8. VERIFICATION OF ASSETS AND LIABILITIES

PART – 1: AUDIT OF TANGIBLE FIXED ASSETS

Q.No.1.What are the General Principles of Verification of Assets. (A) (PM,MTP-M17)

GENERAL PRINCIPLES OF VERIFICATION OF ASSETS:

1. **Title deeds and other documents:**
   - **a)** Examine the title deeds and Register of Fixed assets to see whether the client holds the title on the balance sheet date.
   - **b)** If the asset is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them.
   - **c)** Physical inspection should be done at some periodical intervals. Sometimes physical inspection is not possible, e.g. goods lying with consignee. Then certificating of such parties should be obtained.
2. **Original cost and valuation:**
   - **a)** The cost of fixed assets including any additions should be verified with the invoice of supplier together with evidence in respect of other incidental expenses chargeable to the account, including installation expenses.
   - **b)** In case if self constructed assets or additions, verify the basis on which the expenditure has been allocated should be verified and also a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.
   - **c)** See that the fixed assets 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.
3. **Depreciation:**
   - **a)** The cost of fixed assets should be appropriately depreciated in accordance with AS 10 “Property, Plant and Equipment” and Schedule II to Companies Act, 2013.
   - **b)** When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.
4. **Repairs and renewals:** Ensure repair expenditure which increases the earning capacity of the asset should be capitalised to the asset and current repairs should be taken statement of profit and loss.
5. **Sale of assets:** When an asset is sold, its sale-proceeds should be vouched by reference counterfoil of the receipt issued to the purchaser. Capital profits should be transferred to capital reserve. However, the profit limited to the original cost or a loss should be transferred to the Statement of Profit and Loss.
6. **Proper disclosures:** Ensure the disclosure requirements of Schedule III to the Companies Act, 2013 shall also be complied with.

MASTER MINDS

Q.No.2. Building (A) (PM, M 14 – 4M)

Refer above answer Q.No.1

Q.No.3. Plant and Machinery (B)

Refer above answer Q.No.1

Q.No.4. Lease Hold Property / Assets Acquired On Lease. (A)
(PM, N14, N 11 - 4M, N09 – 5,M17-4M)

1. **Lease deeds and other documents:**
   - **a)** Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions.
   - **b)** Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with. E.g. maintenance of lease and property in satisfactory state etc.
   - **c)** A lease exceeding the period of one year is not valid unless it has been registered by an instrument (section 107 of the Transfer of Property Act, 1882). Hence this has to be ensured.
2. **Original cost and valuation:**
   - **a)** Ensure that the cost of the lease including any legal expenses incurred to acquire the lease is amortised over the unexpired term of the lease.
   - **b)** Verify relevant document to check the cost of property.
     - **i)** In case of 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;
     - **ii)** In case of finance lease, ensure all the substantial risks and rewards to ownership are transferred, considering the indication as prescribed in AS-19, and 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.
3. **Proper disclosures:**
   - **a)** Ensure the disclosure requirements of Schedule III to the Companies Act, 2013 shall also be complied with.
   - **b)** Ensure assets acquired under finance lease are segregated from the assets owned.
4. **Special points:**
   - **a)** He should ascertain that the clause entitles the lessee to sub let any part of the leased property and examine the counterpart of the tenants' agreements, if any.
   - **b)** 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.

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Q.No.5. Assets Acquired on Hire Purchase. (A) (N 14 RTP, N 13 – 4M)

1. Examine the Board's Minute Book approving the purchase on hire-purchase terms.
2. 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.
3. Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount.
4. Verify that initial recognition of lease should be as an asset and a liability at equal amounts.
5. 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.
6. Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

7. 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.

SIMILAR QUESTIONS:

1. **Machinery acquired under hire – purchase System:**

(PM, M17MTP, N 14 RTP,RTP-M17)

A. Refer above answer

Q.No.6. Furniture, Fittings and Fixtures (B)

1. The cost of these assets should be verified by reference to the invoices of suppliers.
2. The entire expenditure incidental to their purchase also should be debited to the appropriate asset account.
3. Further, the auditor should carefully scrutinise the details of the cost of additions debited to these accounts so as to ascertain that only the cost of genuine additions has been debited to such accounts.
4. In the case of assets in regard to which there is a danger of loss through pilferage, there should be a satisfactory system of inventory control over them.
5. It requires that each article of furniture is entered in a Inventory Register before its price is paid and the inventory number under which it is entered is painted over it also and at the end of each period, an inventory is prepared and reconciled with the Inventory Register and
6. Costs of all the articles which becomes unserviceable or have been lost is written off under proper authority.
7. Ensure disclosure requirements of Schedule III have been complied with.

MASTER MINDS

Q.No.7. Purchase of Motor Car, Motor Lorries, Vans, Etc.: (B) (PM)

1. Ascertain whether the purchase of car / lorry / vans has been properly authorized.
2. The cost of these assets should be verified by reference to the invoices of suppliers and their ownership confirmed from permit and Registration Books.
3. Ensure that all expenses relating to purchase of car have been properly capitalized and the same have been disclosed properly in the balance sheet.
4. The auditor should also verify that the vehicles are covered by a comprehensive policy of insurance.
5. Check whether adequate depreciation has been provided in respect of each of them.
6. In case the number of vehicles is large, there should be a Vehicle Register similar to the Plant Register.
7. Ensure disclosure requirements of Schedule III have been complied with.

Q.No.8. Assets abroad. (B) (PM)

1. Examine the title deeds of immovable properties abroad.
2. Ensure that the immovable properties abroad have been properly classified and disclosed.
3. 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.

4. Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.
5. The auditor should state in his report whatever evidence has been produced for his verification.

Q.No.9. Capital Work - in - Progress. (B) (PM)

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-

1. Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.
2. Obtain the break up in details of the amount shown in the Balance Sheet under this head.
3. Check purchase cost of plant machinery or other assets with reference to the contract with, and amount paid to the suppliers.
4. Examine the allocation of common costs to the Capital Work-in-Progress in case such items have been constructed internally.
5. Ensure that the assets already put to commercial use are not included under Capital Work -in - Progress.
6. Verify that only expenses incurred up to pre commissioning stage are capitalized under this head.
7. 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.
8. 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.

MASTER MINDS

SIMILAR QUESTIONS:

1. **Contracts in course of completion.**

A. Refer above answer.

PART – 2: AUDIT OF INTANGIBLE ASSETS

Q.No.10. Intangible Assets (B) (PM, N15 – 4M)

MEANING: 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. For example: goodwill, patents, copyright etc.

VERIFICATION ASPECTS:

1. An intangible asset should be measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortization and any impairment losses.
2. 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.
3. 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.

4. 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.
5. 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 or as an intangible asset under AS 26, judgement is required to assess as to which element is predominant.
6. Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

Q.No.11. Goodwill (B) (PM)

MEANING: 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. Goodwill should be recorded in the books, only when some consideration in money or money's worth has been paid for it.

ASPECT TO BE CONSIDERED FOR VERIFICATION OF GOODWILL:

1. 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.
2. 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.
3. 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.
4. 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.
5. 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.
6. Ensure that the goodwill not yet written off has been properly disclosed as per Schedule III requirements.
7. See that the goodwill is being amortised as per financial prudence over a reasonable period.

MASTER MINDS

Q.No.12. Patents (A)

1. Obtain schedule of Patents duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.
2. The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent.
3. Examine the written agreement in case of assignment of patents and Assignment Deed in case of transfer of trade marks. Also ensure that patents have been duly registered.
4. The cost of a patent includes it purchase price and the registration cost if brought outright.
5. If the patent has been developed by the client in-house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalized.
6. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed.

7. The auditor should ensure that patents are being shown at cost less amortisation charges.
8. The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter.
9. AS-26 has suggested ten years as useful life until and unless there is clear evidence that useful life is longer than ten years.
10. Ensure disclosure requirements of schedule III has been complied with.

Q.No.13. Trademarks (A) (N14 RTP)

Same answer as in Q.No. 12

Q.No.14. Copy Rights (A) (N14 RTP)

Same answer as in Q.No. 12

SIMILAR QUESTIONS:

1. **Trade Marks and Copyrights? (PM, M17 MTP, N14 RTP, M17- 4M,RTP-M17)**

A. Refer Q.No 12 in above.

PART – 3: AUDIT OF INVESMENTS

Q.No.15. Investments (B) (PM)

MASTER MINDS

1. Obtain schedule of investments to verify the description of investment, date of purchase, face value, book value, market value, rate of interest, etc.
2. The auditor should ascertain whether the transactions for the purchase/sale of investments are made by proper authority.
3. The acquisition / disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc. to see whether they are purchased or sold cum-dividend, ex-dividend, cum – interest / ex - interest, cum rights/ex-rights or cum bonus / ex - bonus.
4. The auditor should examine whether in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.
5. The auditor should see title deeds of immovable properties and see that same have been properly classified.
6. Where the amount of purchases or sales of investments are substantial, the auditor should check the prices paid/received with reference to stock exchange quotations.
7. The auditor should also physically inspect investments. In case investments are not held by the entity in its own custody - then certificate should be obtained from the relevant authority to the effect of holding of investments.
8. In case investments are held otherwise than in the name of the entity, e.g. in the name of nominees/trustees, the auditor should ascertain the reasons for the same and examine relevant documentary evidence.
9. The auditor should also examine the relevant provisions of section 143(1) of the Companies Act, 2013 when investments are sold at less than cost.
10. Ensure compliance with AS 13 "Accounting for Investments" and disclosure requirement of schedule III.

SIMILAR QUESTIONS:

1. **Purchase of Quoted investments.** **(PM)**

A. Same as above

Q.No.16. Investment in Shares and Debentures of Subsidiary. (A) (PM, N14 - 4M)

1. 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.
2. All the particulars entered in the schedule should be verified with the relevant account in the General Ledger.
3. 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.
4. 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.
5. The shares or debentures of a subsidiary are valued at cost.
6. 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.

MASTER MINDS

PART – 4: AUDIT OF CURRENT ASSETS

Q.No.17. Verification of Inventory. (B)

1. **Examination of records:** The auditor should examine the records maintained by the management with respect to inventory showing in respect of each major item the receipts, issues and balances with reference to the relevant basic documents e.g., goods received notes, , material issue notes, bin cards, etc..
2. **Attendance at inventory-taking:** It involves,
   - **i)** Inspecting the inventory to ascertain its existence and evaluate its condition.
   - **ii)** Performing test counts;
   - **iii)** Observing compliance with management's instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
   - **iv)** Obtaining audit evidence as to the reliability of management's count procedures.
3. **Obtaining confirmations from third parties**: Where significant inventories of the entity are held by third parties, the auditor should examine that whether such holding is proper and obtain confirmations from those third parties by reference to SA 505, "External Confirmation".
4. **Examination of valuation and disclosure:**
   - **a)** The auditor should satisfy himself that the
     - valuation of inventories is in accordance with the normally accepted accounting principles as dealt with in Accounting Standard (AS) 2, of 'Valuation of Inventories' and is on the same basis as in the preceding year.
     - inventories have been disclosed properly in the financial statements in accordance with Schedule III

b) the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realisable value.

5. **Analytical review procedures:** It involves analysis of trends and ratios of inventories to identify any abnormal deviations including investigation of those deviations. For example comparison of Current year closing inventory, gross profit ratio with previous years etc.

6. **CARO Requirements:** 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.

Q.No.18. State the different types of analytical review carried out in Verification of Inventories. (A) (PM, M17- 6M)

ANALYTICAL PROCEDURES FOR VERIFICATION OF INVENTORIES:

The auditor can adopt the following analytical procedures to verify the inventory of inventories-

1. Quantitative reconciliation of opening inventories, purchases, production, sales and closing inventories;
2. Comparison of closing inventory quantities and amounts with those of the previous year.
3. Comparison of the inventory turnover ratios for the current year with that of the previous year and with industry standards if available.
4. 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.
5. Comparison of the relationship of current year inventory quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year
6. Comparison of current year gross profit ratio of the previous year.
7. Comparison of yield with the corresponding figure for the previous year
8. Comparison of actual inventory, purchase and sales figures with the budgeted figures if available.
9. Comparison of raw-material yield/wastage with previous year figures.
10. Comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry and with the industry norms.

The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

MASTER MINDS

Q.No.19. Work in Progress. (A)
(PM, N14 RTP, M17 MTP, M17 4M , M13 4M, M15 - 4M, RTP-M17)

1. Involve a technical expert in verification and valuation of WIP, if necessary.
2. Ensure that cost sheets are duly attested by the works manager.
3. Test the correctness of the cost sheet by verification quantities, cost of material wages and other charges with reference to the record.
4. Verify stage of completion with component of cost involved with underlying records.

5. Compare the unit cost as shown by the cost sheet with standard cost for any large variations.
6. Ensure that the allocation of overhead expenses has been made on reasonable basis, same as used in earlier period and that total of the overhead expenses does not include any amount in respect of selling distribution and office expenses. .
7. Compare the cost-sheet in detail with that of the previous year both in regard to the composition of cost and the value placed on various components. If they vary materially, investigate the causes thereof
8. 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.

Q.No.20. Goods / Inventory lying with third party (A) (PM, RTP N17, N 15 RTP)

1. The auditor should check that the materiality of the item under this caption included in inventories.
2. 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.
3. Adjustment in accounts should be made for any discrepancies between inventory confirmed and inventory sent out as per memorandum records.
4. 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.
5. The goods lying with them for the very long period would merit auditors' special attention for making provision.
6. 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.
7. The excise gate pass, entry in such records, information in returns, be also cross verified.
8. 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.
9. The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.
10. Check that the disclosure requirements as specified in Schedule III to the Companies Act, 2013 and AS 2 "Valuation of Inventories" have been followed.

MASTER MINDS

SIMILAR QUESTIONS:

1. **Inventory Lying With Sub-Contractors for Fabrication.** **(PM)**
2. **The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year.** **(PM)**

A. Refer above answer for both the questions.

Q.No.21. Trade Receivables or Book Debts (B) (PM, RTP M16)

1. The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the trade receivables balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

2. The auditor should check the agreement of balances as shown in the schedules of trade receivable with those in the ledger accounts. Any differences in this regard should be examined.
3. The following are some of the indications of doubtful and uncollectible debts, loans and advances:
   a) The terms of credit have been repeatedly ignored.
   b) There is stagnation, or lack of healthy turnover, in the account etc.
4. While examining the schedules of trade receivables with reference to the trade receivables' ledger accounts, the auditor should pay special attention to the following aspects:
   a) The auditor should examine whether the age of the debts has been properly determined.
   b) Whether provisions for allowances, discounts and doubtful debts should recognise that even though a trade receivable may have confirmed the balance due by him, he may still not pay the same.
   c) Verification of subsequent realizations.
5. Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.
6. In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized.
7. The auditor should examine whether bills discounted with bank have been clearly shown as contingent liability.
8. **Direct confirmation from debtors:**
   a) The auditor should obtain direct confirmation from the debtors to ascertain whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak.
   b) The trade receivables may be requested to confirm the balances 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.
   c) The form of requesting confirmation from the trade receivables may be either
      i) the 'positive' form of request, wherein the trade receivable is requested to respond whether or not he is in agreement with the balance shown, or
      ii) the 'negative' from of request wherein the trade receivable is requested to respond only if he disagrees with the balance shown.
   d) Any discrepancies revealed between the confirmations received and the books of account, and then the entity should be asked to investigate and reconcile the discrepancies.
9. Ensure the disclosure requirements of Schedule III have been complied with.

MASTER MINDS

SIMILAR QUESTIONS:

1. **Receipt from accounting receivable** **(RTP M16)**

A. Refer above answer

Q.No.22. 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. (A) (PM, M12 - 8M)

<u>INDICATIONS OF DOUBTFUL AND UNCOLLECTIBLE DEBTS</u>: 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:

1. The terms of credit have been repeatedly ignored.
2. There is stagnation or lack of healthy turnover in the account.
3. Payments are being received but the balance is continuously increasing.
4. Payments though being received regularly, are quite small in relation to the total outstanding balance.
5. An old bill has been partly paid (or not paid), while later bills have been fully settled.
6. The cheques received from the trade receivables have been repeatedly dishonoured.
7. The debt is under litigation, arbitration, or dispute.
8. 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.
9. Amounts due from employees, which have not been repaid on termination of employment.
10. Collection is barred by statute of limitation.

MASTER MINDS

Q.No.23. Describe "Analytical Review Procedures" in Audit. Briefly discuss analytical procedures for verification of trade receivables. (A) (PM, M 14 – 8M)

<u>ANALYTICAL REVIEW PROCEDURE:</u>

- 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.

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-

a) Comparison of <u>closing balances</u> of trade receivables with the corresponding figures for the previous year;

b) Comparison of the relationship between <u>current year</u> <u>trade receivable balances</u> and the current year <u>sales with</u> the corresponding <u>budgeted figures</u>, if available;

c) Comparison of <u>actual closing</u> balances of trade receivables with the corresponding <u>budgeted figures</u>, if available;

d) Comparison of current year's <u>ageing schedule</u> with the corresponding figures for the previous year;

e) Comparison of significant ratios relating to trade receivables with similar ratios for other firms in the same industry, if available;

f) Comparison of significant ratios relating to trade receivables with the industry norms, if available.

g) Check whether there is any change in credit policy of the organization.

h) Check the percentage of bad debts of previous years and current year.

i) 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.

Q.No.24. Bills Receivable. (B)

1. The auditor should inspect the schedule of bills in hand and agree their total with the balance in the Bills Receivable Account.
2. The auditor should vouch the entries in cash with respect to the bills that have become matured and cash has been received on such bills.
3. If some bills were discounted, then vouch the entries made in the books and also the collection of their proceeds should be verified.
4. Where a number of bills are found to have been discounted before the close of the year the auditor should see that the amount of the bills so discounted is shown as a contingent liability on the Balance Sheet.
5. Where a new bill is reported to have been taken in lieu of a bill which has matured, the auditor should inspect the bill.
6. If some of the bills are with bankers for collection, the auditor should obtain a certificate from them.
7. Generally, it will be the duty of the auditor to ensure that the bills were properly drawn and stamped and that they were not dishonoured. Where some of the bills were dishonoured, the auditor should ensure that they have been noted and protested.
8. Ensure the disclosure requirements of Schedule III have been complied with.

MASTER MINDS

Q.No.25. Verification of Loans and Advances (B)

1. Obtain a list of all advances and compare them with balances in the ledger.
2. Ascertain that the advances were made under proper authority and were being recovered regularly by agreed installments.
3. Wherever there is an agreement the same should be inspected.
4. In the case of old balances, ensure that adequate provision has been made in respect of irrecoverable advances.
5. Examine the Loan Agreement and the acknowledgement from parties of the Amount outstanding.
6. Loans and advances granted as per requirements of AOA and MOA.
7. **Compliance of Section 143 (1):**

   a) The auditor should enquire whether the loans and advances made by the company based upon security has been properly secured and whether the terms are prejudicial to the interest of the company.

b) The auditor should also check whether loans and advances given are shown as deposits.

8. Security for loans and advances should be verified on the basis of supporting documentation. For example, mortgage deed, deed of hypothecation, title deeds deposited by borrower etc.

Q.No.26. Advances to Suppliers: (A) (PM, MTP N17)

1. Examine the bought ledgers to ascertain the debit balance of trade payables and trace the corresponding entry to the cash/bank book and also pay particular attention to the age of the balances.
2. Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.
3. Examine that the advances have not been shown as deposits in balance sheet as per Section 143(1) of the Companies Act, 2013.
4. Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.
5. Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.
6. Ensure proper classification in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.
7. Pay special attention to long outstanding advances and enquire about the reason thereof and check as to whether any of them would require provisioning.

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Q.No.27. Advance given to a Director of a Company. (B) (PM)

1. Verify articles of association for powers of the company to grant advances to director.
2. Verify the compliance of Section 185 of the Companies Act, 2013.
3. Check the bank book/cash book entries with vouchers.
4. Study the contract /loan agreement, terms, rate of interest and inquire whether they are prejudicial to the interest of the company.
5. Check the confirmation received from the director for outstanding advances.
6. Check interest had been duly charged for the outstanding unless it is an interest free advance.
7. The loan or advances made to the directors should be distinctly shown in the balance sheet.
8. Check the related party transaction with director is disclosed in notes to the account (as per AS 18.

Q.No.28. Cash in Hand: (B)

1. Check whether the following balances are included under the head "Cash in hand"
   a) cash balance in hand;
   b) petty cash balance in hand;
   c) balances of stamps in hand;
   d) cash in transit;

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e) cash at branches; and

f) cash with agents;

The first three of the above mentioned items are verified by actual count. The remaining balances should be verified from documentary evidence available and subsequent remittances.

2. The cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice to know any chances of frauds or misappropriations especially in the form of teeming and lading.
3. If there are more than one cash balances, e.g., when there is a cashier, a petty cashier, a branch cashier, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others.
4. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared containing details of the cash balance counted.
5. If cashier is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash. Such an attempt is known to have been made in the past.
6. If the auditor is unable to check the cash balance on the date of the Balance Sheet, he should arrange with his client for all the cash balance to be banked. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at the close of the year.
7. In case banking the cash is not possible, the auditor should verify the receipts and payments of cash up to the date he counts the cash. This should be done soon after the cash balances have been counted.
8. The Cash Book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked.
9. If any cheques or drafts are included in cash balance, the total thereof should be disclosed.
10. If the auditor finds any slip or chit in respect of temporary advances paid to the employees included as part of the cash balance he should have them initialled by a responsible official and debited to Appropriate Accounts.

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Q.No.29. Verification of Cash at Bank or Bank Balance. (A) (PM, RTP N17, N11 - 5M)

1. 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.
2. 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.
3. 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.
4. Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
5. 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.

6. 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.
7. 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 inappropriate cases.
8. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.
9. 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.
10. **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.

SIMILAR QUESTION:

1. **What procedure an auditor should adopt to test the authenticity of cash at bank?**

A. Refer above answer. **(PM, N11 - 5M, RTP N14)**

2. **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.** **(PM)**

A. Refer above answer.

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Q.NO.30. Write a short note on Defalcation of Cash with examples. (B) (PM)

Defalcation (i.e., misappropriation) of cash has been found to perpetrate generally in the following ways -

1. **By inflating cash payments:** Making payments against fictitious or inflated vouchers.

   For example manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.

2. **By suppressing cash receipts:** Few Techniques of how receipts are suppressed are:
   - **a) Teeming and Lading:** **(N15 – 2M)**
     - The amount received from the first customer is misappropriated;
     - And to prevent its detection, the money received from the second customer subsequently being credited to the account of the first customer.
     - Similarly, money received from the third customer who has paid thereafter, will be 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 timewhich may lead the management to send reminder letter to the debtors.
   - **b)** Adjusting unauthorized or fictitious rebates, allowances, discounts etc. to customer accounts and misappropriating amount paid by them.

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

d) Not accounting for cash sales of goods or miscellaneous receipts e.g. sale of scrap etc.

e) Writing down asset values in whole, selling them subsequently and misappropriating the proceeds.

3. **By casting wrong totals in the cash book.**

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

SIMILAR QUESTIONS:

1. **While auditing the accounts of xyz ltd., it has come to the notice of the auditor that receipts have been suppressed. Discuss explaining at least five techniques as to how receipts may be suppressed. (RTP M14)**

A. Refer 2nd point in above.

Q.No.31. Land Holdings in the case of Real Estate Dealer (A) (N 13 – 4M)

1. The auditor should verify existence of Land by physically inspecting it.
2. The auditor should verify ownership of Land by inspecting the registration certificate which contains information as to ownership etc.
3. In case number of Land holdings is large, a Land holdings registeris generally maintained. Examine it to ascertain existence, ownership and possession.
4. Verify the purchases by checking Board resolution.
5. See that the basis of distribution of the common charges between different plots of land acquired during the period is reasonable.
6. Cost of each plot = Cost of acquisition (Direct/Apportioned) + Common charges distributed.
7. See that the plots of the land were sold for at the predetermined rate only.
8. See that the sale deeds were made under the sanction of the appropriate authorities.
9. Since the land holding in the case of a real estate dealer is a current assetthe same shall be valued at cost or market value which everis less.
10. See that this is disclosed under the head "Stock in trade" on the assets side of the B/s.

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PART – 5: AUDIT OF LONG TERM LIABILITIES

Q.No.32. Loans and Borrowings. (A) (PM)

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-

1. Examine the MOA and AOA to see that the loans obtained are within the borrowing powers of the entity and it has been duly authorised.
2. Examine the compliance with Sec 180 of the Act as regards maximum amount of loan that the company can raise or borrow.
3. In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders like bank statement. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.

4. Examine the loan agreement and ensure that the terms therein have been duly complied with.

5. Ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made.

6. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with. E.g. Sec 77 of Companies Act, 2013 and also ascertain certificate from bank to confirm the charge.

7. Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

8. In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

9. The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect.

10. Loans and borrowings are classified as Short term borrowings and long term borrowings as per Schedule III under the companies act, 2013. This has to be verified.

SIMILAR QUESTIONS:

1. How will you verify "Borrowings from banks". (PM, M17 RTP)

A. Refer above answer.

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Q.No.33. Debentures. (C)

1. Prepare a schedule of debenture holders with reference to the Register of debenture holders and tally the total amount received from debenture holders.

2. Study the Memorandum and Articles of the company to ascertain the borrowing powers of the company; also whether any limitation has been placed thereon.

3. Inspect a copy of the debenture bonds that have been issued in acknowledgement of amounts received to ascertain the terms of repayment and charge created, if any.

4. Ensure compliance with the requirements relating to appointment of Debenture trustee as laid in section 71 of the companies act, 2013.

5. See in the case of secured debentures, that the obligations undertaken by the company under the debentures trust deed to the debenture holders were being strictly honoured.

6. Confirm the information has been duly communicated to the Registrar of Companies as required by law in accordance with Section 77 and Section 82 of the Companies act, 2013.

7. Debentures may be redeemable according to the terms of issue at specified dates by annual or other drawings or, at the option of the company, after due notice has been given of the intent to repay.

8. While vouching entries in respect of debentures redeemed, the minutes of the Board of Directors authorising their redemption should be referred to for authority and the cancelled debenture bonds of stock certificates should be examined.

9. Examine the compliance with Sec 180 of the Act as regards maximum amount of loan that the company can raise or borrow.

10. If the debentures are redeemed at a premium, the amount of the premium should be written off by debit to the Statement of Profit and Loss.

Q.No.34. Repayment of amount of Foreign Loan for purchase of an asset. (A) (PM)

1. Check the loan agreement, rate of interest, terms of security.
2. Check the remittances made during the year towards installments of repayments made.
3. Ensure that the repayment is properly accounted in the books in Indian Rupees.
4. Examine the treatment in respect of Interest on Foreign Currency Loan.
5. Obtain confirmation from the Creditor regarding the balance amount due to at the year–end.
6. See whether Foreign Exchange earnings and payments have been properly reported in the Board of Directors' Report for the relevant period.
7. The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.
8. 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.
9. Check banker exchange rate chart for correctness of the conversion.
10. Check RBI or other agencies' permission for remittances outside India.

PART – 6: AUDIT OF CURRENT LIABILITIES

Q.No.35. Trade Payables: (A) (PM)

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1. 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.
2. Compare the balances in the schedule of trade payables with balances in bought ledger.
3. Compare the balances with the confirmation or statement of account received from trade payables.
4. Check posting in the bought ledger from books of prime entry.
5. The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.
6. While examining schedule of trade payables and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:
   - **a)** Long outstanding items;
   - **b)** Unadjusted claims for short supplies, poor quality, discount, commission, etc.;
   - **c)** Liabilities not correlated/adjusted against related advances;

   Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.
7. In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.
8. The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.
9. See that trade payables are classified and shown in the balance sheet as per requirement of Schedule III to the Companies Act, 2013.

Q.No.36. Bank Overdraft. (A) (PM, N 15 RTP, N09 - 4M)

1. The auditor should ensure that the facility of overdraft is authorised by the Board's resolution / partner's resolution.
2. Pursue the agreement with the bank and see whether the overdraft is clean or against hypothecation or pledge of company's property.
3. Verify the register of charges and ensure that the charge has been registered with Registrar of Companies.
4. Verify the rate of interest and other terms and conditions from the agreement.
5. Verify the amount of overdraft from the books of accounts and compare it with the passbook.
6. If the overdraft is against hypothecation of assets like inventories, a certificate from the bank should be obtained.
7. 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.

Q.No.37. Bills Payable: (B) (PM)

1. Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.
2. 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.
3. Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.
4. 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.
5. Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

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PART - 6: OTHER ASSETS AND LIABILITIES

Q.No.38. Endowment Policies (A) (PM, MTP N17, RTP N17, RTP – M 15, N 16)

MEANING: Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures and policies for other similar purposes, being in the nature of quasi-fixed assets.

ASPECTS TO BE VERIFIED:

1. Ascertain the specific purpose for which the endowment policy is taken by inspection of policy document.
2. Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.
3. Check that last premium has been deposited in time and the policy is in force.
4. Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

Q.No.39. Discounted Bill Receivable Dishonoured. (A)(PM, RTP N17,N12 - 4M,N17 – 4M)

1. Obtain the schedule of discounted bills receivable dishonoured.
2. Check the entry in bank statement regarding the amount of bills dishonoured and sees that the bank has debited the account of client.
3. Verify the bills receivable returned by the bank along with bank's advice.
4. The auditor should ascertain what portion, if any, of the amount will not be recovered and ensure that provision for the same has been made.
5. 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.
6. Check that bank commission, if any, charged by the bank has been recovered from the party.

Q.No.40. Balance with Excise Authority: (B) (PM)

1. The balance with excise authority in PLA Account should be checked with the statements of accounts / records kept with excise section of the unit.
2. The remittance into the account, the utilization out of it etc should be cross checked with bank book, clearance forms etc.
3. The balance confirmation may be checked.
4. The balance should be shown under current assets and advances in balance sheet.
5. It is to be ensured that the balances in PLA is used only to the extent of liability after adjusting Cenvat credit where available.

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Q.No.41. Live Stock (C)

1. **Live stock register:**
   a) Examine Livestock Register and note various particulars like breed, year of purchase, purchase price, write-offs, etc. for various categories of animals.
   b) See that the animals have been identified by assigning identification number.
2. **Yield Register:** Examine the Yield and Employment Record to ensure that the same are in existence.
3. **Valuation:** Verify the basis of valuation, noting the following points:
   a) In case of animals purchased at the age of maturity, purchase price plus freight should be capitalized.
   b) The entire stock of animals should be re-valued on a uniform basis, from year to year,
   c) The cost of animals which have either been sold or have died during the year being excluded, and that of newly born or purchased during the year being added.
   d) Where an animal is reared from its conception and then brought to maturity, the cost of calving, cost of fodder etc. consumed till maturity and suitable share of overheads (water, maintenance of sheds, medicines, etc.) less sale proceeds if any, should be capitalized.
   e) Verify that when the earning capacity of the animal starts declining, the cost accumulated up to the maturity stage of animal has been written off by straight-line method over the remaining life.
   f) See that disposal value at the end of life has been adjusted properly. Normally this value may be taken at Nil because the carcass does not fetch anything substantial.

Q.No.42. Patterns, Dies, Loose Tools. (A) (PM, M 13 – 4M)

Several entities have large investments in such assets which have a relatively short useful life and low unit cost. So it is difficult to prepare a separate account for each such asset although a careful control over such property is necessary.
On these considerations, there are several methods of accounting for these items.

1. **Treating all the articles as an expense:**
   - **a)** 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.
   - **b)** But still 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.
2. **Treating all the articles as an asset:**
   - **a) As a regular asset:**
     - **i)** 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;
     - **ii)** The sum total of opening balance and purchase reduced by the value of closing inventory is charged off to Production Account in respect of such assets.
   - **b) As an asset for replacement:**
     - **i)** 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.
3. **Treating only serviceable articles as an asset**:
   - **a)** This is the most satisfactory method.
   - **b)** Preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis.
   - **c)** Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

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Q.No.43. Debt due from Subsidiary Companies: (C)

1. The auditor should verify whether the debts shown as outstanding from the subsidiary are genuine and have resulted from transactions entered into in the normal course of business.
2. Therefore, the balance outstanding should not only be confirmed with the statements of account received from the subsidiary but its basis should also be inquired into.
3. If the debt is covered by an agreement, the same should also be referred to.
4. If any security is deposited against due repayment of advances the same should be inspected.
5. Debts due from a subsidiary company should be disclosed duly classified in the same way as accounts receivables.

Q.No.44. Amount due to Subsidiary Companies. (B) (PM)

1. Examine whether the subsidiary company is authorized by its Memorandum of Association to advance the loan to the holding company.

2. 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.
3. 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.
4. 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.
5. 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.
6. 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.
7. Verify that the loan has been properly reflected in the Balance Sheet as per the requirements of Schedule III to the Companies Act, 2013.

Q.No.45. Deferred Tax Liability. (B) (PM, RTP N17)

1. 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.
2. Check the creation of Deferred Tax Liability and its actual working.
3. Check how much Deferred Tax Liability is reversed during the year.
4. Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.
5. Check that the provisions of AS 22 "Accounting for Taxes on Income" have been complied with.

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Q.No.46. Contingent Liabilities. (A) (PM, RTP N 16, M 15, M17- 4M)

MEANING: AS 29 on 'Provisions, Contingent Liabilities and Contingent Assets', defines Contingent Liability' as a

a) Possible obligation that arises from past events and

- **i)** 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) Present obligation that arises from past events but is not recognized because

- **i)** it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or
- **ii)** Reliable estimate of the amount of the obligation cannot be made.

THE AUDITOR MAY TAKE FOLLOWING STEPS TO VOUCH OR VERIFY THE CONTINGENT LIABILITIES:

1. Inspect the minute books of the company to ascertain all contingent liabilities known to the company.
2. Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.
3. Scrutinise the lawyer's bills to track unreported contingent liabilities.

4. Examine bank letters in respect of bills discounted and not matured.
5. Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
6. Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
7. Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
8. 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".

Q.No.47. Discuss the Recognition Principles of Contingent Liability. (A) (PM, N15 – 4M)

RECOGNITION PRINCIPLES OF CONTINGENT LIABILITY:

1. 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.
2. 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.
3. 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.
4. 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.
5. 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.

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PART - 7: SOME ACCOUNTING CONCEPTS

Q.No.48. Write a short notes on capital expenditure and Revenue expenditure? (A)

CAPITAL EXPENDITURE:

1. **Purpose of capital expenditure:** A capital expenditure is that which is incurred for the under mentioned purposes - **(N16 - 6M)**
   a) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.
   b) Making additions to the existing fixed assets.
   c) Increasing earning capacity of the business.
   d) Reducing the cost of production.
   e) Acquiring a benefit of enduring nature of a valuable right.

   Examples: The different forms that capital expenditure takes are: (i) land; (ii) building; (iii) plant and machinery etc.

2. **Revenue expenses becomes Capital expenditure:** 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. **(M 14 – 4M)**

   Examples of capital expenditure are-

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

   b) **Legal expenses**- capital expenditure when incurred in connection with the purchase of land or building.

   c) **Freight**- capital expenditure when incurred in respect of purchase of plant and machinery.

   d) **Repair**- Major repairs of a fixed asset that increases its productivity.

   e) **Wages**- Wages paid on installation costs incurred in Plant & machinery.

   f) **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 capitalised 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.

REVENUE EXPENDITURE:

An expenditure, the benefit of which is immediately say within oneyear expended or exhausted in the process of earning revenue.

Examples of revenue expenditure are- Postage, Printing and Stationery, Rent, rates and taxes, Insurance etc.

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SIMILAR QUESTIONS:

1. **Mention the purposes for which the capital expenditure is incurred? (N16 - 6M)**

A. Write point no. 1 in "CAPITAL EXPENTIURE" above

2. **Indicate expenses which are essentially of a revenue nature, if incurred for creating an asset, are also regarded as expenditure of a capital nature. (M 14 – 4M)**

A. Write point no. 2 in "CAPITAL EXPENTIURE" above

Q.No.49. Define Depreciation and discuss various purposes of providing depreciation? (A) (PM, M11 - 8M)

MEANING: 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.

PURPOSE OF PROVIDING DEPRECIATION: (PM, N12 - 5M, N14 - 4M)

The main purpose of providing depreciation is as under:

1. **To keep the capital intact:** This is accomplished by retaining the amount of depreciation charged in the Statement of Profit and Loss in the business.

2. **To ascertain the true cost of production:** As the value of fixed assets decreases 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.

3. **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.

4. **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.

5. **To comply with the legal necessity:** 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, either out of the profits of that financial year, or out of the profits of any other previous years.

6. **To comply with the matching principle.**

Q.No.50. Write a short note on "Impairment of assets". (B) (PM, M 13 – 4M)

1. Besides charging annual depreciation on assets by the reason of normal wear and tear, effluxion of time and obsolescence,
   a) it is also necessary to provide for impairment loss to in order to re-instate the correct value of the assets after considering the future cash flows that the assets can generate.
2. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss.
3. 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.
4. The auditor must ensure that the provisions of AS 28 "Impairment of Assets" are followed.

MASTER MINDS

Q.No.51. Distinguish between Reserves and Provisions. (A) (PM, M12 - 5M)

RESERVES AND PROVISIONS:

1. Reserve is an appropriation of profit whereas provision is a charge against Profit.
2. 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 adisputed claim.
3. 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.
4. 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.
5. 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.

Q.No.52. Write a Short Note on "Provisions Versus Specific Reserves". (A) (PM)

PROVISIONS VERSUS SPECIFIC RESERVES:

1. **Definition:**
   a) 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.

b) A specific reserve is created for some definite purpose out of the profits of the company.

2. **Charge against, or Appropriation out of, profits:**

   a) Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit.

   b) Though specific reserves 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.

3. **Purpose of creation:**

   a) Provisions are the 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 etc.

   b) The purpose of creating specific reserves may be anything connected with the business which the Article of Association or, the directors want to be provided for.

   Some of the reserves may be required under contractual obligation or legal compulsion. E.g. sinking fund, statutory reserves in case of banks etc.

4. **Necessity of profits:**

   a) 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.

   b) While to create any specific reserve, existence of profit is essential.

MASTER MINDS

QUESTIONS FOR ACADEMIC INTEREST – SELF STUDY

Q.No.53. Floating Charge. (PM)

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, 2013in the case of a company.

Q.No.54. Write a short note on floating assets. (C) (M16 – 4M)

a) <u>**Meaning:**</u> Floating asset means those current assets which are manufactured or purchased during the normal course of business.

   Examples: Raw Materials, work in progress, finished goods, consumables, debtors, sundry receivables.

b) They are held for a shorter period and may be converted into cash within a year.

c) <u>**Valuation:**</u> The stock in trade shall be valued at cost or market price whichever is less. The sundry debtors and bills receivables are valued at net realizable value.

Q.No.55. Outstanding assets. (C)

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.

If revenue expenditure has been incurred, the benefit off which is to be derived even after the year is over and therefore 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 asset 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 payments have been made in advance but for which benefit of service will be received later.

Some examples:

a) **Insurance charges paid in advance:** Insurance premia are always paid in advance; and, in case of a large business, the amount paid, the benefit of which will arise in the succeeding period, may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated and included as on outstanding asset.

b) **Advertisement:** Sometimes payments under advertising contracts are made in advance. In such a case, the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be adjusted as on outstanding asset.

MASTER MINDS

Q.No.56. Explain the difference between Depreciation and Fluctuation in Value. (PM)

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.

Q.No.57. How do you verify Misappropriation of Assets? (C)

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

a) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).

b) Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

c) Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

d) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party). Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Q.NO.58. Comment on "The cash-book showed a huge cash balance on hand consistently throughout the year". (PM)

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 balances 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 eek 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.

MASTERMINDS

PRACTICAL QUESTIONS

Q.NO.1. 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. (PM, N09 - 4M)

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.

THE END