

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 confirm the existence, ownership, possession, completeness, valuation and disclosure of items relating to balance sheet.
- Verification is based on observation as well as documentary examination.
- Verification requires experienced people and done by the senior staff.
- Verification includes valuation

Question 1

Comment on the “The cash-book showed a huge cash balance on hand consistently throughout the year”.

Answer

Maintenance of huge cash balance

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

Accordingly, if the entity is consistently maintaining huge cash balance, which is not justified by its operational requirement needs, the Guidance Note on Audit of Cash and Bank Balances recommends that the auditor should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balance as shown by the books.

Auditing and Assurance

If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

Question 2

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

Answer

The Guidance Note on Audit of Inventories specifies that the responsibility for properly determining the quantity and value of inventories rests with 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 stock records in the form of Stores/Stock ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case. In valuation aspects, compliance with AS 2 should also be ensured.

Question 3

As an auditor, what would you do in the following situations?

- (a) *The method of depreciation on plant and machinery is to be changed from SLM basis to WDV basis from the current year.*

- (b) *The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year.*

Answer

(a) Change in the method of depreciation

As per “Accounting Standard 6 Depreciation Accounting”, the method of depreciation should be applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if:

- The adoption of the new method is required by statute (or)
- For compliance with an accounting standard (or)
- It is considered that the change would result in a more appropriate presentation or presentation of financial statements of the enterprise.

Therefore, the auditor must ensure that the change in method of depreciation on plant and machinery from SLM to WDV basis from the current year is made in accordance therewith. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. Further, it should be ensured that the deficiency (since change is from SLM to WDV) arising to be adjusted in the year of change by way of a charge to the profit and loss account. The auditor may also ascertain that the change in the method and the effect thereof on the profits of the entity is quantified and disclosed. If it is not done by the management, the auditor has to bring it to the notice of the shareholders through qualification in the audit report.

- (b) **Semi-finished goods lying with third parties:** Semi-finished goods are the assets of the company and therefore such goods, though, at present not with the company, should be included in the closing stock under the head “stock with processors”. The auditor shall be required to undertake the following steps in respect of inventories lying with third parties:

1. Ensure that semi-finished goods have been included for valuation of inventory since these belong to the company.
2. Obtain confirmation letters from such third parties in respect of quantity lying with them at the end of the year. The auditor may also consider carrying out the appropriate audit procedure to obtain assurance about the condition of such inventory.

Auditing and Assurance

3. Examine the basis of valuation. In this case, it shall have to be done on the basis of the cost of work-in-progress and having regard to stage of completion and accordingly accounting for conversions costs.
4. Check that the disclosure requirements as specified in schedule VI to the Companies Act, 1956 and AS 2, "Valuation of Inventories" have been followed

Question 4

Give your comments and observations on the following:

- (a) *Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the year-end.*
- (b) *The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.*
- (c) *Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.*

Answer

- (a) **Confirmation of Balances:** Direct confirmation of balances from debtors/creditors in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor.

"Guidance Note on Audit of Debtors, Loans and Advances" issued by the ICAI recommends that the debtors may be requested to confirm the balance either:

- As at the date of the balance sheet; or
- As at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially mis-stated.

Therefore, it is not necessary that balances of debtors/ creditors should necessarily be verified only at the end of the year only. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically, i.e., Dec, 31 as a cut-off date in one year and June 30 in another year and so on.

Verification of Assets and Liabilities

Therefore, the statement that balance confirmation from debtors/creditors can only be obtained for balances standing in their accounts at the year-end is not correct.

- (b) **Certificate from an Expert:** The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of an expert. SA 620 on "Using the Work of an Expert" also states that an expert may be engaged / employed by the client. It further requires the auditor to assess skill, competence and objectivity of the expert amongst other factors and evaluate the work of an expert independently to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA 620 before relying upon the certificate obtained by the management from the actuary.
- (c) **Revaluation of Fixed Assets:** The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS 10 on 'Accounting for Fixed Assets' requires that "an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution". Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

Question 5

State briefly the duty of an auditor with regard to each of the following:

- (a) *No depreciation has been charged for the year ended 31st March 2010, in respect of a spare Bus purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year.*
- (b) *A sum of Rs.10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing Rs.8,00,000. The amount is credited to the Purchases Account.*

Auditing and Assurance

- (c) *Cost of structural alterations amounting to Rs.60,000 to self-owned factory premises has been charged to Building Repairs.*
- (d) *A loss of Rs.2,00,000 on account of embezzlement of cash was suffered by the company and it was debited to Salary Account.*

Answer

- (a) **Depreciation on Stand-by Asset:** As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare bus was kept ready for use as stand-by, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2010. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.
- (b) **Amount Received from an Insurance Company:** AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" requires that all items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only Rs.8,00,000 while the insurance money received is Rs.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 Rs.10 lacs needs to be taken to profit and loss account under an appropriate head. This is an income arising from an ordinary activity of the enterprise but having regard to amount involved and exceptional nature, a separate disclosure be made in the profit and loss account. Such disclosure would enable the users to understand the performance of an enterprise for the period.
- (c) **Cost of Structural Alterations:** Any subsequent expenditure on fixed assets which increases the profitability or capacity arising from them beyond their previously assessed standards of performance amounts to capital expenditure and, thus, must form part of the cost of the asset. The words "structural alteration" would generally signify that some significant changes have taken place in the design of building to provide more strength to the building or expansion in the capacity of the building. Therefore, cost of Rs.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. It cannot be merged with any other head much less the salary. Being material item, it is required to be disclosed under a distinct head in the profit and loss account.

Question 6

Explain the difference between Depreciation and Fluctuation in Value.

Answer

Depreciation and Fluctuation in Value: Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. It directly affects the earning capacity of an asset. Hence, it is a charge against the profit of the year.

Fluctuation, on the other hand, is a temporary shrinkage or decrease and increase in the value of an asset usually due to external causes such as rise and fall in market price of an asset. But the fluctuation does not affect the earning capacity or working life of an asset. Hence, it is not taken into account and no charge is made against the profit of the year.

Depreciation is only in connection with fixed assets while fluctuation is usually in connection with current assets. Depreciation generally means fall in the value of fixed asset while fluctuation may mean either increase or decrease in the value of any asset, current as well as fixed. Depreciation has a significant effect determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

Question 7

State how you would verify the following:

- (i) *Buildings*
- (ii) *Patent Rights*

Auditing and Assurance

Answer

(i) Buildings

- (i) Examine the title deeds of buildings to see whether the client holds the title on the balance sheet date. If the property has been mortgaged, the title deeds will be in the possession of the mortgagee, from whom a certificate should be obtained to that effect.
- (ii) Verify the original cost of buildings by reference to the deed of conveyance. If the building is constructed by the client, verify the original cost by reference to the cost as recorded in the books of account of the year in which the construction was completed.
- (iii) Verify that appropriate depreciation has been provided against the buildings. In case no depreciation is provided on the buildings, a note to this effect should be given in the profit and loss account.
- (iv) See the appropriate lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc. Also ensure that all 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 VI have been complied with.
- (vi) See that the relevant particulars of buildings have been entered in the fixed assets record maintained by the client.

(ii) Patent Rights : A Patent Right is an official right to inventor to make, use or sell his invention.

- (i) Obtain the schedule containing particulars of the patents owned by the client as on the balance sheet date. The particulars should contain the dates of registration of the patents with the related authorities and the dates in respect of the last renewal.
- (ii) See that the total of the values of the patent rights shown in each list agree with the values shown in the respective ledger accounts.
- (iii) Examine the cost of patent rights.
- (iv) See that the renewal fees in respect of the patent rights have been paid and the same has been treated as a revenue charge.
- (v) Ensure the compliance with the provisions of AS 26.

Question 8

- (a) *Explain the meaning of the term “subsequent events” as used in the SA 560.*
- (b) *Should all type of subsequent events be considered by the auditor in his attest function?*
- (c) *Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in the financial statements.*

Answer

- (a) **Meaning of Subsequent Events:** SA 560 on “Subsequent Events”, defines the term ‘subsequent events’ as events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report., “subsequent events” also refer to significant events which occurred upto the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

- (b) **Consideration of Subsequent Events by the Auditor:** SA 560 requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor’s report. However, the exact manner of treatment would depend upon whether the event falls in the category of ‘adjusting event’ or ‘non-adjusting event’. As per Accounting Standard (AS) 4, events occurring after the date of the balance sheet are of two types, viz., adjusting events which provide further evidence of conditions that existed at the date of the balance sheet; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the date of the balance sheet.

Therefore, an auditor is required to consider all subsequent events while discharging his duties and determine whether those shall have to be adjusted or simply required to be disclosed. However, the auditor should perform work as near as practicable to the date of the auditor’s report.

- (c) **Audit Procedures:** The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor’s report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedure to identify “subsequent events” requiring adjustment or disclosure in financial statements as laid down in SA 560 is as under:

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

Auditing and Assurance

- (b) Inquiring 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.
- (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.

Verification of Assets and Liabilities

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

Question 9

Write a short note on the Contingent Liability.

Answer

Contingent Liability: A contingent liability will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events. The uncertainty as to whether there will be any legal obligation distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against a company in respect of infringement of a patent and the suing company does not possess a legitimate title. Schedule VI to the Companies Act, 1956 requires that contingent liabilities to be disclosed as a foot note to the balance sheet. Some examples of contingent liabilities include claims against the company not acknowledged as debts, arrears of fixed cumulative dividends, etc. AS 4 requires that in case there is a probability that a loss may be incurred and a reasonable estimate of the amount can be made, then such contingent liability must be adjusted in the financial statements. Otherwise, disclosure will have to be made describing nature of the event, uncertainties affecting the event and estimate of the financial effect or a statement that such an estimate cannot be made.

Question 10

As an auditor, comment on the following situations/statements:

- (a) *A Ltd wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue expenditure. The product did not pick up and the sales were negligible. It is anticipated that no material benefit will accrue in future from such heavy advertisement expenditure.*
- (b) *B Ltd. acquired a car for its Managing Director on hire-purchase basis. The interest payable as well as penalty for late payment of installments was added to the cost of the car.*
- (c) *The debit balance in the profit and loss account is shown as a deduction from Investment Allowance Reserve on the liabilities side of the Balance Sheet*
- (d) *Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under Sundry Creditors.*

Answer

- (a) **Treatment of Heavy Advertisement Expenditure:** Advertisement expenditure is generally of revenue nature and is thus written off to the profit and loss account in the year it is incurred. However, A Ltd. has incurred "heavy" advertisement expenditure to launch a new product. In such a case, it is the normal expectation that the benefit of such an expenditure is likely to bring benefits over a longer period. Therefore, heavy expenses for a new product, if campaign is successful, are normally treated as deferred revenue expenditure to be written off over a period of three to five years. Thus, deferral of expenditure is done only with the anticipation that benefit is likely to accrue in future accounting periods. It appears from the given facts that the product did not pick up and the sales were negligible. Therefore, it is almost established that the advertising effort is not going to succeed, i.e., no benefit is likely to flow in future. Thus, the entire expenses incurred should be written off to the Profit and Loss Account. Accordingly, the writing off of the entire expenditure to revenue is appropriate and correct.
- (b) **Car Purchased on Hire-Purchase Basis:** The Managing Director's car was acquired on hire-purchase basis and, thus, the motor car account be debited with the cash price of car by raising a corresponding liability for the amount payable to the financing company. If the cash value is not readily available, it should be calculated by assuming an appropriate rate of interest. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account. In any case, the amount paid as penalty for late payment of installments should be debited as an expense instead of being added to the cost of the car. Under the circumstances, the auditor will have to qualify his report.
- (c) **Disclosure of Debit Balance of Profit and Loss Account:** Part - I of Schedule VI to the Companies Act, 1956 read with the instructions for the preparation of the Balance Sheet of a company clearly stipulates that the debit balance in the Profit and Loss Account should be shown as a deduction from the general reserves or any other uncommitted reserve. Therefore, the treatment followed by the company by deducting the debit balance of profit and loss account from investment allowance reserve is not correct. Accordingly, the auditor will have to qualify the report since the information has not been presented in the manner required by Section 211(5) of the Companies Act, 1950.
- (d) **Assets Purchased under Hire-Purchase System:** Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest. Hire purchased assets are

shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. Thus the treatment followed by the company is correct.

Question 11

Write a short note on - the Cut-off Transactions relating to Inventories.

Answer

Cut-off Transactions relating to Inventories: Cut-off transactions imply a set of procedures applied to ensure separation of one year's transaction from those of the following year. An auditor is expected to devote his attention to the procedures followed by the management regarding cut-off. The auditor should satisfy himself that these procedures adequately ensure that (i) goods purchased for which properly has passed to the client have in fact been included in the inventories and that the liability has been provided for; and (ii) goods sold have been excluded from the inventories and credit has been taken for the sales.

Question 12

How will you vouch and/or verify the following?

- (a) Retirement Gratuity to Employees.
- (b) Sale Proceeds of Junk Materials
- (c) Assets Abroad



Answer

(a) Retirement Gratuity to Employees

- (i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.
- (ii) Verify computation of liability of gratuity on the aggregate basis.
- (iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.
- (iv) See that the annual premium has been charged to Profit and Loss account.
- (v) Ensure that the accounting treatment is in accordance with AS 15, "Accounting for Retirement Benefits in the Financial Statements".

Auditing and Assurance

(b) Sale Proceeds of Junk Materials

- (i) Review the internal control on junk materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.
- (ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk materials.
- (iii) Review the production and cost records for the determination of the extent of junk materials that may arise in a given period.
- (iv) Compare the income from the sale of junk materials with the corresponding figures of the preceding three years.
- (v) Check the rates at which different types of junk materials have been sold and compare the same with the rates that prevailed in the preceding year.
- (vi) See that all junk materials sold have been billed and check the calculations on the invoices.
- (vii) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.
- (viii) Make an overall assessment of the value of the realisation from the sale of junk materials as to its reasonableness. Ensure that proper accounting has been done for it.

(c) Assets Abroad

- (i) Examine the title deeds of immovable properties abroad.
- (ii) Ensure that the immovable properties abroad have been properly classified and disclosed.
- (iii) Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.
- (iv) Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

Question 13

How will you vouch and/or verify the following ?

- (a) *Remuneration to directors.*
- (b) *Consignment sales.*
- (c) *Royalties received.*

Answer

(a) Remuneration paid to Directors

- (i) Refer to General Meeting or Board meeting resolution for the appointment and terms of appointment of the director.
- (ii) Examine Articles of Association and general meeting resolution to determine the mode of payment-monthly, quarterly, or by way of commission.
- (iii) Check agreement with the director.
- (iv) Verify director's attendance in the board meetings.
- (v) Ensure compliance with the provisions of Sections 198, 309, 349 and 350 and Schedule XIII of the Companies Act, 1956, where appropriate.
- (vi) Check computation of the net profits and the commission payable to directors in terms of clause 4A of Part II of Schedule VI to the Companies Act, 1956.

(b) Consignment Sales

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

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

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

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

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

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

Ensure that the goods consigned are not treated as ordinary sales. In cases it is so, the auditor should see that necessary adjustments are made at the year end in respect of the unsold goods, commission and the expense incurred by consignee. The consignee should not be shown as a debtor for unsold goods and in valuation of

Auditing and Assurance

stock, these goods should be included in stock at cost worked out on a consistent basis.

(c) Royalties Received

- (i) Verify the relevant contract and ascertain the provisions relating to the conditions of royalty such as rate, mode of calculation and due date.
- (ii) Check the periodical statement received in respect of books printed, sold and stock lying at different locations..
- (iii) Check the computation in the royalty statement and ensure that any deduction or adjustment made from the royalty due is as per agreement conditions.
- (iv) Verify the provisions for the royalty to be received as at the end of the year.

Question 14

Write short notes on the following:

- (a) *Outstanding Assets.*
- (b) *Extent of Reliance on Analytical Procedures.*
- (c) *Purpose of providing depreciation.*

Answer

- (a) **Outstanding Assets:** It is a well accepted accounting principle that all expenditure pertaining to the year alone should be charged against year's revenue and all income whether received or not should be accrued for the year. Following this principle one has to make certain year end adjustments in the books of account and outstanding assets are brought to book in that process. If expenditure has been made on certain revenue heads, the benefit of which is to be derived even after the year is over and adjustment is made to the original figure of expenditure so as to carry forward the sum that does not pertain to the year an outstanding assets is created. Similarly, if certain income has accrued for the year but has not been received, the amount that has so accrued is usually brought into books as year end adjustment and thereby creating an outstanding assets account.

Generally, outstanding assets are those items for which amounts are yet to be received though services, etc. have been rendered, or items for which benefit of service will be received later. For example, in case insurance amount has been paid in advance then the proportion thereof applicable to the period subsequent to the date of the balance sheet should be calculated and shown as an outstanding assets. Other examples of outstanding assets may include rent receivable, commission receivable, advertising amount paid in advance, interest receivable on loans, etc.

(b) **Extent of Reliance on Analytical Procedures:** As per SA 520 “Analytical procedures” means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor’s assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

- (i) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;
- (ii) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers’ accounts;
- (iii) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and
- (iv) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

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

- (c) **Purpose of Providing Depreciation:** According to AS 6 on Depreciation Accounting, depreciation may be defined as, "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined". This is a measure of the exhaustion of the useful life of an asset during the accounting period. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount irrespective of an increase in the market value of fixed assets. The principal objective of depreciation on fixed assets is to allocate as an expense, the related depreciation amount on a year to year basis. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. The main purpose of providing depreciation is as under:
- (i) To keep intact the capital invested in fixed assets - This is accomplished by retaining the amount of depreciation charged in the profit and loss account in the business.
 - (ii) To ascertain the true cost of production - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.
 - (iii) To determine the profit or loss for the year - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the profit and loss account for determining the profit or loss during a year;
 - (iv) To present a true and fair value of entity's assets in the balance sheet, since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the profit and loss account representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.

Question 15

As an auditor, comment on the following situation:

"The Finance Manager of Belt Ltd. is of the opinion that before declaration of dividends it would not be necessary to set off the carried forward amount of debit balance in the Profit and Loss Account against current revenue profit but the same could be set-off against existing revaluation reserve". Do you agree?

Answer

Adjustment of Carried Forward Losses against Revaluation Reserves: The Guidance Note on "Treatment of Reserve Created on Revaluation of Fixed Assets" recommends that the accumulated losses should not be adjusted against such revaluation reserve, since this would amount to setting of actual losses against unrealised gains. Debit balance in the Profit and Loss Account is a fictitious asset. There is neither mandatory rule in accounting nor any legal requirement that fictitious assets must be written off before declaration of dividend. However, in arriving at divisible profits, the provisions of Section 205(2) (b) of the Companies Act, 1956 should be kept in view. The amount of loss or depreciation (contained in the debit balance of Profit and Loss Account) whichever is less should be set off against current revenue profit before declaration of dividends.

Since, mere revaluation of assets does not result in realised gain, and, thus, as per the sound accounting practice, the accumulated losses should not be adjusted against revaluation reserve because this would amount to setting off actual losses against unrealised gains. Therefore, if the debit balance in Profit and Loss Account is set off against revaluation reserve, and then dividend is declared from out of revenue profits, it would amount to payment of dividend out of capital without making good the amount of loss or depreciation whichever is less. Such a declaration will be violation of the provisions of Section 205 of the Companies Act, 1956. Hence, the opinion of the finance Manager of Belt Ltd. is not correct.

Question 16

How will you vouch and/or verify the following?

- (a) *Contingent Liabilities*
- (b) *Excise Duty*
- (c) *Recovery of Bad-debts written off*
- (d) *Endowment Policies*

Answer

- (a) **Contingent liabilities:** A contingent liability will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events. The uncertainty as to whether there will be any legal obligation distinguishes a contingent liability from an actual liability. An obligation may be a contingent liability when the very basis of the obligation is contested. For example, when a claim is made against a company in respect of infringement of a patent and the suing company does not possess a legitimate title. Schedule VI to the Companies Act, 1956 requires that contingent liabilities to be disclosed as a foot note to the balance sheet. Some

Auditing and Assurance

examples of contingent liabilities include claims against the company not acknowledged as debts, arrears of fixed cumulative dividends, etc. AS 4 requires that in case there is a probability that a loss may be incurred and a reasonable estimate of the amount can be made, then such contingent liability must be adjusted in the financial statements. Otherwise, disclosure will have to be made describing nature of the event, uncertainties affecting the event and estimate of the financial effect or a statement that such an estimate cannot be made. In such circumstances, the auditor may take following steps:

- i. Inspect the minute books of the company to ascertain all contingent liabilities known to the company.
- ii. Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.
- iii. Scrutinise the lawyer's bills to track unreported contingent liabilities.
- iv. Examine bank letters in respect of bills discounted and not matured.
- v. Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
- vi. Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
- vii. Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
- viii. Ensure that proper disclosure has been made as per Schedule VI to the Companies Act, 1956 and AS 4, "Contingencies and Events Occurring after the Balance Sheet Date".

(b) Excise Duty: Excise duty is levied on manufacture. The liability for duty arises only at the point of time at which manufacturing is complete. The point of time at which duty is collected may be determined by consideration of administrative convenience. Normally excise duty is paid before the issue of excisable goods from the factory. For this, the auditor should take into consideration:

- i. Ensure that excise duty is paid at the time of issue of exciseable goods from the godown at factory of the producer. The duplicate copy of the challan as issued by the bank is forwarded for the purpose of issue of the exciseable goods.
- ii. Verify the amount of duty paid with the corresponding value of the goods issued from the stock register of the producer by applying test check. In case where the client maintains an advance deposit with Excise Department, the

Verification of Assets and Liabilities

auditor should see that the permits are issued for delivery of the goods against the advance deposit and corresponding adjustment.

- iii. Ascertain the rates of excise duty and apply it to the total sales and see that the amount actually paid does not exceed the amount thus calculated.
- iv. Ascertain that in case of dispute about the amount of duty payable, a provisional amount may be paid in lieu of final amount. In such cases, the final amount determined as payable should be verified. If the provisional payment was more than the actual amount, the refund of such excess amount should be vouched.
- v. The auditor may also physically verify RG 1 with actuals and see reconciliation of financial records with sales tax records.

(c) Recovery of Bad Debts written off

- i. Check all correspondence and proper authorization of bad debts written off earlier and ensure that the decision of writing off of bad debts was recorded properly.
- ii. Ascertain total bad debts and see whether all recovery of bad debts is recorded properly in the books of account and deposited into bank.
- iii. Check all notifications from Court or bankruptcy trustee and all correspondence from debtors and collecting agencies.
- iv. Check Credit Manager's files for amount recovered and confirm acknowledgement receipts issued to trustee/debtors.

(d) Endowment Policies

- i. Ascertain the specific purpose for which the endowment policy is taken, e.g., Sinking Fund policies for redemption of debentures, redemption of leases or policies taken for other similar purposes, etc.
- ii. Verify the terms and conditions of policies and ensure that all such conditions are in force and being followed.
- iii. Check that premium has been deposited in time and the policy is in force.
- iv. Examine that proper disclosures have been made in the financial statements in respect of items for which the policy has been taken.

Question 17

Write short notes on the following:

- (a) *Intangible Assets*
 - (b) *Floating Charge*
-

Auditing and Assurance

Answer

- (a) **Intangible Assets:** An intangible asset is that asset which does not have a physical identity but which is used by the enterprise for production or supply of goods or for retails to other or for administrative purpose. Such asset does not have any physical existence but their presence in the business is indicated with a value placed thereon. These assets include rights and benefit to owners subject to their being useful. For example: goodwill, patents, copyright etc. AS 26, "Intangible Assets", applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. An intangible asset should measured at cost. After initial recognition an intangible asset should be carried at its cost less any accumulated amortisation and any impairment losses.

Auditor should also ensure that proper disclosure is made in the financial statements about the carrying amount, amortisation methods, useful lives, etc.

- (b) **Floating Charge:** Floating charge refers to a general charge on some or all the assets of an enterprise which is not attached to any specific assets and are given as a security against a debt. It has the effect of creating an immediate charge on the property of the company leaving the company to deal with the same in the ordinary course of business, but subject to the limitations imposed in the instrument of creating the charge. The floating charge, however, becomes fixed or crystallised and the creditor becomes entitled to proceed against the assets on which the charge was created, on violation of any of the terms of the instruments creating the charge. This charge is also required to be registered within 30 days of its creation under section 125 of the Companies Act, 1956.

Question 18

As an auditor, comment on the following situations/statements:

- (a) *You are the Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 20th July. The Sales Ledger balance at 31st March was Rs. 95, 000. By 20th July Rs. 65,000 only had been received against this amount as full and final payment.*

Verification of Assets and Liabilities

- (b) *A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts.*

Answer

- (a) **Consideration of Subsequent Events:** SA 560 "Subsequent Events" requires that the auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting event or non-adjusting event, the auditor has to examine the impact on financial statements. AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" also classifies an adjusting event which provides further evidence of conditions that existed at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. The facts indicated in the question clearly reveal that subsequent realisation has been good. Such consideration helps the auditor in assuring the existence of debtors as also the realisability aspect. The auditor's duties in respect of debtors remaining uncollected at the time of giving audit report involves examination of actual past experience of collections from debtors. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date, legal cases, cheques dishonoured, etc. as on March 31, 2004. Accordingly, the auditor would have now to see that in respect of outstanding amount of Rs.35,000, 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 charging 50% depreciation in their respective books of account is proper. However, such jointly owned assets should be indicated separately in the Fixed Assets Register maintained by the company.

(Note: Alternatively, AS 10 also recommends that the pro-rata cost of such jointly owned assets may be grouped together with similar fully owned assets and appropriate disclosure of the same should be made.)

Question 19

How will you vouch and/or verify the following?

Auditing and Assurance

- (a) *Personal expenses of directors met by the company.*
- (b) *Preliminary expenses.*
- (c) *Advances given to suppliers.*

Answer

(a) Personal Expenses of Directors

- (i) Check the articles of association, service contract, minutes of general meeting, etc., to check the authorisation for such payment.
- (ii) Enquire to ensure that personal expenses are not camouflaged in any other revenue items as contemplated under section 227(1A) of the Companies Act, 1956.
- (iii) Ascertain compliance with disclosure according to requirements of Schedule VI to the Companies Act, 1956.
- (iv) Check documentary evidences to examine the payments reimbursed.
- (v) Check compliance with requirements of CARO, 2003.

(NOTE: Reporting requirements of the Personal expenses of directors met by the company prescribed in MAOCARO, 1988 has been omitted in CARO, 2003).

(b) Preliminary Expenses: It is the expenditure incurred incidental to the creation, formation and floating of a company. It consists of stamp duties, registration fees, legal costs, consultants fees, expenses of printing of memorandum and articles, etc. The following should be checked:

- (i) Check Board's minutes book containing the resolution approving the expenses claimed by promoters as having been spent in formation of the company.
- (ii) Examine supporting papers and vouchers, contracts, agreements, etc. to support the promoters' claims. Also check bills and receipts issued by the printer of the memorandum and articles of association, share certificates, etc.
- (iii) Check receipt for the registration fee paid for registration of the company.
- (iv) Verify rates of stamp required to be affixed on the memorandum and articles of association.
- (v) Ascertain Boards' minutes book for the decision to write off the preliminary expenses over a period. The quantum thereof which has not yet been written off for these expenses should be carried forward in the balance sheet under the head miscellaneous expenditure (to the extent not written off or adjusted) over a period of years.

- (vi) Check that no expenses other than those what constitutes preliminary expenses are booked under this head, e.g. underwriting commission and brokerage paid.

(c) Advances with the Suppliers

- (i) Obtain schedule of debit balances in creditors' account and pay particular attention to the age of the balances. Also scrutinise the bought ledger.
- (ii) Enquiry should be made for long unadjusted outstandings and check as to whether any of them would require provisioning.
- (iii) Examine that the advances have not been shown as deposits in balance sheet as per Section 227(1A) of the Companies Act, 1956.
- (iv) Confirmation of balances should be obtained and reconciliation be done in case of any discrepancies.

Question 20

Write a short note on - the 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 but 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.

Auditing and Assurance

The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, assessment of inherent and control risks, etc.

Question 21

Give your comments on "The CC Ltd., a Pharmaceutical Company, while valuing its finished stock at the year end wants to include interest on Bank Overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses".

Answer

Cost of Inventories: As per Accounting Standard 2 "Valuation of Inventories", cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. However, it makes clear that interest and other borrowing costs are usually not included in the cost of inventories because generally such costs are not related in bringing the inventories to their present location and condition. Therefore, the proposal of CC Ltd. to include interest on bank overdraft as an element of cost is not acceptable because it does not form part of cost of production.

Question 22

How will you vouch/verify the following?

- (a) *Advertisement expenses*
- (b) *Goodwill*
- (c) *Capital work-in-progress*
- (d) *Wages paid to seasonal labourer*

Answer

(a) Advertisement Expenses: The following steps may be taken by the auditor to vouch/verify the different items:

- (i) Ascertaining the value of advertisement expenses to ensure that the said expense has been properly allocated.
- (ii) Examining that such expenses relate to the client's business.
- (iii) Review and examination of the complete list of media of advertisement indicating the dates, location, timing, etc., along with the amounts paid in respect of each category.
- (iv) Examination of the receipts for amounts paid.

Verification of Assets and Liabilities

- (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 under the head "Fixed Assets" as per Schedule VI requirements.
 - (vi) See that the goodwill is being amortised as per financial prudence over a reasonable period.
- (c) **Capital Work-in-Progress:** Capital Work-in-Progress denotes assets under installation. This could either be plant or machinery under construction, or that construction project for establishment of a new factory is under progress. The auditor should take the following steps to verify the same.
- (i) Ensure that the capital project is authorised by the Board. See the relevant Board Minutes for the purpose.
 - (ii) Obtain the break up in details of the amount shown in the Balance Sheet under this head.

Auditing and Assurance

- (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.

(d) Wages Paid to Seasonal Labourers

- (i) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.
- (ii) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.
- (iii) Ensure that the attendance is properly checked by the Time Keeping Department.
- (iv) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.
- (v) Check the computation of wages payable to the labourers, after taking into account the deductions.
- (vi) Confirm that all the payment to the labourers have been acknowledged.
- (vii) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.
- (viii) Reconcile the number of seasonal labourers on payroll as per the Personnel Department's records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.

Question 23

As an auditor, comment on the following:

- (a) *As on 31.3.2009, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalisation of the accounts for the year ended 31.3.2009 (the accounts were finalised on 14th June, 2009), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31.3.2009, which, it says, will be reversed in the next year.*
- (b) *SK Ltd. has fully computerised its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories at the year end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.*

Answer

- (a) **Events Occurring After the Balance Sheet Date:** As per facts of the case on 31.3.2009, there was a claim against the company for damages by a customer for not providing after sales service. It is a condition prevailing as on the date of balance sheet. Part I of Schedule VI to the Companies Act, 1956 requires disclosure of claims against company not acknowledged as debt as a footnote under caption contingent liability if the same had not been provided for in the balance sheet. However, as on that date, the company had provided for the contingent liability perhaps in view of expectation that such a claim may crystallize as liability against it. The winning of the case by the company in its favour (before the accounts were approved) after the date of the balance sheet constitutes additional evidence that will be of help in deciding the treatment of the matter in the accounts as per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date". However, no provision would be needed as the case had been won by the company, since confirmed by subsequent event happening after the balance sheet date. The disclosure of facts of the case is, however, necessary with a view to keeping users of financial statements informed about the nature of event as well as the fact that no provision is necessary.
- (b) **Verification of Inventories – Auditors' Duties:** The audit procedures to be performed by an auditor to obtain sufficient appropriate audit evidence in relation to

Auditing and Assurance

inventories have been recommended in the Guidance Note on Audit of Inventories issued by ICAI. On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at stock-taking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management.

In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year. Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. It must be tested, for example, in case of inventory, physically verifying the same as to see that no discrepancy exists. Pilferage, misappropriation is not the only cause for discrepancies. Inherent product qualities like shrinkage, evaporation, handling loss, etc. may also account for discrepancies. The auditor should require the management to conduct physical verification by or near the year end. If the management does not accept to the auditor's view the auditor may appropriately make modify in his audit report. CARO 2003 requires specific comment by auditor as to the adequacy and reasonableness of the *physical verification* of inventory. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for. Though the new order specifically omits the requirements of "fair inventory valuation" in accordance with accepted accounting principles and consistent method of valuation from year – to – year, since this is one of the basic requirements of Accounting Standards AS-2, the aspect should therefore still be verified.

Question 24

Under what circumstances change in accounting policies is permissible?

Answer

Change in Accounting Policies: Same accounting policies are adopted for similar events or transactions in each period so as to enable the user to compare the financial statements of an enterprise over a period of time. However, Accounting Standard 5, "Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies" provides that accounting policies can be changed under the following circumstances:

- (1) if the adoption of a different accounting policy is required by statute; or
- (2) for compliance with an accounting standard; or

- (3) if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise. AS 5 also requires any change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by AS 5 should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. For instance, how an enterprise should deal with intangible items appearing in its balance sheet when it applies AS 26, Intangible Assets, for the first time.

Question 25

How will you verify/vouch the following ?

- (a) *Stock lying with Third Party*
(b) *Purchase of Motor Car*

Answer

(a) Stock lying with third party

- (1) Obtain confirmations from the third party including the time period and reasons thereof.
- (2) Evaluate condition of goods and see whether adequate provision has been made.
- (3) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.
- (4) Ensure that the goods have been included in the closing stock though lying with third party.

(b) Purchase of Motor Car

- (1) Ascertain whether the purchase of car has been properly authenticated.
- (2) Check invoice of the car dealer to confirm purchase price.
- (3) Examine registration with Transport Authorities to verify the ownership.
- (4) Ensure that all expenses relating to purchase of car have been properly capitalized and the same have been disclosed properly in the balance sheet.

Auditing and Assurance

Question 26

State the different types of Analytical Review carried out in verification of inventories.

Answer

Analytical Procedures for Verification of Inventories: The auditor can adopt the following analytical procedures to verify the stock of inventories:

- (i) Quantitative reconciliation of opening stocks, purchases, production, sales and closing stocks;
- (ii) Comparison of closing stock quantities and amounts with those of the previous year.
- (iii) Comparison of the stock turnover ratios for the current year with that of the previous year and with industry standards if available.
- (iv) Comparison of the closing stock (Raw materials, closing work-in-progress and finished goods are percentage of total stocks) with the corresponding figures of the previous year.
- (v) Comparison of current year gross profit ratio of the previous year.
- (vi) Comparison of actual stock, purchase and sales figures with the budgeted figures if available.
- (vii) Comparison of raw-material yield/wastage with previous year figures.

Question 27

How will you verify/vouch the following ?

- (a) *Purchase of quoted investment*
- (b) *Discounted bill receivable dishonoured*
- (c) *Amount due to subsidiary companies*

Answer

(a) Purchase of Quoted Investment

- (i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/interest/right/bonus.
- (ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.
- (iii) Verify the amount paid towards purchase of investments.
- (iv) Trace the amount in the cheque book counterfoils and bank statements.

Verification of Assets and Liabilities

- (v) Obtain a schedule of investment from Management for physical verification at the year end.
- (vi) Verify the investment certificate to confirm title.
- (vii) Confirm compliance with statutory provisions such as 227(1A) and CARO, 2003 under section 227(4A) of the Companies Act, 1956.
- (viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.

(b) Discontinued Bill Receivable Dishonoured

- (i) to client's account.
- (iv) Verify entries for dishonour passed in the parties account.
- (v) Confirm whether bank charges, noting charges, etc. have been debited to party.
- (vi) Verify whether B/R has been returned along with banker's advice.
- (vii) Obtain a schedule of Bills discounted / dishonoured and examine the same.
- (ii) Trace the credit entry and subsequent dishonour entry in the bank statement.
- (iii) Confirm that no debit is raised by the banker for dishonour, without first adding the amount ensure that the dishonour has been properly noted on the B/R.
- (viii) Examine correspondence with lawyer and other subsequent events, which may provide other evidence of the debt becoming bad or doubtful, etc.

(c) Amounts due to Subsidiary Companies

- (i) Examine whether the subsidiary company is authorized by its Memorandum of Association to advance the loan to the holding company.
- (ii) Verify the interest rate at which the loan has been obtained and particulars of the security that has been furnished for confirming the amount of interest and disclosure of the charge in the Balance Sheet.
- (iii) Inspect the documents executed by the holding company which constitute the basis of the loan and the provision in the Memorandum under which the loan has been raised.

Question 28

As an Auditor, comment on the following situations/statements:

Auditing and Assurance

- (a) *X Ltd. had a major break down in its plant in the month of February, 2010. In the month of March, 2010 it entered into an agreement with an engineering firm for the purpose of repairing its plant for a consideration of Rs. 180 lacs. The engineering firm started the repairing work in the month of April, 2010 and completed it in the same month. X Ltd. made the provision for said expenditure on repairs in its books of account for the financial year 2009-10 on the plea that the event of break down leading to repair expenditure had taken place in the financial year 2009-10, binding contract for repairs was entered into during the financial year 2009-10 and repair work was also completed before the financial statements were approved by the Board of Directors of the company.*
- (b) *The management tells you that WIP is not valued since it is difficult to know the same in view of multiple processes involved and in any case opening and closing WIP would be more or less the same.*

Answer

- (a) **Provisions, Contingent Liabilities and Contingent Assets (AS 29):** As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a liability is defined as a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. A provision is a liability which can be measured only by using a substantial degree of estimation. In the instant case, the engineering firm, during the financial year 2009-10, did not carry out the repair work and hence no liability has arisen as at 31-03-10 as there was no obligation. Thus, the provision made by X Ltd. for repair work as on 31-03-10 is not correct as there was no obligation.
- (b) **Valuation of Inventories (AS 2):** AS 2 deals with the principles and methods for determining the value at which inventories should be carried in the financial statements. Thus, items hold in the process of production is included in the definition of inventory.

Work in Process (WIP) is normally, valued by taking the basic cost of materials, labour and proportionate factory overhead incurred upto the stage of completion. In view of the above, the argument that the value of opening and closing WIP is more or less same is not tenable as the cost of material, labour and overhead might be different and accordingly, arriving at the different valuation of opening and closing WIP is possible.

In the given case, the management should have determined the stage of completion of the production and valued the work in process accordingly.

Verification of Assets and Liabilities

As per the CARO, 2003, the auditor has to report on the physical verification of inventory has been conducted at reasonable intervals by the management; are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported; whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.

Question 29

As an auditor, comment on the following:

RT Ltd. Received Rs. 50 lacs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of Rs. 50 lacs as income in its Profit and Loss Account for the year. What are your views on the accounting treatment of the above receipt of Rs. 50 lacs?

Answer

Accounting treatment of Government Grants: As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. There are two method of accounting. Under one method, the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. Depreciation is charged on reduced value of fixed assets. Under other method, grants related to depreciable assets are treated as deferred income which is recognized in the Profit & Loss account on a systematic and rational basis over the useful life of the assets .

In the given question, accounting treatment of grant received towards part cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report.

Question 30

Write short notes on First in First out (FIFO) method

Answer

First in First out (FIFO) Method : It is a cost formula used in assigning the cost to inventories which are ordinarily interchangeable. The FIFO formula is based on the assumption that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the

Auditing and Assurance

period are those which have been most recently purchased or produced. It is not applied where items of inventory are not ordinarily interchangeable.

Question 31

As an auditor, comment on the following :

- (a) *You are a Principal Auditor of Sri Company Limited which has three branches the accounts of which are subject to audit by qualified branch auditors. One of the branch auditors qualified his report for non-provision of doubtful debts which he considered to be material for the company as a whole. Subsequent to their reporting, but before you could sign the audit report on the accounts of the company as a whole, the management informed you that the debt under the subject-matter of qualification in Branch Auditor's report had been fully recovered.*
- (b) *A Ltd. is a holding company of B Ltd. B Ltd. is going to start a new project estimated to cost Rs. 20 crores. For this A Ltd. made an investment of Rs. 10 crores in the shares of B Ltd. by borrowing the same from financial institution @10% p.a. As on 31st March, 2010 the project was not completed. The Directors of A Ltd. want to capitalize the interest upto 31st March, 2010 on borrowings amounting to Rs. 1 crore and add it to the cost of investments.*
- (c) *A contractor entered into a contract for building roads for Rs. 2 crores. After completing 60% of the contract he came to know that the cost of completing the contract would be Rs. 2.40 crores. The accountant transferred Rs 0.24 crores i.e., 60% of total loss of Rs. 0.40 crores to Profit and Loss account in the current year.*
- (d) *Finished goods costing worth Rs. 10 lacs were damaged due to floods in July, 2008. These goods were included in the closing stock as on March 31, 2009 at an estimated realisable value of Rs. 4 lacs. These goods, ultimately, could be sold for Rs. 3 lacs only in the accounting year 2009-10. The difference of Rs. 1 lac was debited to prior period expenditure in the accounting year 2009-10.*

Answer

- (a) **Qualification in branch auditor's report-subsequent events:** The Branch auditor had qualified on non-provision of a major debt. After his report but before the issue of report by Principal auditor an event happened which has thrown new light on the facts that existed as on the date of balance sheet date. This is a subsequent event within the meaning of SA 560 i.e. event that had taken place between the date of balance sheet date and the date of signing the audit report. In relation to the cases where the component (i.e. branch) is audited by another auditor, the subsequent event would include events that had taken place between the date of audit report of the component and the date of signing the audit report of the entity as a whole by the

principal auditor. On becoming aware of the subsequent events, the auditor should consider whether the accounts had been drawn so as to give effect to the facts of subsequent events. Accordingly, the auditor should omit qualification as the debt is no more doubtful in view of its recovery in full. However, the auditor may check that it has in fact been received by a substantial vouching of the subsequent events which had been considered by him to make himself fully satisfied about his report in the matter.

- (b) **Capitalisation of interest on borrowing cost** : AS 16 states that borrowing cost that are directly attributable to the acquisition, construction or production of a qualifying asset, should be capitalized as a part of the cost of that asset. Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, e.g. manufacturing plants, power generation facilities etc. that require a substantial period of time to bring them to a saleable condition.

In the given case interest of Rs.1 crore should not be capitalized because as per AS 16

- (a) Investment of Rs. 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 Rs. 1 crore should be shown as expenditure in profit & Loss a/c.

- (c) **Recognition of Contract Revenue & Expenditure** : As per AS 7 when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately irrespective of the stage of completion.

In the given case the revenue that can be recognized for the contract i.e. Rs. 2 crore and the expected expense on the contract is Rs. 2.4 cores. 60% of the contract has been completed. Therefore as per AS 7 whole amount of expected loss i.e. Rs.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 Rs. 0.24 crores to the profit & loss a/c is wrong. He must transfer whole Rs.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.

Auditing and Assurance

- (d) **Prior Period Items:** As per AS 5 "Prior Period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."

Prior Period items should be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information become known or the transaction is finally settled.

In the instant case there is no error or omission in prior periods. It is a case of accounting estimates which have changed when the damaged goods have been finally sold.

Thus the difference of Rs. 1 Lac, debited to prior period expenditure in the accounting year 2009-10 is a wrong accounting treatment.

Question 32

How will you verify/vouch the following?

- (a) *Loss of stock by theft.*
- (b) *Stock lying with subcontractor for fabrication.*
- (c) *Sale of empties.*
- (d) *Expenditure for advertisement in newspaper.*

Answer

(a) Loss of Stock by Theft

- (i) The most important evidence for verification will be the First Information Report (FIR) filed with the police for this theft.
- (ii) The contents of the FIR will be cross checked with the financial books and stock records.
- (iii) If no FIR is lodged, then deeper analysis will be required including satisfaction of the reasons for not filing FIR.
- (iv) The quantity and value of the stolen stock is not included in the closing stock will be ensured.
- (v) Verify whether such stock was insured and whether theft claim was lodged with the insurance company.

(b) Stock lying with sub-contractors for fabrication

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

Verification of Assets and Liabilities

- (ii) The necessity of holding stock by them should be vouched. If the stock is lying with them for long, the reason for the same should be ascertained. The condition of the stock should be confirmed by the management.
 - (iii) The stock should be valued at cost or net realizable value whichever is less. The processing charges incurred should be added to the cost. The provision for the liability towards unpaid processing charges should be created.
 - (iv) The stock should be disclosed under the head current assets under the sub head inventory.
 - (v) Adjustment in accounts should be made for any discrepancies between stock confirmed and stock sent out as per memorandum records.
- (c) **Sale of Empties :** When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturer normally agrees to purchase them back at a reduced price as compared to the one charged for them. Therefore check whether
- (i) Separate account of issue and receipt of empties has been prepared.
 - (ii) In separate maintained a/c check how many empties lies in warehouse and how many are with customers.
 - (iii) Check how many empties customers may return after the close of the year.
 - (iv) Check whether proper provision has been made against the contingency of the containers being returned by customers and that for the wear and tear.
 - (v) Check the amount of sale with entry in cash book.
 - (vi) See the sold empties are reduced from the stock.
 - (vii) If the empties are sold on credit, ask for direct confirmation from purchasing party and confirm the sale.
- (d) **Expenditure for Advertisement in News paper**
- (i) Vouch the copy of the newspaper sent by the newspaper/ advertisement agency to ensure that advertisement actually appeared in the newspaper.
 - (ii) See the date of advertisement which appeared in the newspaper should fall in the current accounting year.
 - (iii) Contents of advertisement should be verified to ascertain that the advertisement was of the entity and was for the business and not of personal nature.
 - (iv) Ensure the rate charged with the offer received for rates from newspaper and ensure that the size and placement i.e. page is in accordance with the rate charged.
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Auditing and Assurance

- (v) Ensure deduction of TDS and service tax wherever applicable.
- (vi) Ensure that it is printed in all issues of the newspaper for which newspaper has charged.

Question 33

Write a short note on - Provisions versus Specific Reserves.

Answer

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 Profit and Loss Account before arriving at the amount of profit.

On the other hand, a specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association, or the directors want to be provided for, such as dividend equalization, replacement of fixed assets, expansion of the organization, Income-tax liability for future foreign exchange fluctuation etc. Though the concerned amounts are carried under the earmarked heads, these are available for distribution as dividend on the recommendation of directors but subject to the approval of shareholders, since these are created by appropriation of profits. To create any specific reserve, existence of profit is essential. Some of the specific reserves may be required under the contractual obligations or legal compulsion, for example: (i) funds for redemption of debentures and (ii) development rebate reserve.

Thus provisions are amounts set apart to meet specific liabilities. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. While to create any specific reserve, existence of profit is essential.

Question 34

How will you vouch/verify the following ?

- (a) Advance given to a director of a Company
- (b) Repayment of amount of foreign loan for purchase of an asset
- (c) Grant received for reimbursement of revenue expenditure
- (d) Deferred Tax Liability.

Answer

(a) Advance given to a director of a company

- (1) Verify articles of association for powers of the company to grant advances to director.
- (2) Refer Section 295 of the Companies Act, 1956 if the company is a public company or a private company being a subsidiary of a public company. According to the section any loan or advance to director requires prior permission of central government. (Directors are often provided with advance money for expense for the purpose of the business of the Company. Such advances are outside the scope of Section 295).
- (3) Check the bank book/cash book entries with vouchers.
- (4) Study the contract /loan agreement, terms, rate of interest and inquire whether they are prejudicial to the interest of the company.
- (5) Check the confirmation received from the director for outstanding advances.
- (6) Check interest had been duly charged for the outstanding unless it is an interest free advance.
- (7) The loan or advances made to the directors should be distinctly shown in the balance sheet.
- (8) Check the related party transaction with director is disclosed in notes to the account.

(b) Repayment of amount of foreign loan for purchase of an asset

- (1) Check the loan agreement, rate of interest, terms of security.
- (2) Check the remittances made during the year towards installments of repayments made.
- (3) Check the receipted voucher/account confirmation for the balance of outstanding.
- (4) The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.
- (5) The gain or loss arising on exchange conversion is to be credited or debited to Profit and Loss account in accordance with the Accounting Standard 11 .
- (6) Check banker exchange rate chart for correctness of the conversion.
- (7) Check RBI or other agencies' permission for remittances outside India.

Auditing and Assurance

(c) Grant received for reimbursement of revenue expenditure

- (1) Check the amount of receipt, donor details etc. from relevant voucher.
- (2) Study the terms of grant for its utilization and check whether they had been complied with.
- (3) Check the nature of grant, amounts have been duly disclosed in accounts in accordance with Accounting Standard 12.
- (4) Check the provisions of law, if any, affecting foreign contributions if the grant comes from abroad.

(d) Deferred Tax Liability

- (1) The deferred tax liability is created when there is timing difference which result in deferred tax payable with reduction in current tax to the same extent. For example, when more depreciation amount is claimed in Income tax profits than in accounting profits, the current tax payable will be less with an liability to pay more tax in future. This is called Deferred Tax Liability.
- (2) Check the creation of Deferred Tax Liability and its actual working.
- (3) Check how much Deferred Tax Liability is reversed during the year.
- (4) Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.

Question 35

As an Auditor, comment on the following:

- (a) *Sri Limited is a manufacturing company engaged in manufacture of cement. It had three plants already commissioned in its site at Chennai. The company expanded its plant capacity by contracting with a supplier for the purchase and installation of one additional plant. The project was commenced on 1.7.2009 and the new plant commenced commercial operations on 1.1.20010. The new plant was capitalized and shown as Fixed asset as on 31.3.2010 at cost which included, besides other things, the following:*
 - (i) *Contract price of plant and equipment and installation costs*
 - (ii) *Interest due for the period till 31.3.2010 for the term loan taken from scheduled bank for financing the project which is repayable over five years commencing from 1.7.2010.*
 - (iii) *Salaries, welfare expenses of the plant engineers of the company for the period from 1.7.2009 to 31.12.2009 who supervised the contract work.*

Verification of Assets and Liabilities

- (b) *The Investments of ABC Limited includes 5,000 equity shares of Rs. 100 each in Amudhan Bank Limited. Amudhan Bank Ltd. declared 20% dividend for the year ended 31.3.2009 at its General Meeting held on 30.6.2009. ABC Limited finalised its accounts for the year ended 31.3.2009 on 30.8.2009 and it includes Rs. 1,00,000 being the amount of dividend received by it from Amudhan Bank Ltd. in its other income subsequent to its Balance Sheet date before approval by the Board of Directors.*
- (c) *AS Limited purchased on 1.4.2009 a machinery from a foreign country at a price of \$ 1, 50,000 upon terms of credit that the price should be settled within six months from the date of purchase. The company capitalised the Asset and created Liability for the capital goods converting the foreign currency liability to Indian Rupees at a rate of exchange prevailing as on 1.4.2009. When the company settled the liability on 18.7.2009, it had to incur an additional amount of Rs. 6, 75,000 due to change in foreign exchange rate on the date of settlement. It added this additional amount of exchange variation in the capital cost of the asset and charged depreciation upon the enhanced amount of asset value from 18.7.2009.*

Answer

- (a) **Accounting for Fixed Assets and Borrowing Cost :** According to AS 10, the cost of fixed asset includes all expenses for bringing into existence and working condition the asset for its intended purpose. Accordingly all expenses attributable to the construction of fourth cement plant can be added to the cost except those which had been not permitted by the AS.

The cost of purchase, installation of asset is directly related to bringing the asset into the working condition for intended use and hence is correctly capitalized.

According to AS 16 on borrowing cost, the interest expenditure on borrowing can be capitalized till the date of the cessation of construction. The capitalization ceases when substantially all activities of construction are completed. Simply, the interest can be capitalized till the completion of the project and it should not be capitalized after commencement. In the instant case of capitalization of interest, the company is partly right in capitalizing it till 31.12.2009 and is wrong for capitalizing it beyond 31.12.2009 till 31.3.2010.

The allocation of common overhead is allowed if they are specifically relatable to project. The salary expenditure of plant engineers may be capitalized for the construction period.

Accordingly, the auditor shall qualify his report for the deviation if not adjusted, taking into account the materiality of the impact on accounts.

Auditing and Assurance

- (b) **Dividend Recognition** : ABC Limited accounted the dividend income from its investment in Amudhan Bank Limited declared subsequent to its (ABC Limited) balance sheet but before finalization of the accounts.

According to AS 9 on revenue recognition, the dividend income is recognized when the right to receive it occurs viz. the date of declaration.

As such, the date of declaration is the relevant date. The date of declaration being 30.6.2009 falls after the end of the accounting period.

Hence, the company is wrong in accounting an income which does not pertain to the year under reference. This may warrant a qualification in the audit report subject to materiality consideration.

- (c) **Effects of Changes in Foreign Exchange rates**: According to AS 11, the foreign currency transactions should be initially recognized at the exchange rate prevailing on the date of transaction. Accordingly, the asset and liability should be accounted at exchange rate prevailing on the date of purchase.

The monetary items should be reported at the exchange rate prevailing on the close of the accounting period. The liability for capital goods purchased is a monetary item.

If during the accounting period, if a monetary liability is settled at a rate different from the rate at which it was initially recognized the exchange difference should be charged to P&L account in the year of settlement.

According to AS 11 (revised), hence, it is necessary to write off Rs, 6.75 lakhs being exchange differences at the date of settlement. It cannot be added to the cost of the capital. Hence, the company is wrong in capitalizing foreign exchange differences between the amounts of initial recognition and settlement and computing depreciation on the wrongly capitalized portion of the asset.

This warrants correction by the company. Else, the auditor may qualify his report upon relevant considerations.

Question 36

As on Auditor, comment on the following:

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:

Verification of Assets and Liabilities

- (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 37

As an Auditor, comment on the following:

- (a) *Lehar Ltd. installed a new water treatment plant at its factory on 1.10.2009. The company estimated that the new plant will become obsolete after 4 years only and hence charged depreciation at a rate higher than that envisaged in Schedule XIV to the Companies Act. During the year 2009-10, the company therefore had written off 1/4th of the cost.*
- (b) *Fire Ltd. purchased equipment for its power plant from Urja Ltd. during the year 2008-09 at a cost of Rs.100 lacs. Out of this they paid only 90% and balance 10%*

Auditing and Assurance

was to be paid after one year on satisfactory performance of the equipment. During the Financial year 2009-10, Urja Ltd. waived off the balance 10% amount which was credited to Profit and Loss account by Fire Ltd. as discount received.

Answer

- (a) As per AS 6 on Depreciation Accounting, assessment of depreciation and the amount to be charged in respect thereof in an accounting year/period are usually based on the following three factors:-
- (i) Historical Cost.
 - (ii) Expected useful life of the asset.
 - (iii) Estimated residual value of the asset.

If the management's estimate of the useful life of an asset is shorter than that envisaged under the relevant statute (Companies Act) the depreciation is appropriately computed by applying a higher rate. The depreciation rate provided in Schedule XIV is the minimum rate and a company can charge higher than those prescribed.

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

However, the company has wrongly charged full year's depreciation during 2009-10 instead of half year's depreciation as per requirement of Schedule XIV. The auditor should highlight this to the company and ask to rectify the same.

- (b) According to AS 10 on Accounting for Fixed Assets, the cost of an asset may undergo changes subsequent to its acquisition on account of exchange fluctuation, price adjustment, changes in duty or similar factors. Such changes in price /cost needs to be adjusted with the cost of the asset.

In the given case, Fire Ltd., initially accounted for 100% amount i.e., Rs.100 lacs as cost of fixed asset although they paid only Rs.90 lacs and kept Rs.10 lacs as payable to the credit of Urja Ltd. Now since the supplier has waived off the balance amount of Rs.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 Rs.10. Lacs as discount to Profit & Loss Account is completely wrong and needs to be corrected. It will have effect on depreciation also and needs adjustment.

The auditor should report the matter if suitable changes are not made in the accounts.

EXERCISES

Question 1

As an auditor, how would you react to the following situations?

- (a) The company entered into “an agreement for sale” to purchase an office space in a commercial complex. The company with the consent of the promoters started operations from the said place upon signing of the said agreement and included under fixed assets, the total consideration payable.
- (b) Included under sundry creditors was fees payable to the legal counsel for suits filed against the company. The company is not aware of the status of the suits and hence did not want to provide for the same.
- (c) The company due to liquidity crisis sold and leased back the same vehicles from two different leasing companies on the same terms and conditions. In the notes to accounts the company stated “vehicles taken on lease repayable in 36 instalments of Rs. 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.

Question 2

State your views on the following:

- (a) Events occurring after the Balance Sheet date.
- (b) Verification, valuation and disclosure of fixed assets.

Question 3

Write short notes on the following:

- (a) Intangible assets
- (b) Analytical review
- (c) Floating charge

Question 4

How will you vouch and/or verify the following?

- (a) Inventories
- (b) Sale of assets
- (c) Bills payable

Auditing and Assurance

- (d) Goodwill
- (e) Contingent Liabilities
- (f) Purchase of Quoted Investments.

Question 5

State with reasons, how the following items should be allocated to capital and revenue:

- (i) Repairs to building done shortly after purchase.
- (ii) Costs of raising a loan.

Question 6

- (a) What are the general considerations for valuation and verification of assets?
- (b) What is Depreciation of Fixed Assets and why is it provided? Can a company change the method of providing depreciation?

