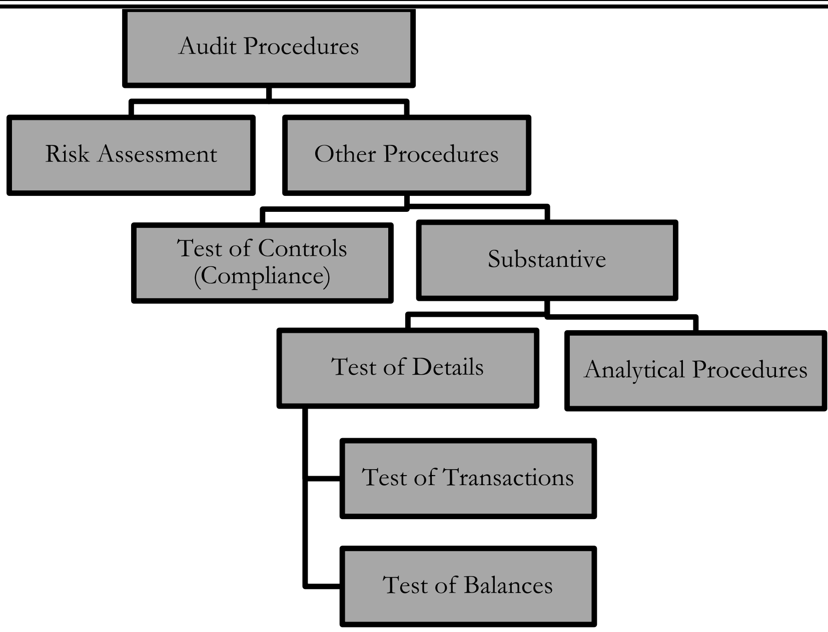
Audit Procedures to Obtain Audit Evidence	
Accounting policies	Accounting policies refers to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.
Fundamental Accounting Assumptions	AS 1 states 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, trade payables, 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 trade payables 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 a short note on Fundamental Accounting Assumptions.

Answer

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-

(i) **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.

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

(iii) **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. However, 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 audit procedures to obtain 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", it is theinformation 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) Audit Procedures to Obtain Audit Evidence: According to SA 500 "Audit Evidence", the auditor may obtain evidence by one or more of the following audit procedures-

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 inventory 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: SA 500 on "Audit Evidence" provides thatthe 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:

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

(2) 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.

(3) 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).

(4) 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).

(5) 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

Advantages of Audit Working Papers: 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 defense 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 goods 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 "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 test of controls and substantive procedures as audit procedure of obtaining sufficient appropriate audit evidence 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) Test of Controls and (b) SubstantiveProcedure.

According to SA 330 "The Auditor's Responses to Assessed Risks", 'test of controls'means an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

SA 330 further explains the 'substantive procedure' as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(i) Tests of details (of classes of transactions, account balances, and disclosures), and

(ii) Substantive analytical procedures.

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

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.

The importance of the concept of true and fair view can also be understood and appreciated from the facts that sections 128, 129 and 143 of the Companies Act, 2013 also discusses this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the said Act provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairsof the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term "financial statement" shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives 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 Statement of Profit and Loss, 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.

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 trade payables.
- 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 trade payables 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 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

Accounting Estimates: 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 a 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, 2013, 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.

(vi) Provisions relating rotation of auditor/audit firm.

Question 13

Answer the following:

(i) 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: According to SA 320 "Materiality in Planning and Performing an Audit", 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 auditor's perception of the financial information needs of users of the financial statements, and 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", external confirmation is an 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) Inventory 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:

(i) Method of depreciation, depletion and amortization –Straight Line Method, Written Down Value method.

(ii) Valuation of inventories – FIFO, LIFO, weighted average etc.

(iii) Treatment of goodwill – write off, retain.

(iv) Valuation of investment – at cost, market or net realizable value etc.

(v) Treatment of retirement benefits – Actuarial, funded through trust, insurance policy etc.

(vi) 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

Assertions while Obtaining Audit Evidence from Substantive Procedure: 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

"Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered." Explain stating the different categories of assertions used by the auditor.

Answer

Risk of Material Misstatement at the Assertion Level: According to SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms-

(a) Assertions about classes of transactions and events for the period under audit:

(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

(ii) Completeness—all transactions and events that should have been recorded have been recorded.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cut-off—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

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

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

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

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

(c) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

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, 2013. 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.

(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 their 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 on "Audit Documentation" states that Audit Working papers are the 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 seven 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: SA 500 “Audit Evidence” requires that 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 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.

Question 22

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. Comment.

Answer

Reliability of Audit Evidence: As per SA 500 on "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:

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

(ii) 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.

(iii) 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).

(iv) 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).

(v) 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.

Applying the above, 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.

Question 23

Discuss "Inquiry is one of the audit procedure to obtain audit evidence".

Answer

Inquiry – Audit Procedure to obtain Audit Evidence: 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.

Question 24

State with reasons (in short) whether the following statement is correct or incorrect:

Teeming and lading is one of the techniques of inflating cash payments.

Answer

Incorrect: Teeming and Lading is one of the techniques of suppressing cash receipts and not of inflating cash payments. Money received from one customer is

misappropriated and the account is adjusted with the subsequent receipt from another customer and so on.

Question 25

Why Tests of Control are performed? Also explain what does they include.

Answer

Tests of Control: Tests of control are performed to obtain audit evidence about the effectiveness of the -

(i) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

(ii) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Tests of control may include:

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

Exercise

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. Bank Reconciliation 9. Tracing in subsequent period.
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

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

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 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:** This method is 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 this method, 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:** This method 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 this method, 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:** This method 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 short notes 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

State 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 "Agreeing the Terms of Audit Engagement" 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.

SA 210 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 5

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 6

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 7

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:

(i) 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;

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

(iii) 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

(iv) 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 8

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.

Question 9

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 10

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-

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

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

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

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

(v) 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.

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

(vii) 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.

(viii) 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-

(i) The partnership deed should be first scrutinized.

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

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

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

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

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

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

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

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

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

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

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

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

(xiv) Do surprise checking of cash balances.

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

Question 11

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 12

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

Answer

Precautions While Applying Test Check Techniques: 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 13

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

Ownership of Working Papers: 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 14

Write a short note 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 inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

Question 15

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: According to SA 580 "Written Representations", the management representation 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.

In the given case, the management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. The management of the company also committed to give representation and further owned responsibility for any errors in these respects.

However, 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. There cannot be any restriction on scope of audit in case of statutory audit.

Question 16

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.

Answer

Audit Programme for Audit of Grant Fund of a College:

(i) The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.

(ii) The government policy on grant should be checked with the relevant application, brochure, and sanction advices.

(iii) The conditions stipulated in award of grant should be studied.

(iv) The receipt of grant should be vouched with bank statement.

(v) The budgeted heads of expenses for the project and actual utilization of the fund should be checked.

(vi) 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.

(vii) 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.

(viii) 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.

(ix) 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.

(x) The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.

(xi) The physical verification of assets pertaining to the project should be done by the management of the college.

(xii) 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 17

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 18

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 19

Explain in briefly the utility of Working Papers to an auditor.

Answer

Utility of Working Papers: 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 20

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) Accepting Management Certificate without obtaining other Audit Evidence: 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 inventory 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) **Ownership of Working Papers:** 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 21

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 22

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

Answer

Areas Where Surprise Checks can Significantly Improve the Effectiveness of an Audit: 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 23

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 24

Write a short note on Knowledge of Client's business.

Answer

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

(i) Clients annual report to shareholders;

(ii) Minutes of shareholders/board of directors;

(iii) Internal financial management reports of current & previous year;

(iv) Previous year audit working papers;

(v) Discussion with client;

(vi) Clients policy and procedure manual;

(vii) Publications like trade journals, magazines, news papers; and

(viii) Visit to client's premises.

Question 25

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

(b) Describe 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 III requires disclosure of items of expenditures which are in excess of one percent of the revenue from operations or ₹ 1,00,000, whichever is higher.

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

(b) Following Instructions are given by the Auditor to the Client Before the Start of Audit:

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

(ii) Vouchers should be serially arranged.

(iii) Schedule of trade receivables and trade payables 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

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

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

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

(iv) 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.

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

Question 26

(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 a short note "Audit risk at the account balance level and at the class of transactions level".

Answer

(a) Change in Terms of Engagement: According to SA 210 "Agreeing the Terms of Audit Engagements", 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. But when the terms of engagement are changed, both the auditor and the client should agree on the new terms. However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

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.

Thus, the auditor should not agree for change in the terms of engagement letter. He may withdraw from the engagement if possible under law; and determine any obligation to report accordingly.

(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 27

"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".

Answer

Sampling Risk: As per SA 530 "Audit Sampling", 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.

Question 28

Write short notes on the following:

(a) Reliability of external confirmations.

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

(c) 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.

SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium.

Factors that may indicate doubts about the reliability of a response include that it-

(i) was received by the auditor indirectly; or

(ii) appeared not to come from the originally intended confirming party.

If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

(b) Factors Governing Modes of Communication of Auditor with Those Charged with Governance: As per SA 260, "Communication with Those Charged with Governance", the form of communication (e.g. 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) Whether the matter has been satisfactorily resolved.

(ii) Whether management has previously communicated the matter.

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

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

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

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

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

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

(c) 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-

(i) Analyse and discuss cash flow, profit and other relevant forecasts with management.

(ii) Analyse and discuss the entity's latest available interim financial statements.

(iii) Read the terms of debentures and loan agreements and determine whether any have been breached.

(iv) Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.

(v) Inquire the entity's legal counsel regarding the existence of litigation and claims; and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

(vi) 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.

(vii) Evaluate the entity's plan to deal with unfilled customer orders.

(viii) Perform audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

(ix) Confirm the existence, terms and adequacy of borrowing facilities.

(x) Obtain and review reports of regulatory actions.

(xi) Determine the adequacy of support for any planned disposals of assets.

Question 29

Write short notes on the following:-

(a) Stratified sampling.

(b) Audit Risk and inter-relationship of its components.

(c) Quality control for audit work at firm level.

Answer

(a) 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.

(b) Audit Risk: An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheet items.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

The nature of each of these types of risk is discussed below-

(i) Inherent risk: It 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. 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.

(ii) Control Risk: It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It 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.

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

(iii) Detection Risk: It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. 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.

Inter-relationship of Components of Audit Risk: Audit risk is a function of the risks of material misstatement and detection risk. The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

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.

(c) Quality Control for Audit Work at Firm Level: SA 220 on Quality Control for an Audit of Financial Statements deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. Quality control systems, policies and procedures are the responsibility of the audit firm. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence. The requirements are-

(i) **Leadership Responsibilities for Quality on Audits:** The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

(ii) **Relevant Ethical Requirements:** Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement.

(iii) **Acceptance and Continuance of Client Relationships and Audit Engagements:** The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

(iv) **Assignment of Engagement Teams:** The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement in accordance with professional standards and regulatory and legal requirements and enable an auditor's report that is appropriate in the circumstances to be issued.

(v) **Engagement Performance:** The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement. He shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures and shall take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall determine that an engagement quality control reviewer has been appointed. Further, if differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

(vi) **Monitoring:** The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

Question 30

State briefly Audit Procedures and Audit Techniques.

Answer

Audit Procedures: Selection of the appropriate audit procedure is again a matter of experience and judgment. For example, the normal procedure for verification of cash balance is counting but this is not practicable in respect of the cash-in-transit. The auditor has to think in advance about the possibilities of departure from the normal procedure and the areas likely to be affected thereby. The procedure should provide for such situations in the programme. Knowledge about accounting may be conveniently used in assembling the procedures in the most rational and natural manner.

According to SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit.

Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and performing substantive tests of details of classes of transactions, account balances or disclosures.

Audit techniques, on the other hand, refers to collection and accumulation of audit evidence. Some of the techniques commonly adopted by the auditors are the following:

(i) Posting checking

(ii) Casting checking

(iii) Physical examination and count

(iv) Confirmation

(v) Inquiry

(vi) Year-end scrutiny

(vii) Re-computation

(viii) Tracing in subsequent period

(ix) Bank Reconciliation.

It may be noted that the two terms, procedure and techniques, are often used interchangeably, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

Question 31

"It is not mandatory to send a new engagement letter in recurring audit, but sometimes it becomes mandatory to send new letter". Explain those situations where new engagement letter is to be sent.

Answer

Issue of Audit Engagement Letter in Recurring Audits: As per SA 210, "Agreeing the Terms of Audit Engagements", on recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

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. However, in the following situations it is appropriate to revise the terms of the audit engagement or to remind the entity of existing terms-

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change in senior management or board of directors.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

Question 32

What is continuous audit? What are the precautions which should be taken to avoid the disadvantages of continuous audit?

Answer

Continuous Audit: A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client the whole year round or when for this purpose the staff attends at intervals, fixed or otherwise, during the currency of the financial period.

The disadvantages of a continuous audit can be avoided if the following precautions are taken:

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

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

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

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

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

Question 33

Are surprised checks desirable in audit, if so, give important recommendations.

Answer

Need of Surprise Checks: The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

The following are the important recommendations-

(i) Surprise checks should be considered as a desirable part of each audit.

(ii) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:

(1) Verification of cash and investments.

(2) Test-verification of stores and inventories and the records relating thereto.

(3) Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.

(iii) 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.

(iv) The results of the surprise checks should be communicated to the management if they reveal any weakness in the system of internal control or any fraud or error or deficiency in the maintenance of records.

(v) The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

(vi) It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor they are material and affect a true and fair view of the accounts on which he is reporting.

Question 34

"An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so." Discuss.

Answer

Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to-

(i) the original engagement; or

(ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall-

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Question 35

With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Answer

Audit Sampling: As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – 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 requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Question 36

Write a short note on Random sampling.

Answer

Random Sampling: *Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–*

(i) ***Simple random sampling:*** *Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 5,000 to ₹ 25,000 and not in the range between ₹ 25 to ₹ 2,50,000.*

(ii) ***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 judgment. For example in the above case, trade receivables balances may be divided into four groups as follows -*

(a) balances in excess of ₹ 1,00,000;

(b) balances in the range of ₹ 75,000 to ₹ 1,00,000;

(c) balances in the range of ₹ 25,000 to ₹ 75,000; and

(d) balances below ₹ 25,000.

Question 37

State with reasons (in short) whether the following statement is correct or incorrect:

Written representation by management as to the quality of inventory is substitute for verification.

Answer

Incorrect: *Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership) and in identifying its quality for example, obsolete, damaged or ageing inventory. Written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.*

Alternative Reason for incorrect answer may be given as: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

Question 38

Write a short note on 'Matters that the auditor may consider when obtaining an understanding of the nature of the entity'.

Answer

Matters that the Auditor may consider when obtaining an understanding of the nature of the entity: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", following are some of the examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity-

(i) Business operations – such as:

- ***Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.***
- ***Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).***
- ***Alliances, joint ventures, and outsourcing activities.***
- ***Geographic dispersion and industry segmentation.***
- ***Location of production facilities, warehouses, and offices, and location and quantities of inventories.***
- ***Key customers and important suppliers of goods and services, employment arrangements.***
- ***Research and development activities and expenditures.***
- ***Transactions with related parties.***

(ii) Investments and investment activities – such as:

- ***Planned or recently executed acquisitions or divestitures.***
- ***Investments and dispositions of securities and loans.***
- ***Capital investment activities.***

- ***Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.***

(iii) Financing and financing activities – such as:

- ***Major subsidiaries and associated entities, including consolidated and non-consolidated structures.***
- ***Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.***
- ***Beneficial owners (local, foreign, business reputation and experience) and related parties.***
- ***Use of derivative financial instruments.***

(iv) Financial reporting – such as:

- ***Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).***
- ***Revenue recognition practices.***
- ***Accounting for fair values.***
- ***Foreign currency assets, liabilities and transactions.***
- ***Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).***

Exercise

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. As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:- (a) every listed company; (b) every unlisted public company having- (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or (ii) turnover of two hundred crore rupees or more during the preceding financial year; or (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and (c) every private company having- (i) turnover of two hundred crore rupees or more during the preceding financial year; or (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year: It is provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.
Who can be appointed as Internal	As per section 138 the internal auditor, who shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided

Auditor?	by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company. Further, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.
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 internal controls; (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 entity's internal controls. It 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; and (iii) **Detection risk**: the risk that the practitioner will not detect a material misstatement that exists. 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.
Audit around the	Audit around the computer involves forming of an audit opinion wherein the existence of computer is not taken into

Computer:	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.

Question 1

"The overall objective and scope of an audit does not change in Computerised Information System (CIS) environment". Comment.

Answer

Objective and Scope of an Audit in Computerised Information System (CIS) Environment: 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 Computerised Information System (CIS) 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 CIS environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Thus, when auditing in CIS environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how CIS 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 CIS 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 CIS.

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 a Computerised Information System (CIS) environment is simpler since the trial balance always tallies'. Analyse critically.

Answer

Audit in a Computerised Information System (CIS) Environment: Though it is true that in CIS environment the trial balance always tallies, the same cannot 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 account 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 CIS environment. Therefore, it can be said that simply because of CIS 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 skepticism 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 Computerised Information Systems (CIS)?

Answer

Different Design and Procedural Aspects of a Computerised Information System (CIS): The development of Computerised Information Systems (CIS) will generally result in design and procedural characteristics that are different from those found in manual systems. These different design and procedural aspects of CIS are-

(i) Consistency of Performance: Computerised Information Systems (CIS) 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 Computerised Information System (CIS) itself without the need for an input document. The authorisation of such transactions may neither be supported by visible input documentation nor documented in the same way as transactions which are initiated outside the CIS (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 Computerised Information System (CIS) Environment.

Answer

Internal Controls in CIS 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 CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS Controls: The purpose of general CIS controls is to establish a framework of overall control over the CIS 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 CIS 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.

CIS Application Controls: The purpose of CIS 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

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 “Usingthe 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 8

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 CIS 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 9

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-

(i) Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.

(ii) Need for a system testing including all clerical procedures at the user company.

(iii) Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.

(iv) 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.

(v) Establishing a system in the user company to ensure that all exceptional reports are received from bureau.

(vi) Establish clerical control to verify the accuracy of computer processing.

(vii) Normally, user has no physical control over the files; therefore, high control over the maintenance of data on master files should be established.

Question 10

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

Answer

Computer Operating System and the Auditor: The installation of computer operating system is an integral and absolutely essential part of a computer even in a standalone 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 11

Explain briefly the approaches to auditing in Computerised Information System (CIS) environment.

Answer

Approaches to Auditing in CIS Environment: 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 CIS 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 updating.

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 12

Write a short note on - Independence of Internal Auditor.

Answer

Independence of Internal Auditor: As per section 138 of the Companies Act, 2013, the internal auditor, who shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company. Further, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It may also be noted that the Central

Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

So, 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. As mentioned above, the internal auditor may be 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 13

Why are Computer Aided Audit Techniques (CAAT) required in Computerised Information System (CIS) environment? 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 Computerised Information System (CIS) environment 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 CIS environment, however, the transaction trail may be partly in machine-readable form, and it may exist only for a limited period of time.

(iii) **Lack of visible output:** In a manual system, it is normally possible to examine visually the results of processing. In CIS environment, the results of processing may not be printed or only a summary data may be printed. Thus, 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 CIS 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 14

GR & Co., a firm of Chartered Accountants has been called upon to audit the accounts of Dee Vee Philips Ltd. The auditors are told that Company is not performing well due to weak accounting and administration system in place. Mr. Preet handling the assignment noticed that there are gaps in internal check system of the company. You are required to explain 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-

(i) 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.

(ii) 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.

(iii) 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.

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

(v) 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.

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

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

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

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

Question 15

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

Answer

Weaknesses in the Internal Control System: 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 16

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 Computerised Data System:

(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 signalled 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 17

Write a short note on - Statutory Auditor versus Internal Auditor.

Answer

Statutory Auditor versus Internal Auditor:

S. No.	Statutory Auditor	Internal Auditor
1.	The extent of the work undertaken by statutory auditor arises from the responsibility placed on him by the statutes.	It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.
2.	The approach of this auditor is governed 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.	The approach of this auditor is with a view to 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.	If internal auditor is an employee of the company. He cannot enjoy independence that statutory auditor has.

Question 18

What are the inherent limitations of Internal Control system?

Answer

Inherent Limitations of Internal Control System: 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 19

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 –

(i) transactions are executed in accordance with management's general or specific authorisation;

(ii) 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;

(iii) assets and records are safeguarded from unauthorised access, use or disposition; and

(iv) 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 20

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 is an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor.

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 21

Distinguish between the Internal Control Questionnaire and Internal Control Evaluation.

Answer

Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE): The internal control questionnaire 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 22

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 23

Why are computer assisted audit techniques (CAAT) needed in a Computerised Information Systems (CIS) environment and how it helps the auditor in obtaining and evaluating audit evidences?

Answer

Need of CAATs in a CIS Environment: Computer Assisted audit techniques (CAATs) 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 24

How would you assess the reliability of internal control system in Computerised Information System (CIS) environment?

Answer

Reliability of Internal Control System in CIS Environment: For evaluating the reliability of internal control system in CIS environment, the auditor would consider the following**-**

(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 25

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 26

Write a short note on Letter of Weakness.

Answer

Letter of Weakness:

(i) 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.

(ii) When he comes across any weakness in the control points, he issues letter of weakness.

(iii) 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.

(iv) Lapses in operation of internal control too are reported in the communication of weakness.

(v) 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 27

(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-

(i) The logic and controls existing within the system.

(ii) 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 28

*Write a 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 some cases, be offset 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.

Question 29

MWF (P) Ltd. is a private company having ₹ 50 lacs paid up capital during the preceding financial year. The company had turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 210 crores, ₹ 205 crores and ₹ 200 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. You are required to state the provisions related to applicability of internal audit as per the Companies Act, 2013 and comment upon the contention of the management of the company.

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

   (1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

   (2) turnover of two hundred crore rupees or more during the preceding financial year; or

   (3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

   (4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

   (1) turnover of two hundred crore rupees or more during the preceding financial year; or

   (2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the instant case, MWF (P) Ltd. is a private company having turnover of ₹ 200 crores during the preceding financial year which is under the limit prescribed for the applicability of provisions on internal audit. Hence, the company has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit. Consequently, the contention of the management of the company is not tenable.

Question 30

Write a short note on "Use of flow charts in evaluation of internal control".

Answer

Use of Flow Charts in Evaluation of Internal Control: It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

Question 31

Comment on the following statements:

(a) Maintenance of internal control system is responsibility of Statutory Auditor.

(b) Internal control is part of internal check system.

Answer

(a) Maintenance of Internal Control System: It is the responsibility of the management for the maintenance of internal control system rather than of the Auditor. Because, internal control is the process designed, implemented and maintained by those charged with governance, management to provide reasonable assurance about the achievement of entity's objectives.

(b) Internal Check Being Part of Internal Control System: Internal check has been defined as "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". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. Therefore, the statement given in the question is not correct.

Question 32

To prepare an audit plan in CIS environment an auditor should gather information. Mention such important information which he has to collect.

Answer

Information to be Gathered While Preparing an Audit Plan in a CIS Environment: The auditor should gather information about the CIS environment that is relevant to the audit plan, including information as to-

(i) How the CIS function is organized and the extent of concentration or distribution of computer processing throughout the entity.

(ii) The computer hardware and software used by the entity.

(iii) Each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies.

(iv) Planned implementation of new applications or revisions to existing applications.

(v) When considering his overall plan the auditor should consider matters, such as:

  (a) Determining the degree of reliance, if any, he expects to be able to place on the CIS controls in his overall evaluation of internal control.

  (b) Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.

  (c) Planning auditing procedures using computer-assisted audit techniques.

Question 33

State with reasons (in short) whether the following statements are correct or incorrect:

(i) As per section 138 of the Companies Act, 2013 private companies are not required to appoint internal auditor.

(ii) Letter of weakness is issued by the Management.

Answer

(i) Incorrect: Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of ₹ 200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year.

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

Exercise

1 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. Comment.

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 *The use of computer facilities by a small enterprise may increase the control risk. Comment.*

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 a 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	**A. General Considerations** (i) Internal Control System

transactions	(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.
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 inventory and records
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) Goods sent out on Sale or Return Basis.

(b) *Borrowing from Banks.*

Answer

(a) 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 trade receivable'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 inventory 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 inventory.

(b) 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 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.

(v) 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

"No entry is passed for cheques received by the auditee on the last day of the year and not yet deposited with the bank". Give your comments and observations.

Answer

Cheques Received on the Last Day of Accounting Year: It is a quite normal that in any ongoing 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 trade receivables' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the trade receivables' ledger should ensure that proper accounting entries have been passed by crediting respective trade receivables' 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 inventory 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 inventory 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 inventory 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 inventories.

(b) Foreign Travel Expenses:

(i) Examine Travelling Allowance 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 and 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 Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(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 of Payments: 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:

(a) Deferred Revenue Expenditure.

(b) Goodwill.

Answer

(a) 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 charged to the Statement of Profit and Loss 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.

While verifying deferred revenue expenditure, the auditor may satisfy himself that:

(i) it is proper to defer the expenditure;

(ii) the period of amortisation of the expenditure is reasonable;

(iii) 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;

(iv) 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.

(v) the necessary principles laid down under AS 26 "Intangible Assets" have been examined, to ensure whether such kind of deferment is allowed to be made or not.

(b) Goodwill:

(i) 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.

(ii) 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.

(iii) 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.

(iv) See whether goodwill has been written off as a matter of financial prudence as per the principles enunciated under AS 26 on Intangible Assets.

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 author & the entity and note 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) Ascertain that the legal life of the trade marks and copyrights have not expired.

(vi) 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.

(v) Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

(vi) 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 Schedule III of the Companies Act, 2013.

Question 7

State briefly how you will verify the following:

(a) Bank Balances.

(b) Bills Payable.

Answer

(a) 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.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) Check the disclosure requirement in the Balance Sheet as per Part I of Schedule III to the Companies Act, 2013 in the case of a company.

(b) 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 a 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 inventory are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory. 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 inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

Question 9

"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". Comment.

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.

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

Causes for Increase in the Rate of Gross Profit on Sales: 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 inventory 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 inventory 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:

(i) 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.

(ii) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.

(iii) Ensure that the sales in fact have taken place and the same has been charged to Statement of Profit and Loss.

(iv) Compare the amount incurred in previous years with reference to total turnover.

(v) Check entries regarding TDS on commission at the time of credit to Payee's Account, or payment, whichever is earlier.

(vi) Ensure that the payment has been made through cheque only, if limit as stated in the clause of tax audit is exceeded.

(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

"Travelling expenses of ₹ 2.25 lakhs shown in Statement of Profit and Loss 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". Comment.

Answer

Personal Expenses Charged to Revenue Account: The auditor should check the service contract, minutes of board meeting, etc., to check the authorisation for such expenditure.

As per the provisions of Section 143(1) of Companies Act, 2013, 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 Statement of Profit and Loss 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 pre-recorded 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

Decrease in 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 inventory or overvaluation of opening inventory either due to wrong valuation of inventory or mistake in inventory taking .

(ii) Change in the basis of inventory valuation. For example, opening inventory was valued at market price above cost when closing inventory 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 inventory.

(viii) Value of unusual inventory of consumable stores (fuel and packing materials) are not shown as inventory or not adjusted from corresponding expenses.

(ix) Expenses which should be charged in the 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

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, 2015 to March, 2016. In the month of January, 2016, 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 2015-16, SMT Enterprises booked sales amounting to ₹ 12 lacs and showed remaining ₹ 12 lacs as Advance against Sales. Comment.

Answer

Recognition of Revenue: Accounting Standard 9 on Revenue Recognition, 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 prepaid 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:

(i) 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.

(ii) The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined.

(iii) 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.

(iv) 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.

(v) 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.

(vi) 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.

(vii) 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.

(viii) The contribution should be appropriately disclosed in the accounts as per Schedule III to the Companies Act, 2013.

(b) Expenditure Incurred for Promotion of a Product:

(i) 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.

(ii) 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.

(iii) 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.

(iv) He should check whether the unpaid amounts and accrued liability towards promotional advertisement contracts had been duly provided for in the accounts.

(v) 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:

(i) The balance with excise authority in PLA Account should be checked with the statements of accounts/records kept with excise section of the unit.

(ii) The remittance into the account, the utilization out of it etc should be cross checked with bank book, clearance forms etc.

(iii) The balance confirmation may be checked.

(iv) The balance should be shown under current assets and advances in balance sheet.

(v) 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:

(i) The claim for backward area subsidy submitted to the authorities should be studied.

(ii) 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.

(iii) The accounting of grant should be in accordance with AS 12 “Accounting for Government Grants”. The revenue grant can be taken to income statement, with appropriate disclosure.

(iv) The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to Statement of Profit and Loss each year in proportion to depreciation of that asset charged in Statement of Profit and Loss.

(v) The receipt of the grant should be checked with bank statement, remittance challan etc.

(vi) 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

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. Comment.

Answer

Recognition of Revenue: 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 collectability.

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 collectability 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

Increase in Gross Profit Ratio: In assessing the reason for considerable increase in Gross Profit Ratio, the auditor should examine the following-

(i) Under valuation of opening inventory due to non-inclusion of certain items or applying lower rate to one or more items of inventory.

(ii) Over valuation of closing inventory either by the inclusion of fictitious items or over valuing some of the items of Inventory.

(iii) Change in the method of valuation of opening and closing inventory. For example, opening inventory was valued at lower of cost and market value, whereas closing inventory has been valued at market price which is higher than cost.

(iv) Goods sold but not delivered are included in inventory.

(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 inventory.

(viii) Goods returned by customers but not debited to sales return and included in closing inventory.

(ix) Inclusion in the closing inventory 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 and Loss Account.

Question 22

How will you vouch/verify the following:

(a) Sale of Investments.

(b) Payment of Revenue Expenses.

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 Statement of Profit & Loss. 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 Accounting Standard 13 on Accounting for Investments 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 Prepaid expenses.

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 Statement of Profit and Loss.

(vi) Ensure that the concern has adhered to the accounting treatment in accordance with AS-15 "Employee Benefits".

(vii) Ensure that the following disclosure requirements of Schedule III to the Companies Act, 2013 have been followed in the case of a company:

In respect of Statement of Profit and Loss, 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 trade receivable 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 to debtors.

(iv) Examine notification from the court, bankruptcy trustee and all correspondence from debtors and 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

How will you vouch and/or verify payment of taxes?

Answer

Vouching of Payment of Taxes:

(i) Obtain the computation of taxes prepared by the auditee and verify whether it is as per the Income Tax Act/ Rules/ Notifications/ Circulars etc. accordingly.

(ii) Examine relevant records and documents pertaining to payment of advance income tax and self assessment tax.

(iii) 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, notice of demand and the receipted challan acknowledging the amount paid.

(iv) The penal interest charged for non-payment should be debited to the interest account.

(v) Nowadays, electronic payment of taxes is also in trend. Such electronic payment of taxes by way of internet banking facility or credit or debit cards shall also be verified.

(vi) The assessee can make electronic payment of taxes also from the account of any other person. Therefore, it should be verified that the challan for making such payment is clearly indicating the PAN No./TAN No./TIN No. etc. of the assessee on whose behalf the payment is made.

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

Verification of Bank Balance of an Educational Institution: 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:

(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) 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-

(i) 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.

(ii) 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.

(iii) The copy of certificate/report containing full particulars of the amount of loss should also be verified.

(iv) 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 Statement of Profit and Loss 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 Statement of Profit and Loss should be appropriately described.

(b) Custom Duty:

(i) Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.

(ii) If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent's bill.

(iii) If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.

(iv) 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.

(v) Lastly, the auditor verifies the duty drawback.

Question 29

On 31.12.2015, 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, 2016, 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

Recognition of Interest on Deposits:

(i) Accounting Standard 9 on Revenue Recognition requires that the revenue arising from interest should be recognised on a time proportion basis taking into account the amount outstanding and the rate applicable. Such revenues should only be recognised when no significant uncertainty as to measurability or collectability exists.

(ii) Further, according to Section 128 of the Companies Act, 2013 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.

(iii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown as per Schedule III Part I requirement of the Companies Act, 2013.

(iv) As such, the profits and current assets are understated and true and fair views of the accounts are thus vitiated.

(v) 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, 2016. 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, 2016, 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) Verification of Cash On Hand: 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 inventory.

(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:

(i) The auditor should trace the total production incentive paid to workers from Statement of Profit and Loss to prime records/division wise/dept wise records.

(ii) The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.

(iii) The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by the accounts department.

(iv) 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.

(v) 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:

(i) The amount of bad debts should be traced to the schedule of bad debts written off during the year.

(ii) Major amount of bad debts in the schedule be taken for scrutiny.

(iii) Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.

(iv) Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.

(v) The bad debts should be properly disclosed in Statement of Profit and Loss according to its materiality.

(vi) 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., a manufacturing concern, 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, 2016. The average net profits of the company for the last three years were ₹ 15 lakhs. Comment.

Answer

Donation to Charitable Institutions: Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bonafide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed 5% of its average net profits for the three immediately preceding financial years.

Facts of the case: In the instant case, XYZ Ltd., a manufacturing concern, has given donation of ₹ 50,000 each to two charitable organisations which amounts to ₹ 1,00,000. 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. For excess of ₹ 25,000 the company is required to take prior permission in general meeting which is not been taken.

Conclusion: By paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. 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 inventory 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 inventory.

(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 inventories, 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 pre-numbered 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 pre-numbered 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 III to the Companies Act, 2013. 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 along with the names of companies (Part I, Schedule III to the Companies Act, 2013).

Question 36

List out some examples of fraud that can be done by ledger keeper in Bought ledger and sales ledger.

Answer

Ledger Keeper and 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 trade receivable, 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 Increases the Gross Profit:

(i) Undervaluation of opening inventory; it may be either the effect of non-inclusion of certain items of inventories or that of valuation of the inventory at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of inventory. 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 inventory, either by the inclusion therein of fictitious items of inventory or over-statement of values of some of them.

(iii) Alteration of the basis of valuation of closing inventory, e.g., where the opening inventory was valued at cost or market rate whichever was lower, valuing the closing inventory at the market price which is higher than cost.

(iv) Increase in the value of some of the items included in the opening inventory above cost, on account of which the unsold inventory of these items at the close of the year is valued at cost.

(v) Under-statement of opening inventory or over-statement of closing inventory, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing inventory or when goods were delivered and taken out of inventory 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 inventory 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 inventory 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

What are the factors to be considered while "Vouching of travelling expenses"?

Answer

Vouching of Travelling Expenses: 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 along with 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.

Question 40

How will you vouch and verify the following:

(a) Remuneration paid to directors.

(b) Profit or loss arising on sale of plots held by real estate dealer.

(c) Purchase with invoice.

(d) Wages paid to seasonal labourer.

(e) Refund of General Insurance Premium paid.

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 as per Section 196 of the Companies Act, 2013.

(ii) Examine Articles of Association and general meeting resolution to determine the manner of payment- monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197(6) of the Companies Act, 2013.

(iii) Check agreement with the director.

(iv) Verify director's attendance in the board meetings.

(v) Ensure compliance with the provisions of Sections 197, 198 and Schedule V to the Companies Act, 2013, where appropriate.

(vi) Check computation of the net profits and the commission payable to directors in terms of Schedule III to the Companies Act, 2013.

(vii) Computation of net profit under section 198 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) Profit or Loss Arising on Sale of Plots Held by Real Estate Dealer: The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value, whichever is less.

Profit or loss arising on sale of plots of land by Real Estate Dealer should be verified as follows-

(i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

(ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.

(iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.

(vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

(c) Purchase with Invoice: While vouching entries for purchases with the invoices, the following points should be specially observed-

(i) that the date of invoice falls within the accounting period;

(ii) that the invoice is made out in the name of the client;

(iii) that the supplier's account has been credited with the full amount of the invoice and that the deduction in the amount of the invoice, if any, has been made on a proper basis;

(iv) that the goods purchased are those that are regularly dealt in by the concern or required for the process of manufacture carried on by it and that the price payable has been correctly arrived at;

(v) that the cost of purchases has been debited to an appropriate nominal account or accounts;

(vi) that the invoice is signed by the accountant to show that he has verified it as well as the store-keeper to indicate that the delivery of goods have been taken by him. If the invoice relates to the purchase of a technical store or a chemical, the price whereof is dependent on its quality, a copy of the report of a technical person showing that the article purchased is of the specification for which the order has been placed; and

(vii) that the manager or some other official, competent to sanction payment, has authorised its payment.

(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 payments 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.

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

(i) Ascertain the reasons for refund of insurance premium.

(ii) Examine insurance policy or cover note to find out the amount of premium.

(iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.

(iv) Scrutinise correspondence between the insurance company and the client.

(v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

Question 41

As an auditor, what are the essential points to be borne in mind while examining a voucher?

Answer

Examining a Voucher: 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.

Question 42

Indicate expenses which are essentially of a revenue nature, if incurred for creating an asset, are also regarded as expenditure of a capital nature.

Answer

Expenses which are essentially of a revenue nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are also regarded as expenditure of a capital nature.

Examples-

(i) **Material and wages:** capital expenditure when expended on the construction of a building or erection of machinery.

(ii) **Legal expenses:** capital expenditure when incurred in connection with the purchase of land or building.

(iii) **Freight:** capital expenditure when incurred in respect of purchase of plant and machinery.

(iv) **Repair:** Major repairs of a fixed asset that increases its productivity.

(v) **Wages:** Wages paid on installation costs incurred in Plant & Machinery.

(vi) **Interest:** Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalized, it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

Question 43

Casting or totaling is an important tool of audit for an Auditor. Comment.

Answer

Casting or Totaling as an Audit Tool: Casting or totaling is an important tool of audit for an auditor as sometimes the totals of a wage bill are inflated by over totaling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from account receivables by under-totaling the receipts column of the cash book. At times, shortages in cash have been also covered up by over totaling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked.

On these considerations, 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. This would deter him from altering the totals on the totaling mistakes being discovered.

Sometimes a fraud is committed in the following manner-

(a) under casting the receipt side of the cash book;

(b) Over casting the payment side of the cash;

(c) fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;

(d) posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and

(e) wrong totals or balances being carried forward in the cash book or in the ledger.

Question 44

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 45

Janta Ltd. has made a contribution of ₹ 7.8 lacs during the financial year ended 31.3.16 to Samaj Seva Party, a political party, for running a teaching institute situated in the rural area, where most of the workers of the company reside. It is admitted that the benefit of the institute is mostly for the children of the workers of the company. The average net profit of the company during the three immediately preceding financial years was ₹ 100 lakhs. Comment.

Answer

Restrictions Regarding Political Contribution: Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, aggregate contribution in any financial year should not exceed 7½ % of average net profit during the three immediately preceding financial years.

In the given case, Janta Ltd. has made a contribution of ₹ 7.8 lacs to Samaj Seva Party, a political party. The average net profit of the company during the three immediately preceding financial years is ₹ 100 lakhs and the 7½ % of this works out to ₹ 7.5 lacs.

As the company has contributed ₹ 7.8 lacs, there is a violation of the provisions of Section 182 of the Companies Act, 2013 although the children of its workers are benefited. Therefore, the auditor would have to qualify his report accordingly.

Question 46

How will you vouch/verify Repair to Assets?

Answer

Repair to Assets:

(i) Since the line demarcating repairs from renewals is slender, usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost.

(ii) It may sometimes be possible to determine this on a consideration of the nature of repairs carried out. The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life should be treated as capital expenditure.

(iii) Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained.

(iv) It should be ensured that Repairs to 'Certain Assets' like Building and Machinery have been separately disclosed as per the requirements of Schedule III to the Companies Act, 2013.

Question 47

Point out any eight areas where external confirmation used as an audit procedure.

Answer

External Confirmation as an Audit Procedure: SA 505, "External Confirmations", lays down standards for external confirmation of balances. External confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other areas where external confirmations may be used include the following:

- ***Bank balances and other information from bankers.***

- ***Accounts receivable balances.***
- ***Inventories held by third parties.***
- ***Property title deeds held by third parties.***
- ***Investments purchased but delivery not taken.***
- ***Loans from lenders.***
- ***Accounts payable balances.***
- ***Long outstanding share application money.***

Question 48

Write short notes on the following:

(a) Remuneration paid to directors in case of a public limited company.

(b) Payment for acquisition of assets.

Answer

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

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

(ii) Examine Adherence to Legal Provisions: The auditor should examine adherence to relevant sections of the Act such as –

(1) Section which deals with manner of payment of managerial remuneration.

(2) Section which deals with payment of sitting fees.

(3) Section which has prescribed the overall limit to managerial remuneration.

(4) Schedule V to the Companies Act, 2013 that has laid down conditions for payment of remuneration for companies having no profits or inadequate profits and companies having negative effective capital.

(5) Proviso to section which provides for increase in remuneration with the approval of the Central Government.

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

(i) The purchase of an asset must be duly supported by the receipt for the amount paid.

(ii) In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore

essential for an auditor to see that property has been registered in the purchaser's name as required by the relevant regulations and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.

(iii) ***In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards existence, value and title of the assets acquired.***

(iv) ***It must also be verified that the assets were purchased only by a person who had the authority to do so. Companies Act, 2013 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset.***

(v) ***If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired.***

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

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

Exercise

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 *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?

3 *How would you verify and vouch the following?*

(a) Income-tax Payment.

(b) Bills Receivable.

(c) Outstanding liabilities for expenses.

(d) Sale proceeds of Rejected Materials.

(e) Consignment transactions in the books of consignee.

(f) Interest and Dividends received.

(g) Empties or Containers.

4 *State briefly the audit objectives of the following:*

(a) Examination of Bank Reconciliation Statement.

(b) Reconciliation of the aggregate balances of the individual Sales Ledgers with the Sales Ledger Control Account.

(c) 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 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

(a) Comment on the "Responsibility for properly determining the quantity and value of inventories rests with the management of the entity".

(b) How would an auditor proceed to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory? Also state reporting requirements for the same in the case of a company.

Answer

(a) Responsibility for Determining Quantity and Value of Inventories: 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 of 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 inventory records in the form of Stores/Inventory 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.

(b) As per SA 501 on "Audit Evidence- Specific Considerations for Selected Items", the following principles are laid down in this respect:

(i) When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(ii) If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures as stated above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

(iii) If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

(iv) If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

(v) When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(1) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(2) Perform inspection or other audit procedures appropriate in the circumstances.

Audit Conclusions and Reporting: ***As per clause (ii) of Para 3 of Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.***

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:

(i) The adoption of the new method is required by statute (or)

(ii) For compliance with an accounting standard (or)

(iii) 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 Statement of Profit and Loss. 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 inventory under the head "inventory with processors". The auditor shall be required to undertake the following steps in respect of inventories lying with third parties:

(i) Ensure that semi-finished goods have been included for valuation of inventory since these belong to the company.

(ii) 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.

(iii) 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.

(iv) Check that the disclosure requirements as specified in Schedule III to the Companies Act, 2013 and AS 2 "Valuation of Inventories" have been followed.

Question 4

Give your comments and observations on the following:

(a) Balance confirmations from trade receivables/trade payables 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 trade receivables/trade payables 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 trade receivables may be requested to confirm the balance either:

(i) As at the date of the balance sheet; or

(ii) 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 trade receivables at a date other than the balance sheet date, he should examine the movements in trade receivable balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that trade receivable balances stated in the balance sheet are not materially mis-stated.

Therefore, it is not necessary that balances of trade receivables/ trade payables 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., December 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 trade receivables/trade payables can only be obtained for balances standing in their accounts at the year-end is not correct.

(b) Certificate from a Management's 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 a management's expert. SA 500 on "Audit Evidence" also states that the preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. It further requires the auditor to evaluate the competence, capabilities and objectivity of that expert; obtain an understanding of the work of that expert; and evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion, 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 500 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 2016, 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, 2016. 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) Claim 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 Statement of Profit and Loss 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 is to be made in the Statement of Profit and Loss. 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 Statement of Profit and Loss.

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 would you verify the Buildings.

Answer

Verification of Building:

(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 Statement of Profit and Loss.

(iv) See the appropriate 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.

(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 II and III to the Companies Act, 2013 shall also be complied with.

(vi) See that the relevant particulars of buildings have been entered in the fixed assets record maintained by the client.

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 on "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 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-

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

(2) 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 "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 Schedule III (of the Companies Act, 2013), 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
- (c) Other commitments (specify nature).

Question 10

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 the Statement of Profit and Loss.
- (v) Ensure that the accounting treatment is in accordance with AS 15 "Employee Benefits".

(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 11

How will you vouch and/or verify the following:

(a) Consignment sales.

(b) Royalties received.

Answer

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

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

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

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

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

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

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

(b) Royalties Received:

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

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

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

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

Question 12

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 asset 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 collectability 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 Statement of Profit and Loss 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 Statement of Profit and Loss 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 Statement of Profit and Loss 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 13

How will you vouch and/or verify the following:

(a) Contingent Liabilities.

(b) Excise Duty.

(c) 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 to vouch or verify the contingent liabilities:

(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 Schedule III to the Companies Act, 2013 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 excisable 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 excisable goods.

(ii) Verify the amount of duty paid with the corresponding value of the goods issued from the inventory 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 requisite registers maintained with actual and see reconciliation of financial records with sales tax records.

(c) 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 14

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 be 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 is 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 crystallized and the trade payable 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 77 of the Companies Act, 2013 in the case of a company.

Question 15

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 trade receivables as also the realisability aspect. The auditor’s duties in respect of trade receivables remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from trade receivables. 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. Accordingly, the auditor would have now to see that in respect of outstanding amount of ₹ 30,000, 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 16

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 143(1) of the Companies Act, 2013.

(iii) Ascertain compliance with disclosure according to requirements of Schedule III to the Companies Act, 2013.

(iv) Check documentary evidences to examine the payments reimbursed.

(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) Examine the compliance of AS 26 with regard to treatment of such preliminary expenses in the books of account.

(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 trade payables' 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 143(1) of the Companies Act, 2013.

(iv) Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.

Question 17

Write a 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 18

The CC Ltd., a Pharmaceutical Company, while valuing its finished inventory 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. Comment.

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 19

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 III 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 Schedule III to the Companies Act, 2013.

(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 20

As an auditor, comment on the following:

(a) As on 31.3.2016, 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 31.3.2016 (the accounts were finalised on 14th June, 2016), 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 31.3.2016, which, it says, will be reversed in the next year.

(b) SK Ltd. has fully computerised its accounting operations. The inventory 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 inventory 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 31.3.2016, 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 III to the Companies Act, 2013 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 inventory-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 modification in his audit report.

Additionally, as per clause (ii) of Para 3 of Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

Question 21

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 22

How will you verify/vouch the following:

(a) Inventory lying with Third Party

(b) Purchase of Motor Car

Answer

(a) Inventory Lying With Third Party:

(i) Obtain confirmations from the third party including the time period and reasons thereof.

(ii) Evaluate condition of goods and see whether adequate provision has been made.

(iii) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(iv) Ensure that the goods have been included in the closing inventory though lying with third party.

(b) Purchase of Motor Car:

(i) Ascertain whether the purchase of car has been properly authenticated.

(ii) Check invoice of the car dealer to confirm purchase price.

(iii) Examine registration with Transport Authorities to verify the ownership.

(iv) 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 23

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 inventory of inventories-

(i) Quantitative reconciliation of opening inventories, purchases, production, sales and closing inventories;

(ii) Comparison of closing inventory quantities and amounts with those of the previous year.

(iii) Comparison of the inventory turnover ratios for the current year with that of the previous year and with industry standards if available.

(iv) Comparison of the closing inventory (Raw materials, closing work-in-progress and finished goods are percentage of total inventories) with the corresponding figures of the previous year.

(v) Comparison of current year gross profit ratio of the previous year.

(vi) Comparison of actual inventory, purchase and sales figures with the budgeted figures if available.

(vii) Comparison of raw-material yield/wastage with previous year figures.

Question 24

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 143(1) of the Companies Act, 2013.

(viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

(b) Discounted 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 trade receivable 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.

(iv) Verify by reference to the Balance Sheet of the subsidiary company that the loan is duly reflected in the Balance Sheet as a loan due from the holding company.

(v) Amounts due to subsidiary companies may be on account of credit purchases at goods or services which should be verified with the relevant documentary evidences.

(vi) Confirm whether the provisions of section 189 of the Companies Act, 2013 (related to maintenance of register of contracts or arrangements), wherever applicable, have been complied with.

(vii) Verify that the loan has been properly reflected in the Balance Sheet as per the requirements of Schedule III to the Companies Act, 2013.

Question 25

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, 2016. In the month of March, 2016 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, 2016 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 2015-16 on the plea that the event of break down leading to repair expenditure had taken place in the financial year 2015-16, binding contract for repairs was entered into during the financial year 2015-16 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 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 2015-16, did not carry out the repair work and hence no liability has arisen as at 31-03-16 as there was no obligation. Thus, the provision made by X Ltd. for repair work as on 31-03-16 is not correct as there was no obligation.

(b) Valuation of Inventories: AS 2 "Valuation of Inventories" 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.

Further, as per clause (ii) of Para 3 of Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

Question 26

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 Statement of Profit and Loss 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 Statement of Profit & Loss 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 27

Write a short note 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 28

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, 2016, the project was not completed. The Directors of A Ltd. want to capitalize the interest upto 31st March, 2016 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 Statement of Profit and Loss in the current year.*

(d) *Finished goods costing worth ₹ 10 lacs were damaged due to floods in July, 2014. These goods were included in the closing inventory as on March 31, 2015 at an estimated* *realisable value of ₹ 4 lacs. These goods, ultimately, could be sold for ₹ 3 lacs only in the accounting year 2015-16. The difference of ₹ 1 lac was debited to prior period expenditure in the accounting year 2015-16.*

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 "Subsequent Events" 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 "Borrowing Costs" 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 the Statement of Profit & Loss.

(c) Recognition of Contract Revenue & Expenditure: As per AS 7 "Construction Contracts", 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 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", "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 2015-16 is a wrong accounting treatment.

Question 29

How will you verify/vouch the following:

(a) Loss of inventory by theft.

(b) Inventory lying with subcontractor for fabrication.

(c) Sale of empties.

(d) Expenditure for advertisement in newspaper.

Answer

(a) Loss of Inventory 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 inventory 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 inventory is not included in the closing inventory will be ensured.

(v) Verify whether such inventory was insured and whether theft claim was lodged with the insurance company.

(b) Inventory Lying With Sub-Contractors for Fabrication:

(i) The inventory lying with the sub contractor for processing should be confirmed by the confirmation letter obtained from the sub contractors.

(ii) The necessity of holding inventory by them should be vouched. If the inventory is lying with them for long, the reason for the same should be ascertained. The condition of the inventory should be confirmed by the management.

(iii) The inventory 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 inventory should be disclosed under the head current assets under the sub head inventory.

(v) Adjustment in accounts should be made for any discrepancies between inventory confirmed and inventory 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 inventory.

(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 30

Write a short note on "Provisions versus Specific Reserves".

Answer

Provisions 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 Statement of Profit and Loss 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 31

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:

(i) Verify articles of association for powers of the company to grant advances to director.

(ii) Verify the compliance of Section 185 of the Companies Act, 2013.

(iii) Check the bank book/cash book entries with vouchers.

(iv) Study the contract /loan agreement, terms, rate of interest and inquire whether they are prejudicial to the interest of the company.

(v) Check the confirmation received from the director for outstanding advances.

(vi) Check interest had been duly charged for the outstanding unless it is an interest free advance.

(vii) The loan or advances made to the directors should be distinctly shown in the balance sheet.

(viii) 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:

(i) Check the loan agreement, rate of interest, terms of security.

(ii) Check the remittances made during the year towards installments of repayments made.

(iii) Check the receipted voucher/account confirmation for the balance of outstanding.

(iv) The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.

(v) The gain or loss arising on exchange conversion is to be credited or debited to Statement of Profit and Loss in accordance with the Accounting Standard 11.

(vi) Check banker exchange rate chart for correctness of the conversion.

(vii) Check RBI or other agencies' permission for remittances outside India.

(c) Grant Received for Reimbursement of Revenue Expenditure:

(i) Check the amount of receipt, donor details etc. from relevant voucher.

(ii) Study the terms of grant for its utilization and check whether they had been complied with.

(iii) Check the nature of grant, amounts have been duly disclosed in accounts in accordance with Accounting Standard 12.

(iv) Check the provisions of law, if any, affecting foreign contributions if the grant comes from abroad.

(d) Deferred Tax Liability:

(i) The deferred tax liability is created when there is timing difference which results 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 a liability to pay more tax in future. This is called Deferred Tax Liability.

(ii) Check the creation of Deferred Tax Liability and its actual working.

(iii) Check how much Deferred Tax Liability is reversed during the year.

(iv) Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.

(v) Check that the provisions of AS 22 "Accounting for Taxes on Income" have been complied with.

Question 32

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 1.7.2015 and the new plant commenced commercial operations on 1.1.2016. The new plant was capitalized and shown as Fixed Asset as on 31.3.2016 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 31.3.2016 for the term loan taken from scheduled bank for financing the project which is repayable over five years commencing from 1.7.2016.

(iii) Salaries, welfare expenses of the plant engineers of the company for the period from 1.7.2015 to 31.12.2015 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 31.3.2015 at its General Meeting held on 30.6.2015. ABC Limited finalised its accounts for the year ended 31.3.2015 on 30.8.2015 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.

(b) AS Limited purchased on 1.4.2015 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 1.4.2015. When the company settled the liability on 18.7.2015, 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 18.7.2015.

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 31.12.2015 and is wrong for capitalizing it beyond 31.12.2015 i.e. till 31.3.2016.

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 30.6.2015 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.

(b) 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 the Statement of Profit & Loss in the year of settlement.

According to AS 11, 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 33

As an 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 - It 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 34

As an Auditor, comment on the following:

(a) Lehar Ltd. installed a new water treatment plant at its factory on 1.10.2015. 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 II to the Companies Act, 2013. During the year 2015-16, 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 2014-15 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 2015-16, Urja Ltd. waived off the balance 10% amount which was credited to Statement of Profit and Loss by Fire Ltd. as discount received.

Answer

(a) Depreciation Accounting: 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 different than that envisaged under the relevant statute (Schedule II to the Companies Act, 2013), justification for the difference shall be disclosed in its financial statement.

Hence, in the instance case, decision of Lehar Ltd., to write off the cost of water treatment plant over four years is absolutely correct as per AS-6, subject to justification.

However, the company has wrongly charged full year's depreciation during 2015-16 as per requirement of statute. The auditor should highlight this to the company and ask to rectify the same.

(b) Change in Price of Fixed Assets: 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 Statement of Profit & Loss 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 35

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, 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 36

How would you vouch/verify the following:

(a) Trade payables.

(b) Advances to suppliers.

Answer

(a) Trade Payables:

(i) Check the adequacy of cut off procedure to ensure that transaction of next period are not accounted and all transactions of year end are accounted.

(ii) Check posting in the bought ledger from books of prime entry.

(iii) Compare the balances in the schedule of trade payables with balances in bought ledger.

(iv) Compare the balances with the confirmation or statement of account received from trade payables.

(v) Pay special attention to long outstanding items and enquire about the reason thereof.

(vi) Verify subsequent payments and reversal entries in the bought ledger of year end entries.

(vii) See that trade payables are classified and shown in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.

(b) Advances to Suppliers:

(i) Examine the bought ledgers to ascertain the debit balance of trade payables and trace the corresponding entry to the cash/bank book.

(ii) Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.

(iii) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.

(iv) Obtain/resort to direct confirmation procedure.

(v) Ensure proper classification in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.

(vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

Question 37

How would you vouch/verify the following:

(a) Borrowings from Bank.

(b) Work in progress.

Answer

(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.

(viii) 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 Schedule III to the Companies Act, 2013.

Question 38

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 Statement of Profit and Loss ₹ 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 equipments and paid ₹ 10 lakh as advance. The hospital took ₹ 10 lakh as income in the Statement of Profit and Loss for the year.

Answer

(a) Treatment of Revaluation Reserve of Fixed Assets: 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) Treatment of Government Grant: 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 Statement of Profit & Loss 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.

In view 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 Statement of Profit & Loss and has distorted the Statement of Profit & Loss by treating the capital item as revenue. The audit should accordingly qualify the report.

Question 39

Write a 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 the provisions of AS 28 "Impairment of Assets" are followed.

Question 40

(a) A Limited Company has filed a suit against trade receivable 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) Subsequent Events:

(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) Using the Work of Management's Expert: 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 500 "Audit Evidence" clearly states that when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,

(i) Evaluate the competence, capabilities and objectivity of that expert;

(ii) Obtain an understanding of the work of that expert; and

(iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

If auditor finds that civil engineer cannot 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 41

How would you vouch/verify- Goods lying with third party?

Answer

Goods Lying With Third Party:

(i) The auditor should check that the materiality of the item under this caption included in inventories.

(ii) 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.

(iii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iv) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(v) The records, voucher/slips for the regulating the movement of inventory 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.

(vi) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vii) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(viii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

Question 42

Write a short note on "Physical attendance by auditor during inventory taking".

Answer

Attendance at Inventory Taking: According to SA 501 "Audit Evidence- Specific Considerations for Selected Items", management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.

Attendance at physical inventory counting involves-

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management's count procedures.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Observing the performance of management's count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

Performing test counts, for example by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Question 43

State the information to be disclosed in the financial statements according to the requirements of AS 6.

Answer

Requirements of AS 6: AS 6 "Depreciation Accounting" 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 44

As an auditor, comment on the MNR Co. Ltd. did not provide for depreciation during the financial year 2014-15 due to inadequacy of profits. The company declared dividend during the financial year 2015-16 without providing for the previous year's depreciation.

Answer

Payment of Dividend Without Providing for Arrears of Depreciation: Section 123(1) of the Companies Act, 2013, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring 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 2014-15 and 2015-16 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 123(1), the auditor should qualify his audit report.

Question 45

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 46

Write a short note 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 Dispatch Note showing the date and mode of dispatch 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 47

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 III 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 III to the Companies Act, 2013).

Question 48

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 49

Mention disclosure requirements of the following in the financial statements (in case of a company):

(a) Trade Receivables.

(b) Bank Balances.

Answer

(a) Disclosure Requirements of Trade Receivables in Financial Statements:

Note 6(P) of Part I of Schedule III to the Companies Act, 2013 requires that company shall disclose "Trade Receivables" in notes to accounts as follows:

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(1) Secured, considered good;

(2) Unsecured considered good;

(3) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(b) Disclosure Requirements for Bank Balance: As per Part I of Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head "Cash and Cash Equivalents" in Current Assets as:

(i) Balances with Banks.

(ii) Earmarked balances with banks (for example, for unpaid dividend).

(iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.

Question 50

Write short notes on 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 Statement of Profit & Loss. 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 Statement of Profit and Loss 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 on a straight line basis over the lease term;

(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 III to the Companies Act, 2013.

Question 51

What are the factors that are to be considered while designing a confirmation request?

Answer

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

(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 52

You are the auditor and examining the book debts of a company. Give some indications which lead to doubt about recovery as uncollectable debts from trade receivables 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 trade receivables have been repeatedly dishonoured.

(vii) The debt is under litigation, arbitration, or dispute.

(viii) The auditor becomes aware of unwillingness or inability of the trade receivable to pay the dues, e.g., a trade receivable 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.

Question 53

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 Statement of Profit and Loss against current revenue profit but the same could be set-off against existing revaluation reserve. Do you agree?

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. However, in arriving at divisible profits, the provisions of Section 123 of the Companies Act, 2013 read with the Companies (Declaration and payment of Dividend) Rules, 2014 should be kept in view. The carried over amount of loss and depreciation should be set off against current 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 Statement of Profit and Loss 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 and depreciation. Such a declaration will be violation of the provisions of Section 123 of the Companies Act, 2013. Hence, the opinion of the finance Manager of Belt Ltd. is not correct.

Question 54

How will you vouch and/or verify the following:

(a) Bank Overdraft.

(b) Patterns, Dies, Loose Tools, etc.

(c) Investment in the Shares and Debentures of Subsidiary.

Answer

(a) 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 inventories, 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 properly disclosed.

(b) Patterns, Dies, Loose Tools, etc.: Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such asset although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused inventory on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum inventory account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing inventory, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. It should be seen that the inventory does not include any worn out or defective articles the life of which has already run out.

(c) Investment in Shares and Debentures of Subsidiary:

(i) The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc.

(ii) All the particulars entered in the schedule should be verified with the relevant account in the General Ledger.

(iii) The auditor should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

(iv) The provisions contained in Part I of Schedule III to the Companies Act, 2013 requires that the shares held in a subsidiary should be shown separately.

(v) The shares or debentures of a subsidiary are valued at cost.

(vi) If the subsidiary has suffered a loss, then a provision for the proportionate part of the loss should be made in the accounts of the holding company.

Question 55

Describe "Analytical Review Procedures" in Audit. Briefly discuss analytical procedures for verification of trade receivables.

Answer

Analytical Review Procedure: As per SA 520, Analytical Procedure means analysis of financial information through analysis of relationship among financial and non-financial data. It includes comparison of the entity's financial information with comparable information with prior period, anticipated results of the entity like budgets etc. or expectations of auditor and similar industry information.

Therefore, an analytical review procedure assists the auditor in planning the nature, timing and extent of other audit procedures. It is an auditing procedure based on ratios among accounts and tries to identify significant changes. Analytical review procedures can be used in the consideration of risks and/or as direct tests of balances. When deciding whether to incorporate analytical review procedures into the examination program as substantive tests of balances, the examiner should consider the extent to which the underlying data should be tested.

Analytical Procedures in case of trade receivables: Following are the analytical review procedures which may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables-

(i) comparison of closing balances of trade receivables with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;

(iii) comparison of actual closing balances of trade receivables with the corresponding budgeted figures, if available;

(iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to trade receivables with similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to trade receivables with the industry norms, if available.

(vii) Check whether there is any change in credit policy of the organization.

(viii) Check the percentage of bad debts of previous years and current year.

(ix) Find the reasons of major variations in the estimated values and actual values.

These are only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of trade receivables. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgment of the auditor.

Question 56

How will you vouch/verify Intangible Assets?

Answer

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

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

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

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

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

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

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

Question 57

Discuss the recognition principles of contingent liability.

Answer

Recognition Principles of Contingent Liability: An enterprise should not recognize the contingent liability but it should be disclosed in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the obligation that is expected to be met by other parties is treated as contingent liability. Contingent liabilities are continuously assessed and if it becomes probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognized.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. An enterprise should disclose for each class of contingent liability at the balance sheet date:

(i) A brief description of the nature of the contingent liability, where practicable.

(ii) An estimate of the amount as per measurement principle.

(iii) Indication of the uncertainty relating to outflow.

(iv) The possibility of any reimbursement.

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

Exercise

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 trade payables 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 *How will you vouch and/or verify the following:*

   (a) *Inventories.*

   (b) *Sale of assets.*

4 *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.*

5 (a) *What are the general considerations for valuation and verification of assets?*

   (b) *What is Depreciation of Fixed Assets and why is it provided?*

7 The Company Audit – I

Question 1

Comment on the following situations:

(a) An auditor purchased goods worth ₹ 501,500 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) KBC & Co. a firm of Chartered Accountants has three partners, namely, Mr. K, Mr. B & Mr. C. Mr. K is also in whole time employment elsewhere and Mr. B & Mr. C. do not hold any audits in their personal capacity or as partners of other firms. The firm is offered the audit of a public company 'ABC Ltd.' and is already holding audit of 40 companies.

Answer

(a) Purchase of Goods on Credit by the Auditor: Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees.

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 five lakh, 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) Ceiling on Number of Company Audits: Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who is in full time employment elsewhere; or a person, or a partner of a firm holding appointment as its auditor, if such person, or partner is at the date of such appointment, or reappointment holding appointment as auditor of more than twenty companies ***other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore***.

In the given case, Mr. K, a partner in the firm KBC & Co., is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. As Mr. B and Mr. 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 40 ***other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore***, and in the given case company is already holding 40 audits, therefore, KBC & Co. can't accept the offer for audit of a public company 'ABC Ltd.'.

Question 2

At the AGM of ICI (P) 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 (P) Ltd. and the conditions to be complied for.

Answer

Appointment of New Auditor in Case of Resignation: Section 139(8) of the Companies Act, 2013 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.

The section provides that a casual vacancy shall be filled by the Board of Directors within 30 days. However, in case a casual vacancy has been created by the resignation of the auditor, the Board cannot fill in that vacancy itself, such appointment shall also be approved by the company at general meeting convened within 3 months of the recommendation of the board and then he shall hold office till the conclusion of the next annual general meeting.

In the instance case, Mr. X had been validly appointed and thereafter he had resigned. Consequently, the casual vacancy has been created on account of resignation.

Therefore, the Board of Directors will have to fill the vacancy within 30 days and such appointment shall be approved by the company at the general meeting within 3 months of the recommendations of the board. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

Question 3

Write a short note on Auditor's Lien.

Answer

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 nonpayment 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 128 of the Companies Act, 2013, 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. The company provides reasonable facility to auditor 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.

Further, as per SA 230 "Audit Documentation", "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.

Question 4

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, 2015, which assignment he accepted. Subsequently in January, 2016 he joined B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

(b) 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.

(c) While conducting the audit of a limited company for the year ended 31st March, 2016, the auditor wanted to refer to the Minute Book. The Board of Directors refused to show the Minute Book to the auditor.

Answer

(a) Disqualifications of an Auditor: Section 141(3)(c) of the Companies Act, 2013 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 (4) of Section 141 provides that an auditor who incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor.

In the present case, A, an auditor of Laxman Ltd., joined as partner with B, who is Manager Finance of Laxman Limited, has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited.

(b) 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 143 of the Companies Act, 2013. Further, remuneration is a matter of arrangement between the auditor and the shareholders. Section 142 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, 2013.

(c) Right of Access to Minute Book: Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company for conducting the audit.

Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the directors' minute book.

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 Book. In the absence of the Minute Book, the auditor may not be able to vouch/verify certain transactions of the company.

The refusal by Chairman to provide access to Directors' Minute Book shall constitute limitation of scope as far as the auditor's duties are concerned. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Question 5

Comment on the following:

(a) 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?

(b) 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

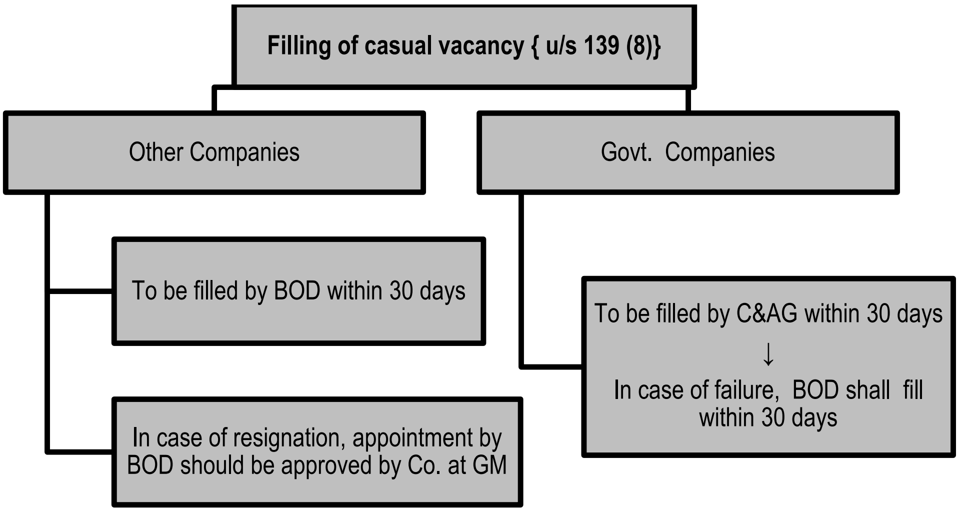
(a) Board's Powers to Appoint an Auditor: As per Section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within he said period the Board of Directors shall fill the vacancy within next 30 days.



In the given case, the Board of directors of X Ltd. has appointed Mr. Hari as the auditor due to resignation of the existing auditor(s). The appointment made by the Board is correct, however, such appointment should be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and newly appointed auditor shall hold office till the conclusion of the next annual general meeting.

(b) **Restrictions on Powers of Statutory Auditors:** Section 143(1) of the Companies Act, 2013 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.

Question 6

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 Statement of Profit and Loss 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 7

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 2015-2016. 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 & 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)(d)(i) of Section 141 of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, the relative may hold security or interest in the company of face value not exceeding ₹ 1 lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

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. Therefore, 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., because one of the partners Mr. Hanuman is holding equity shares of its subsidiary.

(b) Signature on Audit Report: Section 145 of the Companies Act, 2013 requires that the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company in accordance with the provisions of sub-section (2) of section 141 i.e. where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorized to act and sign on behalf of the firm.

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, 2013. If any auditor's report or any document of the company is signed or authenticated otherwise than in conformity with the requirements of Section 145, 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 8

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) The auditor of Trilok Ltd. did not report on the matters specified in sub-section (1) of Section 143 of the Companies Act, 2013, as he was satisfied that no comment is required.

(c) The members of C. Ltd. preferred a complaint against the auditor stating that he has failed to send the auditor's report to them.

(d) One of the directors of Hitech Ltd. is attracted by the disqualification under Section 164(2) of the Companies Act, 2013.

Answer

(a) Appointment of the First Auditor in the Case of Government Company: Section 139(6) of the Companies Act, 2013 lays down that the first auditor or auditors of a company, other than a Government Company, shall be appointed by the Board of directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

Hence, in the case of 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 Health and Wealth Ltd., is null and void.

(b) Comment on Matters Contained under Section 143(1) of the Companies Act, 2013: Section 143(1) 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 (1) 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 143(1).

(c) Dispatch of Auditor's Report to Shareholders: Section 143 of the Companies Act, 2013 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.

(d) Disqualification of a Director under section 164(2) of the Companies Act, 2013: Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under section 164(2) of the Companies Act, 2013. The auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by

Section 164(2).

Since in this case, one of the director is attracted by disqualification under section 164(2) of the Act, the auditor shall state in his report as per section 143 about the disqualification of the particular director.

Question 9

(a) 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?

(b) Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid?

(c) 'B' owes ₹ 5,01,000 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) 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.

(b) 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.

(c) Indebtedness to the Company: As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000 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 ₹ 5,00,000. 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 10

Write a short note on Audit enquiry under Section 143(1) of the Companies Act, 2013.

Answer

Audit Enquiry under Section 143(1) of the Companies Act, 2013: Auditor is required to make an enquiry and report under Section 143(1) of the Companies Act, 2013, if he is not satisfied in respect of the following matters-

(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 prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company 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 documents 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.

Question 11

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) Shifting of Books of Account: As per section 128(1) of The Companies Act 2013, 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 7 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, A Ltd. should maintain its books of account at its registered office at New Delhi. The Managing Director is not allowed to shift its books of account to Indore unless decision in this behalf is taken by the Board of Directors and a notice is also 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: As per Section 146 of the Companies Act, 2013, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

In the instant case, 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.

In view of above discussed provisions of section 146, the statutory auditor of the company should attend the general meetings either through himself or through his authorised representative.

Question 12

Briefly discuss the following with respect to applicable provisions under the Companies Act, 2013 and rules made there under:

(a) Maintenance of Cost Records

(b) Applicability of Cost Audit

(c) Non-applicability of Cost Audit.

Answer

Cost Records and Audit: The provisions related to cost records and audit are covered under section 148 of the Companies Act, 2013 read with Companies (Cost Records and Audit) Rules, 2014. The audit conducted under this section shall be in addition to the audit conducted under section 143 of the Companies Act, 2013.

The Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

(a) Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/industry/sector/product/service prescribed under the said rule are given below:

(A) Regulated Sectors-

(i) Telecommunication services made available to users by means of any transmission or reception of signs, signals, images etc. (other than broadcasting services) and regulated by the Telecom Regulatory Authority of India.

(ii) Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003, other than for captive generation.

(iii) Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board.

(iv) Drugs and Pharmaceutical.

(v) Fertilisers.

(vi) Sugar and industrial alcohol.

(B) Non-Regulated Sectors-

(i) Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items.

(ii) Turbo jets and turbo propellers.

(iii) Tyres and Tubes.

(iv) Steel

(v) Cement.

(vi) Production, import and supply or trading of following medical devices, such as heart valves; orthopaedic implants; pacemaker (temporary and permanent), etc. The rule excludes the foreign companies having only liaison offices.

The rules require the cost records to be maintained in Form CRA-1.

Additionally, as per clause (vi) to Paragraph 3 of the Companies (Auditor's Report) Order, 2016 [CARO 2016], where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

(b) Applicability of Cost Audit: Rule 4 of the Companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of cost audit depending on the turnover of the company as follows-

(1) Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 25 crore or more.

(2) Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is ₹ 100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is ₹ 35 crore or more.

The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

No person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.

It is provided that the auditor conducting the cost audit shall comply with the cost auditing standards.

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter X of the Companies Act, 2013 shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

(c) Non-applicability of Cost Audit: The requirement for cost audit under these rules shall not be applicable to a company which is covered under rule 3, and,

(i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or

(ii) which is operating from a special economic zone.

Question 13

State the matters to be specified in Auditor's Report in terms of provisions of Section 143(3) of the Companies Act, 2013.

Answer

Matters to be Specified in Auditor's Report: As per sub-section 3 of section 143 of the Companies Act, 2013, the auditor's report shall also state –

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(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 purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's Balance Sheet and Statement of Profit and Loss dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

Further, Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

Question 14

Give your comments on the following:

(a) Mr. X, a Director of KP Private Ltd., is also a Director of another company viz., GP Private Ltd., which has not filed the financial statements and annual return for last three years 2013-14 to 2015-16. Mr. X is of the opinion that he is not disqualified u/s 164(2) of the Companies Act, 2013, 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, the Auditor of A Ltd., have been considered for ratification by the members in the 4th general meeting as the sole auditor, where you were one of the joint auditors for the immediately preceding three years and the said joint auditors are not re-appointed.

(d) No Annual General Meeting (AGM) was held for the year ended 31st March, 2016, in XYZ Ltd., Ninu is the auditor for the previous 3 years, whether she is continuing to hold office for current year or not.

Answer

(a) Disqualification of a Director Under Section 164(2) of the Companies Act, 2013: Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director under section 164(2) of the Companies Act, 2013. As per provisions of Section 164(2), if a director is already holding a directorship of a company which has not filed the financial statements or annual returns for any continuous period of three financial years shall not be eligible to be reappointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

In this case, Mr X is a director of KP Private Ltd. as well as of GP Private Ltd., and, GP Private Ltd., has not filed the financial statements and annual return for last three years. Hence the provisions of section 164(2) are applicable to him and as such he is disqualified from directorship of both the companies. Therefore, the auditor shall report about the disqualification under section 143(3)(g) of the Companies Act, 2013.

(b) Appointment of a Practising CA as 'Tax Consultant': A chartered accountant appointed as an auditor of a company, should ensure the independence in respect of his appointment as an auditor, else it would amount to "misconduct" under the Chartered Accountants Act, 1949 read with Guidance Note on Independence of Auditors.

In this case, Mr. Aditya is a "Tax Consultant" and not a "Statutory Auditor" or "Tax Auditor" of ABC Ltd., hence he is not subject to the above requirements.

(c) Appointment of Sole Auditor: When one of the joint auditors of the previous years is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. As per sub-section 4 of section 140 of the Companies Act, 2013, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the said Act.

Accordingly, provisions of the Companies Act, 2013 to be complied with are as under-

(i) Ascertain that special notice u/s 140(4) of the Companies Act, 2013 was received by the company from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice not earlier than 3 months but at least 14 days before the AGM date as per Section 115 of the Companies Act, 2013 read with the Companies (Management and Administration) Rules, 2014.

(ii) 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 115 of the Companies Act, 2013 read with the Companies (Management and Administration) Rules, 2014.

(iii) 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.

(iv) The notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Companies Act, 2013.

(v) Verify whether any representation, received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(d) Tenure of Appointment: Section139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting. But in this regard it is to be noted that the company shall place the matter relating to such appointment of ratification by member at every 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 15

(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 45 companies and none of the partners are holding any audit in their personal capacity or as partners of other firms. The firm is offered 20 public company audits. Decide and advise whether PBS & Associates will exceed the ceiling prescribed under Section 141(3)(g) of the Companies Act, 2013 by accepting the above audit assignments?

Answer

(a) Appointment of First Auditor of Company: Section 139(6) of the Companies Act, 2013 lays down that the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company.

In the instant case, 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 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within 30 days 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: Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Act which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies ***other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore***.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

As 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 ***other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore***. But, the firm is already having audit of 45 companies. So the firm can accept the audit of 15 public companies only, which is well within the limit, specified by Section 141(3)(g) of the Companies Act, 2013.

Question 16

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 Under Section 140(1) of the Companies Act, 2013: 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 17

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) 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, 2016. The average net profits of the company for the last three years were 15 lakhs. Comment.

(c) AAS Limited had provided for doubtful debts to the extent of ₹ 23 lakhs during the year 2014-15. The amount had since been collected in the year 2015-16. Another debt of ₹ 25 lakhs had been identified to be doubtful during the year 2015-16. The Company made an additional provision of ₹ 2 lakhs during the year. The Statement of Profit and Loss for the year ended 31.3.2016 charged the same as 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 Statement of Profit and Loss under various heads explaining clearly the nature of the operations. The auditor of the company requires that the Statement of Profit and Loss 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) Donation to Charitable Institutions: Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent. of its average net profits for the three immediately preceding financial years.

In the instant 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. For excess of ₹ 25,000 the company is required to take prior permission in general meeting which is not been taken.

Conclusion: By paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence the auditor should qualify his audit report accordingly.

(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 Statement of Profit & Loss. This practice does not seem to be good as per AS 5. Company may show the net debit in Statement of Profit & Loss 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 "Segment Reporting", 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 18

M/s Seeman & Co. had been the company auditor for Amudhan Company Limited for the year 2015-16. 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. Comment.

Answer

Right of Access of Company Auditor for Branch Records: The audit of the branch of a company is dealt with in Section 143(8) of the Companies Act, 2013. 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 cannot 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.

Question 19

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 III to the Companies Act, 2013, 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 20

During the year 2015-16, 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?

Answer

Appointment of Branch Auditor: The Companies Act, 2013 leaves it to the company to designate or not to designate any establishment of the company as 'branch office'. Under the

Companies Act, 2013, only establishment "described as such by the company" shall be treated as a 'branch office'.

Further, as per Section 143(8) of the Companies Act, 2013, where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

It is provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

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.

Question 21

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 1.4.2016 due to differences of opinion among the partners. The Board of Directors of Old Ltd. in its meeting on 6.4.2016 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) Auditors to Attend General Meeting: According to Section 146 of the Companies Act, 2013, the auditor of a company are under an obligation 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.

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 146.

Thus, the action of the board of directors is contrary to the provisions of law and curtails the right of the auditor.

(b) Holding of Office in Case of Casual Vacancy: Section 139(8) of the Companies Act, 2013 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. Taking its natural meaning it may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firm etc.

Furthermore, Section 139(8) 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) Independence of Auditor: 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 auditorship 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 22

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.

(iv) Evaluation of evidence as valid or invalid, pertinent or not pertinent, sufficient or insufficient.

(v) Formulation of judgement as to the fairness of the assertions under consideration.

Question 23

State the basic elements of the Auditor's Report.

Answer

Basic Elements of the Auditor's Report: As per SA 700 "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 24

When does an auditor issue unqualified opinion and what does it indicate?

Answer

Unqualified Opinion: 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 25

Under what circumstances the retiring Auditor cannot be reappointed?

Answer

Circumstances where Retiring Auditor Cannot be Reappointed: In the following circumstances, the retiring auditor cannot be reappointed-

(i) A specific resolution has not been passed to reappoint the retiring auditor.

(ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.

(iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.

(iv) He has given to the company notice in writing of his unwillingness to be reappointed.

(v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.

(vi) 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 141(3)(g) of the Companies Act, 2013.

Question 26

Write short notes 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.-

(1) Books of A/c’s of the company seized by IT authorities.

(2) 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 27

Write a 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 28

As an auditor comment on the following:

(a) On 31.3.2016 inventory taking by Identity Ltd. revealed an inventory of ₹ 50 crores at its godown. Due to a fire on 1st April, 2016, inventory 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 31.3.2016 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.

(d) Mr. D is a director of X Ltd. and Y Ltd. On 30th June, 2015, 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, 2015 as related party transactions.

Answer

(a) Subsequent Event: 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 Subsidiary 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) Charging 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 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.

Thus, the auditor may suitably qualify the report stating that depreciation has not been provided.

(d) Disclosure of Related Party Transaction: 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, 2015 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. ***Even though X Ltd. has***

correctly identified and disclosed the related party transactions, the auditor need to report under clause (xiii) of CARO, 2016 about whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards.

Question 29

Comment on the following:

(a) 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.

(b) 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.

(c) Mr. Amar, a Chartered Accountant, bought a car financed at ₹ 7,00,000 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) Compliance with Standards on Auditing: As per sub-section 9 of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further as per sub-section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

It is provided that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

Further, 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.

(b) Appointment of Auditor in the Case of Government Company: According to Section 2(45) of the Companies Act, 2013, 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 company of such a Government Company.

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.

As per section 139 of the Companies Act, 2013, the auditor of a government company shall be appointed by the Comptroller and Auditor General of India.

Nickson Ltd. is a subsidiary company of Ajanta Ltd. Hence Nickson Ltd. covers in the definition of a government company. Thus, the Auditor of Nickson Ltd. can be appointed only by C&AG.

Therefore, appointment of 'P' is invalid and 'P' should not give acceptance to the Directors of Nickson Ltd.

(c) Indebtness to the Holding Company: According to section 141(3)(d)(ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of any company, if he is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5 lakh.

In the given case Mr. Amar is disqualified to act as an auditor under section 141(3)(d)(ii) as he is indebted to Chaudhary Finance Ltd. for more than ₹ 5,00,000. Also according to Section 141(3)(d)(ii), 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 30

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 Statement of Profit and Loss for the year ended March 31, 2016. Comment.

Answer

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 Statement of Profit and Loss 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 Statement of Profit and Loss over useful life of asset in proportion in which depreciation will be charged on the assets concerned. Deferred income pending its apportionment to Statement of Profit and Loss should be disclosed in the Balance Sheet with a suitable description i.e. Deferred Government Grant.

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 Statement of Profit & Loss.

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.

Question 31

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 128(1) of The Companies Act 2013, 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 7 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 Firm: 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 32

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 33

Discuss the following:

(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: Section 141(3)(g) of the Companies Act, 2013 prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies ***other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore***.

In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

(b) Filling of a Casual Vacancy: As per Section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within he said period the Board of Directors shall fill the vacancy within next 30 days.

(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 34

White Star Ltd. was incorporated on 01.08.2015 and Mr. T, who is a relative to the Chairman & Managing Director (CMD) of the Company, appointed as auditor by the Board of Directors in their meeting on 04.09.2015. 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 139(6) of the Companies Act, 2013, the first auditor of a company shall be appointed by the Board of Directors within 30 days from 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 30 days from the registration of company because the date of incorporation of White Star Ltd. is 01-08-2015 and the date of appointment of auditors by the Board of Directors is 04-09-2015.

Accordingly if the Board fails to appoint the first auditor, it shall inform the members of the company, who shall within 90 days at an extraordinary 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 & Managing Director (CMD) becomes redundant.

Question 35

Mr. A was appointed auditor of AAS Ltd. by Board to fill the casual vacancy that arose due to death of the auditor originally appointed in AGM. Subsequently, Mr. A also resigned on health grounds during the tenure of appointment. The Board filled this vacancy by appointing you through duly passed Board resolution. Comment.

Answer

Filling of a Casual Vacancy: Section 139(8) of the Companies Act, 2013 provides that any casual vacancy in the office of an auditor shall be filled by the Board of Directors within 30 days. However, if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

In the present case, the auditor Mr. A resigned and the vacancy had been filled in by Board. But, the vacancy caused by resignation cannot be filled by Board itself, such appointment shall also be approved by the company at general meeting.

The fact that the Mr. A was appointed by Board originally is a matter irrelevant in this situation. If the cause of vacancy is resignation, then the power of appointment shall vest with the general meeting only. As such, the appointment made by Board is invalid.

Question 36

Comment on the following situations:

(a) Mr. X, a shareholder of the company pointed out that:

  (i) The goodwill in the Balance Sheet of the company has appeared on same figure during the past three years.

  (ii) Premium received on issue of shares prior to the date of Balance Sheet has been transferred to Statement of Profit and Loss for arriving at the figure of commission payable to the managing director.

(b) ABC Company Ltd. removed its First Auditor before the expiry of his term without obtaining approval of the Central Government.

Answer

(a) (i) Disclosure of Intangible Assets in the Books of Accounts: As per the provisions of AS 26 "Intangible Assets", an intangible assets should be carried in the books at cost less accumulated amortization and accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a reputable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use according to Para 63 of AS 26. In the given case, the company has not amortized any value of goodwill since past three years. The auditor should have indicated this fact in his report that no amount of goodwill has been written off during the past three years.

(ii) Treatment of Premium Received on Issue of Shares*:* Premium received on issue of shares is capital receipt and should not be credited to Statement of Profit and Loss. As per the provisions of Section 198 of the Companies Act, 2013 on calculation of profits, premium on issue of shares should not be considered in computation of net profit. The same need to be complied with for the purpose of managerial remuneration. The auditor should have qualified the audit report and qualified the amount by which the profit stands inflated.

(b) Removal of Auditor Before Expiry: As per sub-section (1) of Section 140 of the Companies Act, 2013, an auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the prior approval of the Central Government in that behalf as per Rule 7 prescribed under Companies (Audit & Auditors) Rules, 2014:

(i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(ii) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.

(iii) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

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

In the instant case, the first auditor was removed by the company before the expiry of his term without obtaining approval of the Central Government.

Therefore, it may be concluded that the action of the company for removal of the auditor before expiry of term is not justified and auditor may be removed from his office only by following the above mentioned procedure.

Question 37

C Ltd. declared dividend amounting to ₹ 5 lacs out of Profits for the year ended 31.3.2016. Subsequently, it was noticed that company had failed to make provisions for outstanding expenses of ₹ 7.80 lacs and closing stock was also overvalued, which was not reported by *auditors of the company. Management of C Ltd. held auditors responsible for this situation. Comment.*

Answer

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 of ₹ 7.80 lacs and by overvaluation of closing stock and based on such inflated profit the company has declared and paid dividend of ₹ 5.00 lacs. Thus it can be said that dividend has been paid out "inflated profit" and not out of "real profit". If there is insufficient profit after above adjustment of outstanding expenses and correction of stock valuation and there is no past reserve, it would amount to payment of dividend out of capital.

It was the duty of auditor to ascertain whether the Balance Sheet and Statement of Profit and Loss 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 various items of Balance Sheet and Statement of Profit and Loss. The auditor should have checked whether all the outstanding expenses have been provided or not and whether closing stock has been properly valued as per AS-2. If he was not satisfied, he should have issued a qualified report or adverse report. In the instant case he has failed to do so, he will be guilty of gross negligence in the performance of his duty.

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 38

Audit Committee is to be formed by each and every company and the auditor has right to vote in the meeting of such Audit Committee. Comment.

Answer

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

(i) all public companies with a paid up capital of ten crore rupees or more,

(ii) all public companies having turnover of one hundred crore rupees or more,

(iii) all public companies having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

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

Question 39

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. Comment.

Answer

Indebtness to the Subsidiary Company: As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding ₹ 5,00,000, then he is not qualified for appointment as an auditor of a company.

Where an auditor purchases goods or services from a company audited by him or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, whether in normal course of business, he is definitely indebted to the company and if the amount outstanding exceeds ₹ 5,00,000, he is disqualified for appointment as an auditor of the company. In such a case, he becomes indebted to the company and consequently he has deemed to have vacated his office.

In the given case, Sri & Company, a firm of Chartered Accountants was appointed as statutory auditors of Aaradhana Company Ltd. where the company 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.

Accordingly, the partner Mr Sri is not disqualified to be appointed as auditor of the company as he is indebted to the company for an amount not exceeding ₹ 5,00,000.

Due to this, Sri & Company, is not disqualified to be appointed as an auditor of Aaradhana Company Ltd.

Question 40

What are the various types of companies covered under Companies (Auditor's Report) Order, 2016 [CARO, 2016]?

Answer

Types of Companies Covered Under CARO, 2016: The Companies (Auditor's Report) Order, 2016 is an additional reporting requirement Order which has been issued by the Central Government in consultation with the Institute of Chartered Accountants of India under section 143(11) of the Companies Act, 2013. The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2O13. However, the Order specifically exempts the following class of companies-

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

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

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;

(v) a small company as defined under clause (85) of section 2 of the Companies Act; and

(vi) ***a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.***

It may be noted that the Order shall not apply to auditor's report on consolidated financial statements.

Question 41

Mr. Y was appointed as an auditor of PQR Ltd. for the year ended 31.3.2016 at the Annual General Meeting held on 16.08.2015. Mr. Y has been indebted to the company for sum of ₹ 5,10,000 as on 01.04.2015, 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 10.8.2015. One of the shareholders, complains that the appointment of Mr. Y as an auditor was invalid because he incurred disqualification u/s 141 of the Companies Act, 2013. Comment.

Answer

Indebtness to the Company: According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding ₹ 5,00,000 shall be disqualified to act as an auditor of such company and he should vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, Mr. Y was appointment as an auditor of PQR Ltd. for the year ended 31.03.2016 at the Annual General Meeting held on 16.08.2015. He repaid the loan amount fully to the company on 10.8.2015 i.e. before the date of his appointment.

Hence, the appointment of Mr. Y as an auditor is valid and the shareholder's complaint is not acceptable.

Question 42

State the circumstances which could lead to any of the following in an Auditor's Report:

(a) A modification of opinion

(b) Disclaimer of opinion

(c) Adverse opinion

(d) Qualified opinion.

Answer

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

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

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

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

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

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

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

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

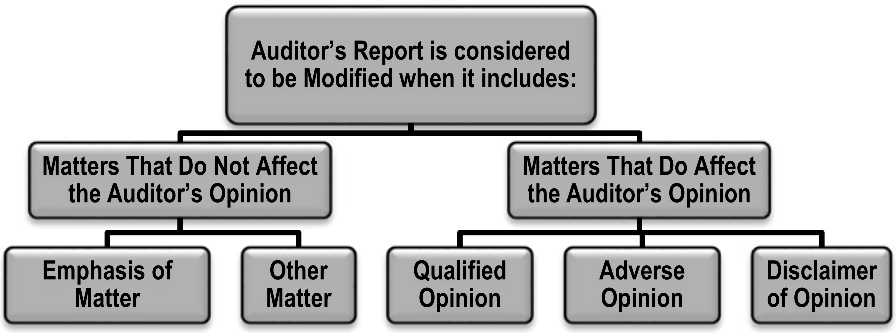
(ii) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Question 43

What are Modified Reports? Discuss disclosure pattern when the auditor includes an Emphasis of Matter paragraph in the Auditor's Report.

Answer

Modified Reports: As per SA 705 “Modifications to the Opinion in the Independent Auditor’s Report”, an auditor’s report is considered to be modified when it includes-



(a) Matters That Do Not Affect the Auditor’s Opinion

- ✓ emphasis of matter
- ✓ Other Matter

(b) Matters That Do Affect the Auditor’s Opinion

- ✓ qualified opinion
- ✓ disclaimer of opinion
- ✓ adverse opinion

Therefore, Modified Reports can be of two types (a) Matters that do not affect auditor’s opinion (b) Matters that do affect auditor’s opinion.

The auditor shall modify the opinion in the auditor’s report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Further, as per SA 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”, the inclusion of an Emphasis of Matter paragraph in the auditor’s report does not affect the auditor’s opinion. When the auditor includes an Emphasis of Matter paragraph in the auditor’s report, the auditor shall:

(i) Include it immediately after the Opinion paragraph in the auditor’s report;

(ii) Use the heading “Emphasis of Matter”, or other appropriate heading;

(iii) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and

(iv) Indicate that the auditor’s opinion is not modified in respect of the matter emphasised.

Examples:

- ❖ An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- ❖ Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
- ❖ A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 44

"Provisions regarding rotation of auditors affect only specific class of companies". Discuss.

Answer

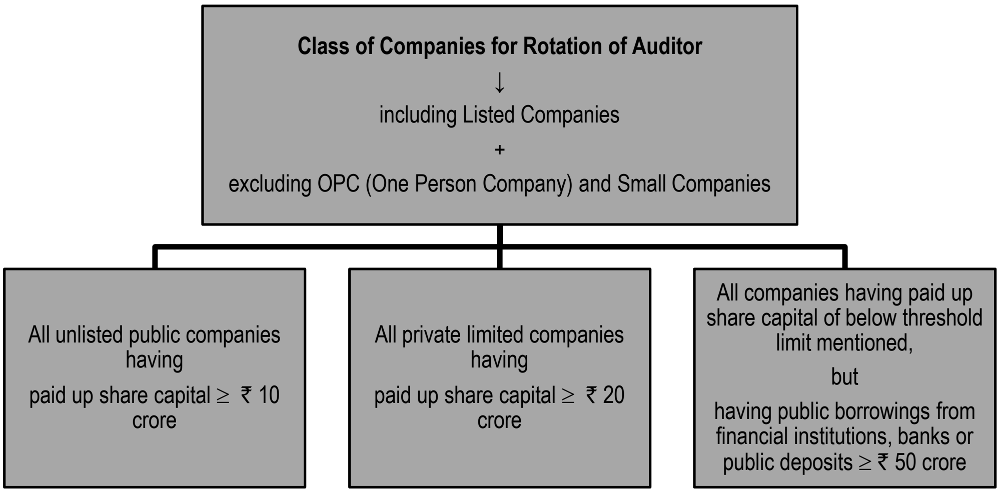
Applicability of Provisions Related to Rotation of Auditors: The provisions related to rotation of auditor as provided under section 139(2) of the Companies Act, 2013 are applicable to all listed companies and other class or classes of companies as prescribed under Companies (Audit and Auditors) Rules, 2014.

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

(i) all unlisted public companies having paid up share capital of ₹ 10 crore or more;

(ii) all private limited companies having paid up share capital of ₹ 20 crore or more;

(iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ₹ 50 crores or more.



Question 45

State the disclosure required to be made in the financial statements if these do not comply with the accounting standards.

Answer

Deviations from Accounting Standards: According to Section 129(5) of the Companies Act, 2013, if the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements the following namely-

(i) the deviation from the accounting standards,

(ii) the reasons for such deviation, and

(iii) the financial effects, if any, arising out of such deviation.

Question 46

Explain the following:

(a) Appointment of First Auditor of a Non-Government Company.

(b) Appointment of First Auditor of a Government Company.

(c) Appointment of Subsequent Auditor of a Non-Government Company.

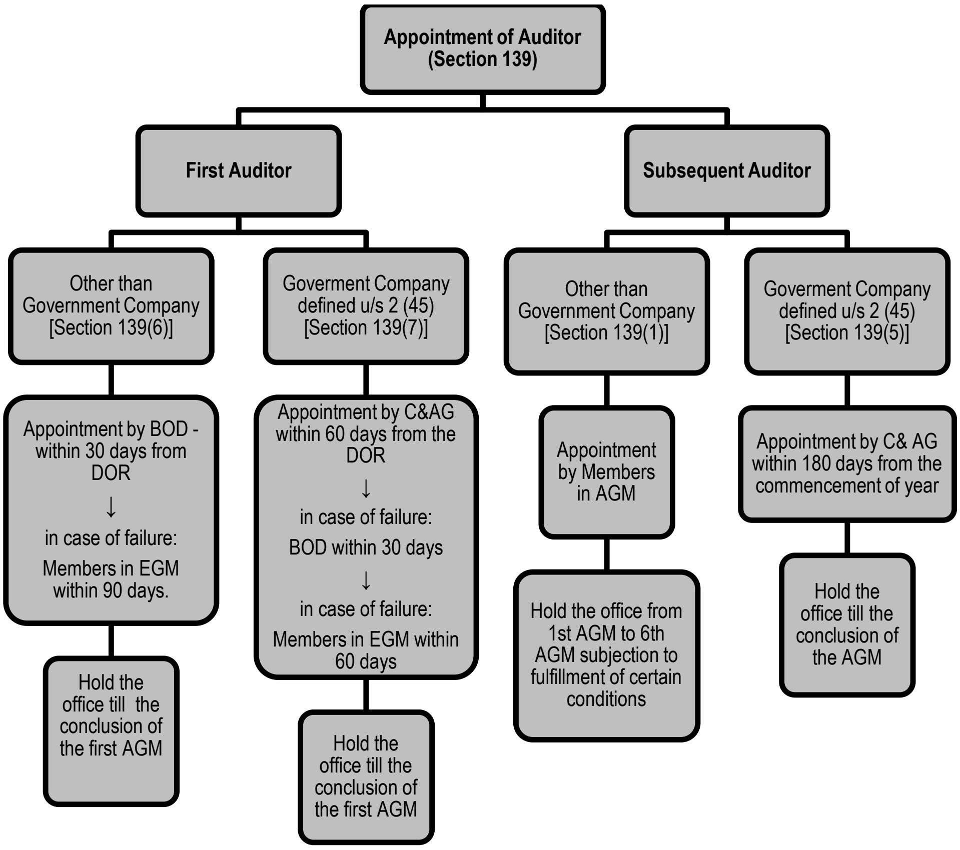
(d) Appointment of Subsequent Auditor of a Government Company.

Answer

Appointment of Auditors: Section 139 of the Companies Act, 2013 contains provisions regarding appointment of Auditors. Provisions related to appointment of auditors may be grouped under two broad headings-

I Appointment of First Auditors.

II Appointment of Subsequent Auditors.



(a) Appointment of First Auditor of a Non-Government Company: As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

(b) Appointment of First Auditor of a Government Company: Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

(c) **Appointment of Subsequent Auditor of a Non-Government Company:** As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

(d) **Appointment of Subsequent Auditor of a Government Company:** As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Question 47

State with reasons (in short) whether the following statements are correct or incorrect:

(i) ***The auditor shall not modify the opinion in the auditor's report.***

(ii) ***The first auditor of a Government company was appointed by the Board in its meeting after 10 days from the date of registration.***

(iii) ***Director's relative can act as an auditor of the company.***

(iv) ***If an LLP (Limited Liability Partnership Firm) is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor.***

(v) ***AB & Co. is an audit firm having partners Mr. A and Mr. B. Mr. C, the relative of Mr. B is holding securities having face value of ₹ 2,00,000 in XYZ Ltd. AB & Co. is qualified for being appointed as an auditor of XYZ Ltd.***

(vi) ***The auditor of a Ltd. Company wanted to refer to the minute books during audit but board of directors refused to show the minute books to the auditors.***

(vii) ***Manner of rotation of auditor will not be applicable to company A, which is having paid up share capital of ₹ 15 crores and having public borrowing from nationalized bank of ₹ 50 crore because it is a Private Limited Company.***

(viii) ***The auditor should study the Memorandum and Articles of Association to see the validity of his appointment.***

(ix) ***Managing director of A Ltd. himself appointed the first auditor of the company.***

(x) A Chartered Accountant holding securities of S Ltd. having face value of ₹ 950 is qualified for appointment as an auditor of S Ltd.

(xi) Mr. N, a member of the Institute of Chartered Accountants of England and Wales, is qualified to be appointed as auditor of Indian Companies.

(xii) The auditor has to report to Central Govt. within 90 days of his knowledge of an offence involving fraud.

Answer

(i) Incorrect: The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(ii) Incorrect: According to section 139(7) of the Companies Act, 2013, in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. If CAG fails to make the appointment within 60 days, the Board shall appoint in next 30 days.

(iii) Incorrect: As per section 141(3) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.

(iv) Incorrect: As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorised to act and sign on behalf of the firm.

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

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

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

(vii) Incorrect: According to section 139 of the Companies Act, 2013, the provisions related to rotation of auditor are applicable to all private limited companies having paid up share capital of ₹ 20 crore or more; and all companies having paid up share capital of below threshold limit mentioned above, but having public

borrowings from financial institutions, banks or public deposits of ₹ 50 crore or more.

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

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

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

In addition, the auditor should study the appointment letter & the prescribed Form submitted to the Registrar of the Companies to see the validity of his appointment.

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

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

(x) Incorrect: As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if he is holding any security of or interest in the company.

As the chartered accountant is holding securities of S Ltd. having face value of ₹ 950, he is not eligible for appointment as an auditor of S Ltd.

(xi) Incorrect: A person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

It may be noted that a firm whereof majority of partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

Thus, Mr. N is disqualified to be appointed as an auditor of Indian Companies.

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

Question 48

State the manner of rotation of auditors on expiry of their term.

Answer

Manner of Rotation of Auditors on Expiry of their Term: *Prescribed manner of rotation of auditors on expiry of their term is given below-*

(1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.

(2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.

(3) For the purpose of the rotation of auditors-

(i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;

(ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

The term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Further, for the purpose of rotation of auditors,-

(a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;

(b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.

(4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

Question 49

The auditor's report is considered to be modified under certain circumstances. Discuss.

Answer

Modified Report: *An auditor's report is considered to be modified when it includes -*

(A) Matters That Do Not Affect the Auditor's Opinion

(i) Emphasis of Matter paragraph: Sometimes the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements.

(ii) Other Matter paragraph: If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report and this is not prohibited by law or regulation, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter", or other appropriate heading.

(B) Matters that Do Affect the Auditor's Opinion

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

(1) 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

(2) 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.

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

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

The auditor shall modify the opinion in the auditor's report when:

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

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

Exercise

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 Accounts Receivables, as they had been covered in the Directors Report.*

   (c) *While conducting the audit of a company for the year ended 31st March, 2016 the auditor called for the General Ledger for the year ended 31 March 2013 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, 2016, 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.*

8 The Company Audit – II

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 an 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

"Credit for the profit arising out of a hire-purchase sale was fully adjusted in the year of sale". Comment.

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 Statement of Profit and Loss 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 accounts receivable" for purposes of disclosure in the Balance Sheet.

Question 3

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 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) Subsidy Received by the Company: The accounting treatment of 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 Company had received a subsidy of ₹ 1 crore, for establishing an undertaking in the backward/notified area. 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 4

"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 189 in terms of section 184(2) or section 188 of the Companies Act, 2013. While auditing the company accounts, the auditor is required to verify such transactions.

Further, as per clause (iii) to Paragraph 3 of the Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor is also required to report whether the company has entered into transaction with the parties covered in the register to be maintained under section 189 of the Companies Act, 2013.

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 189.

In such a case, the auditor should obtain the necessary information regarding the every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement or proposed contract or arrangement entered into or to be entered into-

(a) with a body corporate in which such director or such director in association with any other director, holds more than two per cent shareholding of that body corporate, or is a promoter, manager, Chief Executive Officer of that body corporate; or

(b) with a firm or other entity in which, such director is a partner, owner or member, as the case may be,

shall disclose the nature of his concern or interest at the meeting of the Board in which the contract or arrangement is discussed and shall not participate in such meeting.

It may be noted that where any director who is not so concerned or interested at the time of entering into such contract or arrangement, he shall, if he becomes concerned or interested after the contract or arrangement is entered into, disclose his concern or interest forthwith when he becomes concerned or interested or at the first meeting of the Board held after he becomes so concerned or interested. However, while reporting on it, the auditor should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register.

Question 5

Write a short note on Sweat Equity Shares.

Answer

Sweat Equity Shares: As per section 54 of the Companies Act, 2013, 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-

(a) the issue is authorised by a special resolution passed by the company;

(b) the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(c) not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and

(d) where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

Question 6

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."

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.

However, the 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 128(1) of the Companies Act, 2013. 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 7

State briefly, how you will audit the following in a joint stock company:

(a) Issue of shares for consideration other than cash.

(b) 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) 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 143(1) of the Companies Act, 2013. 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) 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. SH-7 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 8

In carrying out the "Share Transfer Audit" of your client, what aspects would be required to be examined by you as an auditor?

Answer

Share Transfer Audit: As per section 56 of the Companies Act, 2013 read with Rule 11 of the Companies (Share Capital and Debentures) Rules, 2014, the following aspects are required to be examined by the auditor in conducting the share transfer audit-

(i) No transfer of securities or the interest of a member takes place in case of a company having no share capital, other than the transfer between persons both of whose names are entered as holders of beneficial interest in the records of a depository.

(ii) Check where an instrument of transfer of securities held in physical form is in Form No.SH.4 duly stamped, dated and executed by or on behalf of the transferor and the transferee and specifying the name, address and occupation, if any, of the transferee has been delivered to the company by the transferor or the transferee within a period of sixty days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

(iii) Check where the instrument of transfer has been lost or the instrument of transfer has not been delivered within the prescribed period, the company registers the transfer on such terms as to indemnity as the Board may think fit.

(iv) Company has the power to register, on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted.

(v) Where an application is made by the transferor alone and relates to partly paid shares, examine that the transfer is not registered, unless the company gives the notice of the application in Form No. SH.5 to the transferee and the transferee gives no objection to the transfer within two weeks from the receipt of notice.

(vi) Examine that the company, unless prohibited by any provision of law or any order of Court, Tribunal or other authority, delivers the certificates of all securities allotted, transferred or transmitted:

(a) within a period of two months from the date of incorporation, in the case of subscribers to the memorandum;

(b) within a period of two months from the date of allotment, in the case of any allotment of any of its shares;

(c) within a period of one month from the date of receipt by the company of the instrument of transfer under sub-section (1) or, as the case may be, of the intimation of transmission under sub-section (2), in the case of a transfer or transmission of securities;

(d) within a period of six months from the date of allotment in the case of any allotment of debenture.

(vii) where the securities are dealt with in a depository, examine that the company intimates the details of allotment of securities to depository immediately on allotment of such securities.

(viii) If there any default made in complying with the provisions. Verify the amount of fine paid.

Question 9

Explain 'Option on Share Capital'.

Answer

Option on Share Capital: Schedule III to the Companies Act, 2013 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;

(iv) Other contracts, such as for supply of capital goods and/or merchandise.

[Requirements of Schedule III to the Companies Act, 2013]:
As per Schedule III to the Companies Act, 2013, 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 Schedule III to the Companies Act, 2013
• 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 10

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, 2016 has placed an order with Globe Machinery Limited, Bombay for a machinery costing ₹ 20 lakhs against cash payment during the month of June, 2016. The company has added a foot-note to the Balance Sheet as at 31st March, 2016 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 cannot 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 11

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 distribution 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-

(i) The Articles of the company permit such a distribution,

(ii) It has been realised in cash.

(iii) 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 (i) and (ii) above. This is because AS 10 requires that any profit on sale of fixed asset has to be routed through the Statement of Profit and Loss. 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 Schedule III to the Companies Act, 2013 have been complied with.

[Requirements of Schedule III to the Companies Act, 2013]:
As per the Schedule III to the Companies Act, 2013, 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 and 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 12

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) **Treatment of 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 Statement of Profit and Loss 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 Statement of Profit and Loss should be charged 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 Statement of Profit and Loss 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 13

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.

Thus, the auditor should ensure compliance with all these requirements and in case of failure he should qualify the report.

(d) Utilisation of Share Premium: Section 52 of the Companies Act, 2013 deals with application of premium received on issues of shares. Section 52(1) requires 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. Section 52(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;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under Section 68.

Thus, it is clear from the above that share premium can be utilised only for specific purposes. Further, section 123 of the Companies Act, 2013 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 14

Comment on the following:

(a) Asian Overseas Oil Ltd.'s oil wells were damaged in Iraqi war in November, 2015. 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 2015-16 accounts.

(b) Trade receivables of a company as a 31-3-16 include ₹ 10 lakhs from M/s Unreliable Traders, who have been declared as insolvent on 4-4-2016.

Answer

(a) Non-Provision of Losses: As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability 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.

Further, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

As per SA 570 "Going Concern", there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. 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 is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

In the instant case, as per AS 29 the company should made provision. Further, proper disclosure explaining the loss incurred and the subsequent position relating to the situation should be made. In case of failure, the auditor may issue a qualified report.

(b) Non-provision of Trade Receivables on Account of Insolvency: According to AS 4, "Contingencies and Events Occurring after the Balance Sheet Date", any significant event occurring after the date Balance Sheet date but before the date of approval of financial statements by the Board requires adjustments to assets/liabilities as on the date of Balance Sheet in case additional evidence is available in respect of conditions existed on the date of the Balance Sheet. In this case, the trade receivables' balance has to be suitably adjusted since conditions existed on the date of the Balance Sheet in respect of which additional evidence has been provided by the insolvency of M/s Unreliable Traders.

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.

Question 15

Ganga-Kaveri Project Ltd. was incorporated on 1.7.2015. During the year ended 31.3.2016 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 and Loss or any other statement except a Balance Sheet as at 31.3.2016. Comment.

Answer

Preparation of Financial Statements: Section 128 of the Companies Act, 2013 requires every company to prepare its financial statements for every financial year which gives a true and fair view of the state of the affairs of the company and such books shall be kept on accrual basis, and according to the double entry system of accounting. Further, the definition of "financial statement", given under section 2(40) of the Companies Act, 2013, includes balance-sheet, statement of profit and loss, cash flow statement, a statement of change in equity if applicable and explanatory note as annexure.

In the given 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.

Though the company did not carry any manufacturing or trading activity, 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 Statement of Profit and Loss. Therefore, the contention of the Chief Accountant is not correct.

Question 16

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 Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head "Cash and Cash Equivalents" in Current Assets as:

(i) Balances with Banks.

(ii) Earmarked balances with banks (for example, for unpaid dividend).

(iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.

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

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

Question 17

Z Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31st March, 2016:

	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 "Statement of Profit and Loss" on the assets side of the Balance Sheet. Comment.

Answer

Debit Balance of Statement of Profit and Loss: Part I of Schedule III to the Companies Act, 2013 requires that the 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.

Hence, the accumulated loss of ₹ 40 lakhs should be presented as negative figure in Part I of Schedule III. In the present case, the disclosure requirements of Schedule III to the Companies Act, 2013 have not been followed and, accordingly, the auditor should modify his report.

Requirements of Schedule III to the Companies Act, 2013:
As per Schedule III to the Companies Act, 2013, 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*
General Instructions for Reserve and Surplus under Schedule III to the Companies Act, 2013
(i) 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)*
>
> *(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.*
>
> *(iii) 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 18

Write a short note on Capital Redemption Reserve.

Answer

Capital Redemption Reserve: As per Section 55 of the Companies Act, 2013, where preference shares are proposed to be redeemed out of the profits of the company, there shall (out of such profits) be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve to be called the Capital Redemption Reserve Account. The provisions of the Companies Act, 2013, 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 unissued 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 III to the Companies Act, 2013.

Question 19

Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2015-16 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2015-16 was less charged by ₹ 75 lacs on account of arithmetical error on the part of Insurance Company. Bonafide Ltd. paid the said sum of ₹ 75 lacs during the accounting year 2015-16 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 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 20

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 of Profit and Loss. 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 21

What are the special considerations in an audit of a Limited Company?

Answer

Special Consideration in an Audit of a Limited Company:

(i) 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.

(ii) 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.

(iii) Compliance with relevant provisions of the Companies Act, 2013 relating to share capital; provision relating to Board provisions relating to accounts and audit, etc.

(iv) Compliance with provisions relating to Sections 139 to 146 of the Companies Act, 2013.

Question 22

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.

(iv) Where partly paid shares are forfeited for non-payment of call and re-issued as fully paid, the compliance of the provisions of Section 53 of the Companies Act, 2013 is essential as issuance of shares at discount other than sweat equity share are void.

Question 23

Strong Ltd. holding 60% of the equity shares in Weak Ltd. purchased goods worth ₹ 50 Lakhs from Weak Ltd. during the financial year 2015-16. 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

Disclosure of Related Party Transaction: As per definition given in the AS 18 "Related Party Disclosure" parties are considered to be related if at any time during the reporting period 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.

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

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

Question 24

Explain the Director's responsibility statement in brief.

Answer

Director's Responsibility Statement: According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. However, the provisions related to Director's Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

(i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) 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 and loss of the company for that period;

(iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) the directors had prepared the annual accounts on a going concern basis;

(v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.

    Here, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and

(vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

Question 25

TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, has 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

Appropriateness of Going Concern Assumption: As per SA 570 on "going concern", when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor's judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.

To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources.

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 26

Discuss in brief the power of Company to buy backs its own Securities.

Answer

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

(i) its free reserves; or

(ii) the securities premium account; or

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

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

The other important provisions relating to the buyback are-

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

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

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

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

(c) the buy-back is equal or less than 25% of the total paid-up capital and free reserves of the company:

It may be noted that in respect of the buy-back of equity shares in any financial year, the reference to 25% shall be construed with respect to its total paid-up equity capital in that financial year.

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

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

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

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

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

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

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

(iii) The buy-back may be—

(a) from the existing shareholders or security holders on a proportionate basis; or

(b) from the open market; or

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(iv) Where a company has passed a special resolution under clause (b) of Sub-section (2) or a resolution under item (ii) of the proviso thereto, to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any.

However, no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

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

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

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

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

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

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

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

Schedule III to the Companies Act, 2013 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 27

Breifly discuss the provisions of the Companies Act, 2013 with regard to issue of shares at a discount.

Answer

Issue of Shares at a Discount: According to Section 53 of the Companies Act, 2013, except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Question 28

C Ltd. declared dividend amounting to ₹ 5 lacs out of Profits for the year ended 31.3.2016.

Subsequently, it was noticed that company had failed to make provisions for outstanding expanses of ₹ 7.80 lacs and Closing stock was also overvalued, which was not reported by auditors of the company. Management of C Ltd. helds auditors responsible for this situation. Comment:

Answer

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 & Statement of Profit and Loss 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 Statement of Profit and Loss & 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 29

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

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 whether the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on such application have been received by the company.

(vi) Check that the amount payable on the application on every security is not less than five percent of the nominal amount of security or such other percentage or amount as may be prescribed by the SEBI.

(vii) If the stated minimum amount has not been subscribed and the sum payable on subscription is not received within a period of thirty days from the date of issue of the prospectus or such period as my be specified by the SEBI, check that the amount received above is returned within a period of fifteen days from the closure of the issue and if in case the amount is not repaid within such period, the directors in default shall jointly and severally be liable to repay that amount with interest at the rate of fifteen percent per annum.

(v) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

Question 30

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 and section 71 of the Companies Act, 2013, 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 31

Discuss the audit procedure for verification of payment of dividends.

Answer

Verification of Payment 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 123 of the Companies Act, 2013. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf.

(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 and the amount of CDT, if applicable. Verify the casts and crosscast 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) 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". 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.

(ix) In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of 7 years from the date of such transfer shall be transferred to Investor Education and Protection Fund.

(x) Ensure the compliance, in case dividend is paid in case of inadequate profits.

Question 32

Anandbhai & Co. Ltd. issued shares to the equity shareholders in the proportion of one bonus share for every three existing shares. As an auditor of the Company, how would you verify this issue?

Answer

Verification of Issue of Bonus Shares: Section 63 of the Companies Act, 2013 allows a company to issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like -

(i) it is authorised by its articles;

(ii) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(iv) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(v) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(vi) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same;

(vii) the bonus shares shall not be issued in lieu of dividend.

Exercise

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*

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 Statement of Profit and Loss is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet.*

(c) *Trade receivables 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.*

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: Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within

	sixty days from the date of receipt of the audit report have a right to, (a) conduct a **supplementary audit** of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, 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 Comptroller and Auditor-General of India may direct; and (b) **comment upon or supplement such audit report:** It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report. **Test Audit:** Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

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 Inventory 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

Audit of an Entity from Incomplete Records: 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 trade receivables. 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 trade payables' 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: Role of C&AG is prescribed under sub-section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the

Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to,

(i) conduct a **supplementary audit** of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, 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 Comptroller and Auditor-General of India may direct; and

(ii) **comment upon or supplement such audit report**: It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Audit of Government Companies

Section 143(5)
↓
Appointment of auditor by C&AG as per section 139(5) or 139(7)
+
Directions by C&AG, the manner in which accounts shall be audited
+
Submission of Auditor's Report to C&AG including-
* Directions issued, if any
* Action taken thereon
* Impact on Accounts

Section 143(6)
↓
C&AG's right to-
*Conduct supplementary audit
* Comment upon or supplement such audit report

Section 143(7)
↓
C&AG may, by an order, cause test audit

Question 6

Draft an Audit Programme to audit the accounts of a Recreation Club with facilities for indoor games and in-house eating.

Answer

Audit Programme to Audit the Accounts of a Recreation Club:

(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, 2013 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 inventory 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 inventory of unsold provisions and stores, at the end of the year should be verified physically and its valuation checked.

(vii) Check the inventory of furniture, sports material and other assets physically with the respective inventory 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: NGOs 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. NGOs can also be incorporated as a company under section 8 of the Companies Act, 2013. 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 counterfoil 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) **Inventory in Hand:** Verify inventory 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 Inventory -** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory 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, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

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 Inventory 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, 2013.

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, 2013 are applicable.

Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company or any other company owned or controlled, directly or indirectly, 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, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to,

(i) conduct a **supplementary audit** of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, 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 Comptroller and Auditor-General of India may direct; and

(ii) **comment upon or supplement such audit report**: It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

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 C&AG. 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.

Question 13

What special steps will you take into consideration in auditing the accounts of a hotel?

Answer

Auditing the Accounts of a Hotel: 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, inventory 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 inventory 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) **Inventory:** The inventories 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 inventories must be properly documented.

(b) Areas where inventories 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 inventories on a continuous basis throughout the year.

(e) The auditor should ensure that all inventories 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 inventory 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 inventory of edibles, control over issue and physical inventory 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.

Question 14

(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:

(i) **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.

(ii) **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.

(iii) **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.

(iv) **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.

(v) **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.

(vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

(i) **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.

(ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.

(iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.

(v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(vi) **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:

(i) Evaluate the internal control system regarding entry and collection for entry tickets including rotation of staff.

(ii) Ensure that tickets are pre numbered.

(iii) Ensure that the deposit of cash collected into the bank account very same next day.

(iv) Compute analytical ratios in respect of the receipts pattern i.e. on weekends, 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 inventory 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) inventory of tickets is kept in proper custody.

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

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

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

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

(vi) Cross check the entertainment tax deposited.

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

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

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

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

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

(xii) Confirm that depreciation on machinery and furniture has been charged 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&AG 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

Auditing Income and Expenditure Account of a Charitable Institution Running a Hospital: 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 a short note 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

State the background of "Local Bodies". Draft an audit programme for conducting audit of accounts of a Local Body.

Answer

Background of Local Bodies: A municipality can be defined as a unit of local self-government in an urban area. By the term ‘local self-government’ is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees.

Audit Programme for 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 -

(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

Examination of Income and Collection of Fund by an NGO: 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

What steps would you take in to consideration in Auditing the receipts from patients of a Hospital?

Answer

Auditing the Receipts from Patients of a Hospital: Following are the steps to be considered-

(i) Examine the internal check system as regards the receipts of bills from the patients.

(ii) Vouch the register of patients with copy of bills issued to them.

(iii) Verify bills for a selected period with the patient's attendance record to see that the bills have been correctly repaired.

(iv) See that bills have been issued to all the patients according to the rules of the hospital.

(v) Check cash collections as entered in the cash book with the receipts, counterfoils and other evidence.

(vi) 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 24

Briefly explain the powers of C&AG in connection with the performance of his duties.

Answer

Powers of Comptroller and Auditor General: The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 gives the following powers to the C&AG 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 25

What are the special audit points to be considered by the auditor during the audit of a Hospital?

Answer

Audit of Hospital: The audit points to be considered by the auditor during the audit of a Hospital are stated below-

(i) **Income from Services**: 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) **Collection of Cash**: 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) **Income from Investments**: 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) **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) **Reconciliation of Subscriptions**: 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) **Authorisation and Sanctions**: 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) **Grants and TDS**: 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) **Budgets**: 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) **Internal Check**: 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 Inventory Register and that issues have been made only against proper authorisation.

(x) **Depreciation**: See that depreciation has been written off against all the assets at the appropriate rates.

(xi) **Registers**: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) **Inventories**: 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.

(xiii) **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Question 26

What procedure may be adopted by an auditor while auditing leasing transactions entered into by the leasing company?

Answer

In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor:

(i) The object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.

(ii) Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.

(iii) The lease agreement should be examined and the following points may be noted:

(1) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).

(2) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

(3) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.

(4) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

(iv) Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.

(v) Ensure that the invoice is retained safely as the lease is a long-term contract.

(vi) Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.

(vii) See the Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.

(viii) See that the copies of the insurance policies have been obtained by the lessor for his records.

Question 27

"Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG." Discuss.

Answer

Audit of Stores and Inventories: Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out. The aim is also to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

The audit of purchase of stores is conducted in the same manner as audit of expenditure, namely, that these are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority. The auditor has to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

Accounts of receipts, issues and balances are checked regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

Question 28

State the important objectives of local body's audit.

Answer

Objectives of Audit of Local Bodies: The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are-

(i) reporting on the fairness of the content and presentation of financial statements;

(ii) reporting upon the strengths and weaknesses of systems of financial control;

(iii) reporting on the adherence to legal and/or administrative requirements;

(iv) reporting upon whether value is being fully received on money spent; and

(v) detection and prevention of error, fraud and misuse of resources.

Exercise

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 *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.*

3 *Discuss the provision of the Constitution of India to safeguard the independence of the Comptroller and auditor General of India.*