Definition:

The term **Auditing** refers to the process of examination of books and records together with the evidence relating to enterprises, whether profit - oriented or not and whether it is required by law or not, for the purpose of formation of opinion with regard to true and fair view disclosed by financial statements.

Advantages of Auditing

A. General

1. Unbiased professional opinion
2. Acts as a moral check on employees
3. Highlighting of weakness in the internal control system
4. Enables timely tax assessments and quick disposal of tax returns.
5. Financial assistance made easier.
6. Solutions to trade disputes and labour disputes
7. Enables sanctioning of license by Govt.
8. Enables early settlement of Insurance claims

B. From the point of view of partnership Firms

1. Mutual settlement of Accounts among the partners
2. Protects the interest of minors and non-resident partners
3. Determination of goodwill at the time of admission, retirement and death.
4. Determination of purchase consideration at the time of Amalgamation,

Limitation of Audit

1) Excessive dependence in ICS which suffers from inherent weakness
2) Application of test check makes it less reliable
3) It only enables formation of overall opinion about state of health of entity and does not give assurance about the future viability of entity or the effectiveness of management by owners.
4) Audit evidence is more persuasive in nature rather than conclusive in nature

Qualities of a Good Auditor

i) Integrity, confidentiality, objectivity,
ii) Independent in his approach
iii) Posses technical skill in accounting and Auditing
iv) Thorough knowledge of legal provisions and statutes
v) Common sense
vi) Communication skill
vii) Supervisory abilities
viii) Inter personal skills

Kinds of Audit

1. Audit can be classified as
   a) Statutory Audit
   b) Non-Statutory Audit

<u>Statutory Audit:-</u>

This refers to audits which are mandatory in nature.

Examples are

i. Audit of companies under law provision of company act
ii. Audit of insurance company
iii. Audit of Banking company
iv. Audit of co-operative societies

Audit to be performed by CA's and not by any other person

<u>Non-statutory Audit</u>

i. These are other than statutory audits
ii. No statutory requirement for Audit

E.g. Sole trader, partnership firm

Object of Audit

1. Meaning
   i) Refers to the purpose or the ultimate end audit
   ii) Knowledge of object relevant for audit
   iii) Common for both statutory and non statutory audit

2. Classification

Can be classified as

i) Primary object ii) Secondary object

Primary object is to form opinion on the true and fair view disclosed by financial statements. Financial statements include Balance Sheet, P & L accounts and cash flow statements.

Secondary object is to detect fraud and error

The auditor should ensure that the financial statements do not contain misstatement on a/c of fraud and error. Both objectives are interdependent and not independent

Basic Principles governing an Audit (AAS 1)

1) Integrity
   - i) Honest and straight forward
   - ii) Auditor not to practice dishonest means for satisfying client's requirement

2) Confidentiality
   - i) Not to divulge information about the clients to third parties
   - ii) Also covered by CA regulations
   - iii) If required by law, he may disclose information with the consent of client.

3) Objectivity:
   - i) Refers to purposefulness
   - ii) To conduct audit keeping in mind secondary and primary objectives

4) Independence:
   - i) Should not be capable of being influenced by anybody
   - ii) Relevant for judging opinion on view presented by Financial Statements

5) Skill and Competence
   - i) Be capable of applying the skill in practical situation.
   - ii) Update and upgrade knowledge in the relevant fields.

6) Audit planning
   - i) Audit be based on proper planning
   - ii) The plan of Audit must be developed before commencement of Audit
   - iii) It also includes programming

7) Audit evidence
   - i) Audit be conducted by considering evidences
   - ii) Evidence is available in the form of books and records, voucher.
   - iii) It is available form from internal and external sources.

8) Audit Documentation
   - i) Auditor to record his observation of findings in working paper
   - ii) To be maintained at Auditor's Office

9) Using the work of others
   - i) Involvement of other experts in the Audit of financial statement
   - ii) Auditor to use the work of other intelligently

10) Evaluation of ICS and AS
   - i) Client's responsibility to introduce ICS which includes AS
   - ii) Auditor to evaluate the system before commencing Audit
   - iii) It is useful for Audit to determine the extent of checking and nature of Audit procedure

11) Audit conclusiveness
   i) Formation of Opinion
   ii) Report in specific format
   II) Address to specific authority

Concept of Independence of Audit

1) Independence is a state of mind
2) Should exist at all times
3) Existence enhances transparency
4) Auditor not to be influenced or coerced by the client
5) Auditor not to have vested interest in clients business
6) Companies Act 1956 contains following provision regarding independence
    1. Auditor (other that 1st auditor) to be appointed by shareholder
    2. Share holder not to delegate power to board
    3. Casual vacancy due to resignation to the filled only by shareholder.
    4. Central government sanction compulsory for removing auditor prior to completion of terms of office
    5. Sometimes special resolution to be passed to remove auditor
    6. Officer / employer of company not to be appointed as Auditor
    7. Share holder of company cannot audit accounts
    8. Indebtedness exceeding Rs.1000 to company results in disqualification
    9. Scope of Auditor cannot by reduced either by director or share holder
    10. Relative of director can be Auditor provided he discloses the nature of his interest.

Object and scope of Audit if Financial Statements (AAS 2)

1. Object

This refers to purpose of Audit. The objects are classified into:

A. Primary objectives
B. Secondary objectives

The primary objective of Audit is to form and opinion regarding true and fair view disclosed by the financial statements which includes Balance sheet & Profit & Loss a/c.

The responsibility for the preparation of financial statements rests with the management of the entity. The secondary objective of Auditing is to defect frauds and errors which would result in material mis-statements.

2. Scope

This refers to the extent and coverage of Auditing. While the object is the end of Auditing, scope refers to means of Auditing.

Determinants of Scope

The following are the 3 sources through which scope can be determined

A. Statute

It means the relevant legislation I Act passed in the parliament. In case of Co's, Banking Co's and insurance Co's the scope of Auditor is determined Act eg. Companies Act 1956.

B. Terms of Engagement:

In the case of sole traders and Partnerships, the scope is determined by terms of engagement arrived at mutually between the Auditor and the client. Upon receipt of appointment letter from the client, the Auditor issues a letter of engagement to the client laying down his understanding of the scope of the work.

C. Pronouncements of ICAI

ICAI issues pronouncements on various matters such as Accounting and Auditing through

1. AS - Accounting Standards.
2. AAS - Auditing Assurance Standards.
3. Guidance Notes.
4. Statements.

Modification of Scope:

The scope determined by statue is minimum requirement and it cannot be reduced even by passing special resolution. On the other hand it can be expanded based on mutual agreement.

Phases in Audit / Functions of Audit

It refers to stages in the conduct of Audit. Irrespective of whether it is statutory/Non statutory,

Audit is carried out in the following stages.

1) Study and evaluate the Accounting and internal control system.
2) Ensuring the authenticity and validity of transactions.
3) Confirming that the transactions entered into are properly recorded.
4) Verification of the financial Statements by checking from Trial Balances.
5) Ensuring the compliance with Law and Professional requirements.
6) Analyzing and interpreting the results for formati9on of opinion.
7) Submission of Audit reports to appropriate Authorities.

Audit Documentation: (AAS 3)

(i) Meaning

1) Refers to various information provided to the Auditor by the client in support of matters disclosed in financial statement.
2) Collectively known as working paper.
3) Also includes Audit note book

(ii) Purpose

1. It supports Audit conclusions reached
2. Evidence which can be presented in the court supporting nature of Audit work.
3. Provides guidance for future period audit staff
4. Fixes responsibility on the audit staff executing the Audit work
5. It is a proof that GAAP has been regularly followed

Classification / Kinds

1) Broadly classified as (a) Permanent file & (b) Current file
2) Permanent file
    1) Kept at Auditor's office
    2) Contains documents which are required for Audit of recurring nature
    3) Members of Audit team refer to this for updating basic information about client.
    4) Cannot be taken to client's location
    5) Contents are updated periodically

CONTENTS OF PERMANENT FILE (few examples)

1) Copies of MOA and AOA
2) Copies of collaboration agreements
3) Extract of legal provisions applicable
4) Extract of legal pronouncements such as AS
5) Published accounts previous periods
6) Major frauds occurred and detected in previous period
7) Organizational charts
8) List of officers, their power and duties
9) List of accounting policies followed
10) List of bank accounts operated
11) Evidence that ICS has been evaluated
12) Statement showing trend of accounting ratios

Current file

1) Refers to papers linked to current period F.S.
2) Generated at the client's office
3) Information are either founded by clients or generated by Auditor directly
4) The contents support conclusions reached by Auditors
5) Ultimately stored in Audit's offices
6) It is indexed and numbered in the systematic manner

Contents:-

1) Advance planning memorandum
2) Audit programme
3) Inventory sheet
4) Confirmation letters
5) Draft financial statements
6) Draft Audit report
7) Branch financial statement
8) Management representation
9) Statement of accounting ratios
10) Audit conclusions

Ownership

1) Auditor enjoys unconditional ownership
2) All working paper files are kept in Auditors office for a specified duration

Distinction before current file and permanent file

Permanent File	**Current File**
1. It is static and kept in Auditor office	It is dynamic and generated at client's office

	and finally kept and Auditor office
2. It is referred before commencement of audit	Created after completion of Audit
3. It is useful for Audit staff to conduct Audit	Useful for Auditor to support his Audit conclusion
4. The contents are updated every year	Contents are static.

Responsibilities of Auditor with regard to fraud and error in financial statements (AAS 4)

1. Fraud:-
   1. Refers to international misrepresentation of information
   2. Committed by employees or management or 3rd parties
   3. It includes the following
      a) Misappropriation – E.G Cashier misappropriating cash, store keeper taking away expensive items
      b) Non accounting of cash sales
      Falsification of documents – Eg. Alteration of time sheets, over time statements, cash book etc.
      c) Manipulation of records. Eg. Done by management for showing higher profits
      d) Misapplication of accounting policies e.g – done by management for showing higher points
      e) Recording of transaction ignoring substance. E.G. goods sent on consignment accounted as sales.

2 Error:-

Refers to a unintentional mistake due to carelessness, oversight or ignorance

Classified as

a) Error of principle :- involves error in application of accounting principles Eg. Legal expenses related to acquisition of land debited to legal expenditure account

b) Clerical errors indicated as follows

i. Error of commission – arises due to mistake in reading the figures in the document
ii. Error of omission – arise due to omission in recording transaction
iii. Error of duplication : refers to process of recording involves twice
iv. Error of compensation :- Where an error in one account is compensated or off set by an error or similar amount in another accounts.

Responsibility

1. **Management:-**
   a) Responsible for both prevention and detection of fraud and error
   b) Management to introduce
      (i) Internal check system
      (ii) Internal control procedure for preventing fraud.
   c) Introduce internal audit system for detection of fraud and error
   d) The IC System to be reviewed by management.
2. **Auditor**
   1. Not responsible for prevention of fraud and error since it does not affect his obligation to from opinion of financial statements (Primary) Should design his audit program in such a way that frauds and errors can be detected in the ordinary course of audit.
   2. Not to suspect about existence of fraud and error.
   3. Should exercise due skill in executing his work. Failure to do so results in liability
   4. Should evaluate the IC system and internal audit system to satisfy regarding reduction of the risk of mistake due to fraud and error.
   5. The risk of mistake due to fraud is greater than error due to
   a) Involvement of material amount
   b) An active initiative to conceal fraud
   6. Application of test check – No defence to auditor for non detection of fraud.

Disclosure

1) Amount of fraud to be disclosed separately in financial statement
2) Based or material of the errors, correction to be effected to financial statements

Audit evidence (AAS 5)

1. MEANING

Evidence refers to various information or explanation provided by the client to the Auditor.

It is the backbone of auditing since Auditor can come to a conclusion based on evidence

Management responsible for providing evidences to Auditor

Evidence include books, records and vouchers

2. Significance

Auditor to carry out objective analysis of evidence for opinion formation

Gives assurance to Auditor about the conclusion

3. Kinds

Based on sources of evidence it can be

a) Internal

b) External

Internal evidences are created within the entity by client's staff. Internal evidence maintained at client's office permanently and can be referred in future also.

E.g. Copies of cash receipts, dispatch notes, gate pass, copies of sales invoices, goods received notes, inspection report, bin cards etc..

External evidence:

1) Generated from outside enterprises or third parties
2) Ultimately retained by the client in his files
3) It can be direct or indirect
4) It case of direct, Auditor gets the external confirmation without the interference of client

E.g. Suppliers invoices, Bank statement, Bank confirmation letter, account sale of consignees, agreement signed by 3rd parties.

The evidence can be written or oral; accordingly Auditor obtains corroborated audit evidence

Reliability / Standards of evidence:

1) Written is more reliable than oral
2) External is more reliable that internal
3) Evidence created by Auditor directly is more reliable than evidence created through client
4) Internal evidence is reliable only if a good internal control is in existence

Procedures for collection of evidence

1) <u>Compliance Test</u>

1) Compliance means adherence
2) Management introduces IC system
3) Evaluation of ICS by auditor
4) The auditor carries out auditing in depth and surprise check for this purpose
5) Object is to ascertain whether the personnel have complied with ICS.

Objective of compliance test

1) Existence of system
2) Effectiveness of system

3) Continuance of system

The Auditor is concerned with all the above concurrently

2) <u>Substantive test</u>

1) Phrase 'substantive' derived from the word to substantiate i.e. to prove

2) It refers to

a) Test of details of transaction

b) Analytical test

Following are objective with reference to Balance sheet

1) Existence
2) Rights and obligations
3) Valuation
4) Disclosure

With regard to P & L account following are the objectives

a) Occurrence of transaction
b) Measurement of transaction
c) Disclosure

Methods of collection of evidence

1. Inspection
   (1) Refers to physical examination of tangible assets
   (2) It relates to both tangible assets and documentary evidences E.g. verification of cash in hand, investments, examination of agreements and contracts etc.
   (3) Can be done either at year end or during the year
2. Observation
   (1) Refers to process of looking at an act performed by the client
   (2) Auditor is not involved in actual performance of the process, but he only looks at the process. E.g. – Stock observation at year end when client carries out stock taking
   (3) Auditor does some test check of the items
   (4) Any defects observed during observation reported by auditor to client
3. Enquiry and confirmation
   (1) Enquiry refers to seeking answer from client's personnel relating to accounts.
   (2) It is a process of questioning
   (3) These are directed at various levels of the staff
   (4) Confirmation refers to response to enquiry
   (5) It can be oral or in written form
4. Analytical procedure
   (1) Refers to calculation of significant ratios and relationships
   (2) E.g. – GP ratio, NP ratio etc.

(3) Investigation is a must if there are wide fluctuations

(4) Auditor to compare the ratios of different periods.

5. Computation

Refers to calculations of certain figures

(1) Eg. Tax computations, Bonus computation, Computation of provisions

(2) May be done either though calculator or computer

Internal Audit

Meaning: Refers to independent appraisal of management activities within the organization as a service to management and it acts as control over other controls.

Features:- It is an appraisal function

On behalf of management

Continuous audit activity

May be done by an individual who is an employee or by a firm of accountants

Report to management or audit committee.

The management decides about scope of the work of internal auditor.

Internal audit is very useful to management on

a. Review of Internal control system
b. Review of procedures adopted for safeguarding assets
c. Review of organizational structures
d. Review of management information system
e. Review of implementation of policies, plans and strategies
f. Review of accomplishment of result by line managers.

It is useful to statutory audit in the following areas.

1. Evaluation IC system
2. Carrying out physical stock taking procedure
3. Obtaining evidences for contingent liability
4. While sending out request for confirmation of balance debtors and creditors
5. Ensuring correctness of FINANCIAL STATEMENTS through a system of pre-audit.

Internal Audit	**Statutory audit**
1. It is an audit activity carried out on behalf Of Management.	It is carried out on behalf of share holders
2. Non statutory in nature	Statutory in nature
3. No prescribed qualification	Only CA can do the audit
4. Appointment by management	Appointment by share holder
5. The term of office is continuous	Term expires at every AGM
6. Less independent because of status i.e. scope amenable for change	More independent, statute determine scope and it can be increased but not reduced
7. It is not considered for audit ceiling	Considered for purpose of ceiling U/S 224
8. Proprietary orientated approach	Compliance oriented approach
9. Submit report to management which includes recommendations also.	Address report to share holders. Does not contain any recommendation but only opinion

Reliance on work on internal Audit (AAS 7)

1. Not mandatory for statutory auditor to compulsorily rely on work of internal audit.
2. Even if he relies on the work of internal audit, he is still not protected from liability
3. CARO 2003 requires statutory auditor to mention in his report whether internal audit system is commensurate with size and nature of business. In case of company having share capital + reserves at Rs.50 Lacs or the average annual turnover has crossed Rs. 5 Crores for last 3 financial years.

Criteria for placing reliance on the work of internal auditor

1. Independence
    a. To whom is the chief internal auditor reporting?
    b. Is the internal audit dept. free from interference by other managers?
    c. What is the designation of the chief of the internal audit dept?
2. Skill and competence
    a. Is the chief internal auditor is a qualified and experienced person?
    b. Is there a proper training of internal audit staff within the organization?
    c. Does the management sponsor the internal audit staff to participate in conferences and seminars organized by professional bodies?
3. Audit Planning
    a) What is the composition of qualified, unqualified staff in the internal audit dept?
    b) Is the staff turn over rate of internal audit dept. comparable with the organization turn over rate?
    c) What is the method of hiring and training internal audit staff?
4. Use of documentation
    a. Whether internal audit staff use questionnaires, flow charts and check lists for evaluating internal control system
5. Audit procedure
    a) Is there an internal audit manual in existence
    b) Is the internal audit work done as per an audit program and whether the audit program is frequently amended?
    c) Is there a consultation with the statutory auditor regarding the audit program?
    d) Is there a system of rotating the functions among internal audit staff?
    e) Is there a system of maintaining working papers by internal audit staff?
    f) Whether the work of internal auditor is subjected to supervision by managers?
6. Audit coverage
    a. Does the internal auditor cover only financial areas or also operational areas?
    b. Does it cover:
        1. Investigations
        2. Statutory compliance
        3. Year end stock taking procedures

7. Audit Report

a) To whom is the internal audit report submitted?
b) Does it contain recommendations in addition to observations?
c) Is there a follow up of earlier recommendations!
d) What is the management's attitude towards internal audit recommendations?
e) What is the periodicity of audit report?

Audit planning (AAS 8)

Meaning

1) Refers to foreseeing the audit activity before it is commenced by auditor
2) Applicable for all types of audit
3) Based on knowledge of client's business

Coverage of planning

It covers the following aspects:-

1) Acquiring knowledge of client's accounts system accounts polices and IC procedure
2) Establishment of expected degree of reliance to be placed on IC
3) Determination of nature, timing and extent of audit procedures through proper programming
4) Co-ordination of the audit.

Constituents:-

The planning process includes

a. Development of an overall audit plan
b. Development of an audit programme shown nature, timing and extent of audit procedures

Advantages

1) Appropriate attention is devoted to important areas of audit
2) Identification of potential problems.
3) Completion of work expeditiously (on time)
4) Utilization of assistance properly
5) Coordinating work done by other auditors and experts.

Documentation of planning

The auditor prepares a plan and it is known by

1) Overall audit plan
2) Advance planning memorandum
3) It is part of current working paper file

Development of overall audit plan

The following matter to be considered

1) Terms of engagement
2) Statutory responsibilities
3) Nature and timing of reports
4) Accounting policy followed by client including changes therein
5) Identification of significant audit areas
6) Setting up of materiality level for audit
7) Conditions increasing risk of fraud and error.
8) Extent of reliance of an IC accounting system
9) Possibility of rotation of emphasis on specific audit areas.
10) Nature and extent of audit evidence
11) Effectiveness of internal audit system
12) Involvement of others such as branch auditor, experts etc

Audit Programme

It refers to a document in writing prepared by an Auditor prior to commencement of audit. It contains written instructions issued by the Auditor to his staff members for conducting the audit. Normally the audit programme contains directions consisting of the methods and procedures for conducting the audit. The Audit program is complied for each year for each client separately.

Contents:

1. Extent of checking i.e.% of checking of transactions as a test check.
2. Initial /Signature by audit staff
3. Remarks
4. Level of staff deputed
5. Audit procedures and techniques.

The Audit Programme normally covers both B/S and P & L audits.

Advantages:

1. Replaces mental plan
2. Effective monitoring device
3. Coverage (wide)
4. Systematic approach to audit
5. Source of planning for future
6. It provides guidance to audit staff
7. Acts as evidence in the court of law.
8. Enables fixation of responsibility on the audit staff
9. Ensures continuity of audit
10. Compliance with Auditing practices

Limitations:

1. Rigidity
2. Monotony
3. Does not encourage creativity
4. Provides an easy way of escape for inefficient staff

Using the works of experts (AAS 9)

Who is an expert?

An expert is a person, from or AOP possessing special skill, knowledge and experience in a particular field

During the audit, the auditor may seek to obtain evidence in the form of reports, opinions etc. from an expert. The following are the situations:

a) Valuations of certain types of assets eg. Work of art, precious stones, etc.
b) Determination of quantities or physical conditions of assets, eg. Minerals in stock piles, petroleum reserves and remaining useful life of plant and machinery.
c) Determining the amounts payable to employees as gratuity through actual valuation method.
d) In the case of contracting Co's to assess and measure the work complete in physical units.
e) Legal opinions.

Need for Expert Opinion

1. Auditor may have to consider the use of expert while forming his opinion
2. Auditor to consider the materiality of item and possibility misstatement therein
3. Expert may be either engaged or appointed by the client or by the auditor.

<u>Auditor's obligation while using the work of experts</u>

1. Evaluating the work of the expert

When the auditor intends to use the work of an expert, he should examine the following matters and general considerations.

1. The objective and scope of experts work.
2. A general outline regarding the specific items in the experts reports.
3. Confidentiality of the expert's work.
4. The expert's relationship with the client.

2. Examination of source data

The auditor has to check the source data provided to the expert to obtain an assurance that the conclusions drawn by the expert are reliable.

3. Review of assumptions

The Auditor can obtain an understanding of the assumptions used by the experts without questioning the correctness of such assumptions. He can compare the assumptions with the previous periods.

4. Review of the results of the experts work

In the light of the Auditors overall knowledge of the business and the results of the audit procedures employed, he can come to his own conclusion about the findings of the expert. He can also hold discussions with the expert and the management to sort out the variations.

5. Reporting

After performing the above procedures, if the Auditor finds that he can rely on the work of the expert, he will issue on unconditional opinion. On the other hand, the Auditor can seek from the management, a direction to engage a 2 expert to restore the inconsistency. Even after the above procedures, if the auditor is not satisfied, he should express a qualified opinion or disclaimer or adverse opinion, as the case may be.

Using the work of another auditor (AAS – 10)

Definition:

1. Principal auditor. The one who is responsible for the audit for accounts of entity as a whole. In case of companies, statutory auditor is the principal auditor
2. Component auditor: The one responsible for auditing the accounts of a specific component or factory or unit. Also known as Branch auditor.

Audit procedure for using the work of other auditor.

1. Generally, the principal auditor is justified in placing reliance on work of component auditor unless there are circumstances which indicate that he should not so rely.
2. The following are the obligations of the principal auditor.
    - I. Consider the professional competence of the other auditor especially when he is not member of ICAI
    - II. Coordination with component auditor while planning audit work.
    - III. Hold discussion with other auditor as to the nature of use to which latter's work will be part to.
    - IV. Advise the other auditor on significant accounting, auditing and reporting requirements
    - V. Advise the other auditor about time schedule and itinerary
    - VI. Consider the significant audit findings of other auditor.
    - VII. Request the other auditor to provide a check list as to the nature of audit procedure deployed by other auditor.
    - VIII. Record in the working papers, the following matters.

a) name of branch or division audited by other auditor
b) significance of those branches or divisions to the entity's financial statement as a whole
c) Any conclusion reached about the immateriality of braches or division
d) Manner of dealing with qualification or adverse remark in other auditor's report.

Responsibility of principal auditor

1. The principal auditor is obliged to report on the basis of report of other auditor
2. Clearly mention in his report, the division of responsibility by indicating the extent to which the financial statements audited by other auditor have been included in the overall financial statements.

Obligation of other auditor

a. Should adhere to the time schedule given by principal auditor
b. Should communicate with principal auditor, major observation which my have impact on overall FS.
c. Submit a questionnaire or check list detailing the manner of work performed to the principal auditor.
d. Extend co-operation to principal auditor when the latter requires addition information e. Submit audit report of component giving all necessary details.

Reporting Aspect

1. When the principal auditor concludes that the work of other auditor cannot be used, he should express a qualified opinion or disclaimer of opinion as appropriate.
2. It the other auditor modifies his report or intend to modify his report, the principal auditor should consider the modification of other auditors report and whether any modification is required in principal auditor's report as a consequence of modification by other auditors in his report.

Representation by Management (AAS 11)

Meaning

1. It refers to written or oral confirmation by management regarding items presented in the financial statement.

2. Known as letter of representation or overall management certificate.

Need:

1. When auditor conducts the audit, he needs several information or explanation.
2. Provided by management in the form of books, records and vouchers.
3. The accountant and other personnel provide this information
4. Ultimately, the management is requested to provide a letter or report about the Validity information already obtained.

5. In case of companies, auditor to mention in his report, whether he has received Information explanation necessary for the purpose of audit.
6. Who can give representation
   i. To be given by a person not below the rank of director
   ii. Any other representation is invalid

Consideration of AAS 11

This standard considers the following matters.

a. Utility of management representation as audit evidence
b. Procedures to be applied in evaluating management representation
c. Documentation of representation
d. Action to be taken if management refuses to give representation.

Management representation as audit evidence

1. Auditor should obtain evidences in written form
2. Should seek corroborative audit evidence supporting management representation.
3. Evaluate whether the representation is reasonable and consistent with other audit evidence available
4. Check whether the person making the representation is will informed of the matter.
5. Management representation cannot substitute the evidence obtained though application of other substantive procedure.
6. Sometimes, representation by management may be the only evidence. E.g. whether the investment are current or long term in nature.
7. Check whether there is contradiction between management representation letter and other evidences.

Documentation

1. The working paper of the auditor should contain
   a. Letter of representation received from management
   b. Auditors Understanding of representation duly acknowledged by management
   c. Authenticated copy of relevant minutes of the meetings of BOD or committees.

Refusal by management:

1. Sometimes, management refuses to give representation in writing.
2. In such cases, auditor has to prepare in his letterhead the representation received by him from personnel and request the management to confirm the same.
3. If management refuses to that also, auditor to consider the impact of the same as a limitation of the scope and consider proper reporting.

Contents of management representation

1. It should be dated and date should be either on the same date on which accounts are authenticated by directors or earlier date. It should not be later than the date of authentication
2. It should contain specific paragraph duly numbered.

3. Should be in the letterhead of the entity.
4. Signed by director or MD

Responsibilities of Joint Auditors (AAS 12)

1. Joint audit refers to audit of accounts by more than one auditor or firm of auditors.
2. Generally applicable in PSU's and banks
3. Object is to get additional profession opinion
4. The joint auditors are responsible for giving a joint audit report after carrying out audit.
5. There is a need for division work among the joint auditors which may be carried out in following manner.
    a. Period wise
    b. Activity wise
    c. Component of financial statements wise.
    d. Location wise
6. The purpose of division of work is to fix the responsibility on each of the joint auditors.
7. One the work is divided, it should be communicated to the management with the idea of ensuring the management to provide necessary assistance to audit.
8. Management has no say with regard to manner of division of work

Obligations of Co-Auditors

1. To maintain proper working paper file
2. To draft audit programme covering his area
3. To exercise due skill, care and diligence in performance of audit
4. No to give direction or review the work of other co-auditor
5. To convey the information received during the course of audit which may be found useful to other co-auditor.
6. To hold discussion with the other auditor regarding matters of common interest on
    a. Compliance with AAS
    b. Accounting policies
    c. Adjustments arising at the year end
7. To audit the accounts of branches which fall within his jurisdiction

Joint and several liabilities

1. Where there is a division of work, the liability of joint auditors is individual in nature
2. In the following cases, the liability of joint auditor is joint and several
    a. Where there is no division or work
    b. When one co-auditor has conveyed the information to other co-auditor in which there is concurrence.
    c. Disclosure requirements
    d. Compliance with statutory requirements

Difference of opinion between auditors

1. Not always necessary for total concurrence between the auditors
2. If there is non concurrence on certain matters, each auditor may issue separate audit report expressing their individual views.
3. Majority opinion does not bind individual co-auditor.

Advantages of joint Audit

1. Timely completion of audit
2. Extensive coverage in a systematic manner
3. Pooling of expertise.
4. Mutual consultations and thereby increasing the quality

Limitations

1. Ego problem
2. Sharing of fees
3. Difficulty in fixing responsibility in common areas.

Audit Materiality (AAS 13)

What is Materiality?

An information could be regarded as **material** if its misstatement, (may be omission or erroneous) could influence the economic decisions of users taken on the basis of the financial information.

Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. However, what is material in a given situation is a matter of professional judgement. Some items, which individually may not be material but collectively, might be material. It could either be qualitative or quantitative. The auditor should consider materiality from the point of view of both the following:

a. Overall financial information
b. Individual account balances.

Relationship between Materiality and Audit risk

When planning the audit, the auditor considers what would make financial statements materially misstated. His consideration of materiality at the planning stage enables him to decide which items should be examined by application of sampling and analytical procedures and thus to reduce the audit risk.

There is an inverse relationship between materiality and the degree of audit risk. Higher the materiality, lower is the audit risk. The auditor should therefore, at the planning state itself consider the materiality and the risk attached to it so as to carry out the audit more effectively.

The audit should be planned so that audit risk is kept at an acceptably low level. On assessment of the inherent and control risks, he should consider the level of detection risk which he could afford and based upon his judgement, select appropriate substantive audit procedures. The auditor reduces detection risk by performing substantive procedures. The more extensive the procedures performed, the lower the detection risk.

Audit Sampling (AAS 15)

It means carrying out audit procedures in less than 100% of items within an account balance or class of transactions. When using sampling methods, the auditor should design and select an audit sample, perform audit procedures thereon, and evaluate sample results so as to provide sufficient and appropriate audit evidence. There are two methods in which the size of the sample and the selection of individual items of the sample are determined. They are 1. Judgemental sampling and 2. Statistical sampling.

Judgemental sampling

The auditor, on the basis of his personal experience and professional judgement, will determine the size of the sample and express it in terms of number of accounts or transactions to be checked. However, whether the sample selected on the above basis would represent the population in order that the audit objective would be achieved is a questionable matter. This is because of the risk of personal bias in selection of sample items cannot be eliminated.

Statistical Sampling

It is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgement because it involves use of theory of probability. The sample should be selected in such a manner that it is truly representative of the population from which it is being selected. Each item in the population should have an equal chance of being included in the sample. The most important method of selecting a sample using a statistical approach is **Stratified Sampling.**

Stratified sampling

Stratification refers to the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics. Each such sub-population is known as a ***stratum.*** Each stratum is treated as if it was a separate population and proportionate items are selected from each of this stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor's judgement. From these groups, the auditor may pick up different percentage of items for checking / verification or for applying his audit procedures.

Going Concern (AAS-16)

Meaning:

1. Refers to one of the Fundamental Accounting Assumptions.
2. Also refers to the intention and liability of the entity to exist in near foreseeable future
3. Foreseeable future restricted to 1 year
4. It is not mere intention of entity, but should be in reality also.

Relevance for auditor

1. Generally, balance sheet discloses the book value of assets and liabilities assuming that entity continues to operate in future.
2. It this assumption is inappropriate, then values of assets and liabilities should undergo change
3. If Going concern absent and balance sheet is not adjusted on this basis then FINANCIAL STATEMENT S cannot show true and fair view.

Indicators of absence of going concern

1. Can be analyzed under
    a. Financial indicators
    b. Operating indicators
    c. Other indicators

1. Financial indicators
    1. Negative net worth
    2. Negative WC
    3. Adverse key financial ratios
    4. Negative cash flow positions
    5. Persistent and cumulative operating losses
    6. Inability to pay the creditor
    7. Compromise with creditors
    8. Fixed term loan approaching maturity without possibility of renewal
    9. Change in the quality of purchase i.e. from credit purchase terms to cash purchase terms

2. Operating indicators
    1. Loss of key management personnel without replacement
    2. Loss of a major market
    3. Loss of a major supplier or customer
    4. Labor unrest and problems

3. Other indicators
    1. Changes in govt. policies
    2. Pending legal proceedings
    3. Non- compliances of Statutory rules and regulations.

Auditor's obligations

1. Auditor to gather sufficient audit evidence for resolving the question of going concern.
2. The following procedure is recommended
    a) Review the events occurred after the B/S date having a bearing on Going Concern assumption. E g. earthquake, fire, enemy attack etc.
    b) Review the agreement relating to long term debts including debentures and see whether there is any breach of conditions
3. Analyze the latest interim FINANCIAL STATEMENTS
4. Analyze and discuss the latest cash flow statement, operating budget and profit cast.
5. Review the minutes of BOD, share holder and other committees,
6. Obtain legal opinion regarding the pending cases.
7. Review the management future plans by studying the following
    a) Plans to liquidate the assets
    b) Restructuring of debt and further borrowing of money

c) Cost reduction programs.
d) Deferring of major expenditure
e) Increase the ownership of equity

8. Auditor to obtain representation in written form in respect of above matters.

Reporting consideration

1. Where GC assumption is appropriate, auditor should issue unqualified report
2. Where GC assumption is questionable but resolved by management explanation, unqualified report provided adequate disclosure is made in Notes on Accounts stating
   a) The condition which effected the GC
   b) The mitigating factors initiated by management Auditor should invite the attention of shareholders to these notes.
3. GC assumption questionable and management explanation not adequate-Auditor to issue qualified report stating the reasons. Mere disclosure in audit report is not sufficient.
4. GC assumption inappropriate - in case of inappropriateness of GC assumption, the auditor should express an adverse opinion.

Quality control for audit work (AAS 17)

1. Auditor to make conscious effort in giving quality professional service.
2. It can be divided into
   a. General quality control measures for the firm as the whole
   b. Quality control relating to individuals audits

(a) General quality control measure

Following are features of GQC measures

1. Professional requirement:
   The personnel of the firm should be equipped with basic attributes namely, integrity, objectivity, confidentiality and independence.
2. Skill and competence:
   The personnel rendering professional service should posses required skill and competent to apply skill in a given situation.
3. Assignment:
   The partner or senior auditor should assign audit to assistants based on individual level of skill and competence
4. Delegation:
   The process of delegation should be duly supported by direction supervision and review.
5. Monitoring :
   The various quality control measures should be constantly monitored by the auditor

6. Consultation:

   There should be proper consultation by the personnel among themselves and if need be, with outsiders.

7. Acceptance / Retention of clients:

   The firm should be capable of providing quality service and thereby retain the clients.

b. **Quality control measures for individual audit**

This can be discussed under

a) Direction
b) Supervision
c) Review

1**) Direction:-** This stage involves

a. Preparation of a planning documents
b. Drafting of an audit programme containing nature, timing and extent of audit procedure
c. Holding discussion with audit staff prior to commencement of audit regarding the client

2) **Supervision :** The senior auditor should supervise the audit in the following way.

a. Whether there is clear understanding of audit direction
b. Whether the audit staff have executed the functions in a step by step manner.
c. Whether the documentation is adequate
d. Whether all the queries have been duly resolved by the client.
e. Whether the audit conclusion reached are in parity with audit objective

3) **Review**

The senior auditor should constantly carry out a review of following:

a. Planning document.
b. Audit programme
c. Audit WP
d. Draft audit report
e. Audit conclusions

Knowledge of business (AAS 20)

ICAI has made it obligatory for the Auditor to obtain knowledge of the business prior to conducting the audit. This process is a continuous one. It shall be the duty of both senior auditor and audit assistants to obtain knowledge of business before and during audit. It is not a one-time activity. Further knowledge obtained should update the auditor for conducting effective audit throughout the engagement. The permanent file of the working paper should contain a note on the knowledge obtained updated.

Sources of knowledge of business

1. Previous experience with the entity
2. Prior knowledge about the industry to which the client belongs
3. Discussions with directors, managers and personal
4. Discussions with internal audit staff
5. Discussions with other auditors such as branch auditors, legal experts
6. Discussions with knowledgeable people outside the entity e.g. Economists, industry regulators etc.
7. Visiting the clients factory and premises
8. Business publications regarding the industry
9. Legislations, regulations affecting the entity
10. Minutes of directors, shareholders meeting
11. Memorandum and articles of association
12. Reports furnished to regulatory authorities
13. Previous periods annual accounts and financial reports

Utility of knowledge of business

1. Enables assessment of inherent and controlled risk
2. Considering business risks and managements responses thereto
3. For developing an audit program and audit plan
4. For determination of materiality levels
5. Assessment of audit evidence to establish the appropriations and validity of the financial statements assertions
6. Evaluating accounting estimates and management representation
7. Identifying the areas where audit consideration and skills may be necessary
8. Identifying the related parties and transactions with such parties
9. Recognition of conflicting information

Chapter: Internal Control

Definition of Internal Control

The plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving the management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the preparation of reliable financial information.

Objectives of Internal control

a. Transactions are executed in accordance with management's general or specific authorizations.
b. All transactions are promptly recorded so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirement if any, and to maintain accountability for assets.
c. Assets are safeguarded from unauthorized access, use or disposition
d. The recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Scope of Internal control

It extends beyond accounting controls. Basically internal controls can be classified into two broad categories: 1. Accounting controls 2. Administrative controls

Accounting controls primarily aim at provision and timely preparation of reliable financial information by strictly following the procedures and broad policies envisaged by the management.

Whereas administrative controls include all other managerial controls concerned with the decision-making process. E.g. Preparation and maintenance of approved /registered Vendors' register.

Limitations of Internal control

1. The organizational structure of the entity may not be such as to have an effective system.
2. Lack of Management supervision, frequent follow-up measures and so on.
3. Management's perception of cost related to internal control
4. Lack of integrity, interest on the part of the personnel bound to follow the systems.
5. Abuse of power, like a member of management overriding a control.
6. Control system may become redundant with passage of time.
7. Collusion between two or more persons may not be prevented.
8. Manipulation by management itself with respect to transactions or estimates, judgements in preparation of financial statements.
9. The potential for human error.
10. Most controls tend towards transaction of usual nature.

Responsibilities of Management vis-à-vis Auditors

It is the responsibility of the management for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. The management is also vested with the responsibility of closely monitoring the system in place in order to ensure that the basic objectives of installing such control systems are achieved.

Whereas the Auditor, to safeguard his own interest, might resort to examination and evaluation of the internal control that exist in the organization so that his entire audit programme may be formulated only after he satisfies himself that such control systems are adequate and in consonance with the requirements of the business.

After a thorough examination and review of internal controls, if the auditor becomes aware of weaknesses in such internal controls, he should make the client aware of material weaknesses that have come to his attention. Such communication is normally sent to the management in writing, which is termed as a “letter of weakness” or “management letter”.

Review/Evaluation of Internal Control by the Auditor

1. **Ascertaining/Understanding the System**

The Auditor, should acquaint himself with system of internal control with a view to gaining an understanding the flow of transactions/informations and specific control procedures. This can be done in the following ways:

a. Discussions with personnel at various organizational levels
b. Reference to documents such as organization charts, procedure manuals, flow charts etc.
c. Obtain information from the right people by putting forth the right questions.

2. **Testing of internal control**

This is normally done by the application of procedural tests and examination in depth

a. Procedural tests

It means testing the compliance of the procedures laid down by the management in respect of each stage through which a transaction flows. The purpose of such compliance procedures is to provide reasonable assurance that internal controls are being applied as prescribed. The auditor should carry out procedural tests in respect of all internal controls on which audit reliance is desired to be placed. Based on such tests, the auditor is able to satisfy that a system of internal control exists, which is effective and which has been so operated throughout the period of intended reliance.

b. Examination in depth

It means examination of a few selected transactions from the beginning to the end. It involves studying of the recording of the transactions at the various stages, examination of the relevant records, documents, authorities etc. It also involves satisfying that the person who has exercised the authority is fit to do so in the first place and has done so in accordance with the prescribed norms.

On the basis of above tests and proper understanding the internal controls in force, the auditor arrives at a conclusion as given below:

1. The degree, nature and extent of weaknesses in the system.
2. The areas and the extent to which audit reliance may be placed.
3. The nature, timing and extent of his substantive procedures.

Techniques for evaluation of Internal control system

1. Narrative record; 2. Check List; 3. Flow Charts; 4. Internal Control Questionnaire.

Flow Charts

It is a pictorial representation of the internal control system showing the various operations, controls and stages involved in such system. It gives a concise and comprehensive view of what happens in the organization. E.g. how and when documents are raised, how they are dealt with, the departments through which they pass, the authorities / personnel responsible for the maintenance of records/registers, how the flow of goods and cash take place, what the various operations are and so on. This enables the user of such flow chart to understand clearly what control systems are in place and gives a bird's eye view of the transactions so as to enable him to evaluate internal controls in the right perspective and improvements could be suggested. Flowcharts are essentially a means of communication. Hence it should convey precisely and clearly what it intends to convey.

Internal control questionnaire

It lists the various questions which an auditor may put forth to his client in order to verify the existence and efficiency of internal control system. This is the most convenient and widely used method for collecting information regarding the internal control system. Generally the questions are pre-designed and, hence, it can be ensured that all aspects of the system are covered. The questions are so designed that the answer can be "Yes" or "No" or "Not applicable". However space may be provided below each answer for justifying/amplifying such answers wherever necessary.

The Questionnaire is usually issued to the client and the client is required to get it filled by the concerned executives or officers/employees. Based on the answers given by the client, inherent weaknesses, if any, are noticed by the auditor, the matter is further discussed and a report of deficiencies is given to the client with suggestions for improvement.

The Internal control questionnaire should normally be prepared taking into consideration the broad categories as given below:

1. Segregation and rotation of duties
2. Maintenance of records and documents
3. Accountability for, and safeguarding of, assets
4. Procedure for authorizations
5. Independent Checks.

COMPANY AUDIT

A. Appointment (sec 224)

1. Regular Auditor [sec 224]

(a) The statutory auditor of the co. is appointed / reappointed by the shareholders in the GM.
(b) The GM may be either an AGM or EGM (extraordinary GM)
(c) The power of appointment of auditor cannot be delegated by the shareholders to the directors even by passing special resolution.
(d) In case share holders fail to appoint an auditor he shall be appointed by the central govt. u/s 224 (3) / (4)

2. First Auditor [sec224 (5)]

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(a) The first auditor is one who is appointed for the first time after the incorporation of the co.
(b) The first auditor is appointed by BOD's within one month from the date registration of the co.
(c) If the BOD fails, the first auditor shall be appointed by the shareholders in the first AGM.
(d) If the shareholders also fail to appoint the first auditor in the first AGM, then central govt. is vested with the power of appointment of the auditor.
(e) The first auditor can be removed before the expiry of the term of office by the shareholders in the GM for which central Govt's permission is not necessary.
(f) The co. cannot appoint the first auditor by mentioning his name in the A.O.A of the co.

3. Authority of appointment

The following are the persons who are authorized to appoint the auditor

A BOD
B Shareholders
C Central Govt.

The BOD shall appoint

(a) First auditor
(b) Auditor in the place of casual vacancy arising due to the reasons other than resignation
(c) Branch auditor in due consultation with statutory auditor u/s228 (1)

The shareholders

(a) The shareholders of the co. can appoint auditor in case BOD failed u/s 224(5)
(b) Regular auditor u/s 224 (1)
(c) Auditor in the place of casual vacancy arising due to resignation
Central Govt u/s 224 (3) (4)

4. Auditor of a Govt. Co.

As per Co's Amendment Act, 2000,

(a) The auditor's of a Govt. Co. shall be appointed by C &AG without Central Govt's permission
(b) The remuneration of govt. auditor shall be fixed by the shareholders in GM.

5. Power of central govt. to appoint auditor [sec224 (3) and (4)]

(1) Under the following circumstances, the auditor of govt. co. shall appointed by CG.
  (a) Where an AGM has been concluded without appointment of auditor
  (b) Where an auditor appointed in the GM has refuse to accept appointment.

(2) The co. shall give notice within seven days of the conclusion of AGM to central govt. notifying the fact of non appointment of auditor. Similarly, it shall give notice within 7 days of the date of notification of the refusal by the auditor appointed in the AGM
(3) Any failure to give notice to central Govt. shall result in a penalty of Rs.5000 to every officer.
(4) The auditor appointed by central govt. shall hold the office for the conclusion of the next AGM.

6. Term of office

1. It refers to the tenure/ duration of office of auditor
2. It is not covered by a period of 12 months
3. The tenure of office refers to the period covered by 2 AGM's
4. In the case of regular auditor, it is governed by a period between 2 AGM's
5. In the case of appointment by central govt. the term of office commences from the date of appointment and concludes by date of next AGM.

7. Casual Vacancy [sec 224 (6) and (7)]

(a) Reasons for casual vacancy
The vacancy in the office may be caused by;
1. Resignation
2. Death
3. Insolvency
4. Disciplinary action taken against the auditor by the ICAI under CA Act 1949
5. Subsequent disqualification u/s 226 (3)

(b) Authority to fill Vacancy
1. In the case of vacancy due to resignation, it shall be filled only by shareholders in the AGM
2. In the case of vacancy other than resignation, it shall be filled by BOD's

(b) Reappointment of auditor sec 224 (2)
1. Generally an auditor who vacates his office in the AGM offers himself for reappointment and the co. reappoints the auditor
2. However, reappointment is not an automatic process. In other words it is not compulsory / mandatory for the co. to reappoint the auditor
3. The reappointment shall be authorized only by shareholders in the AGM.
4. Under the following circumstances a co. shall not reappoint the auditor automatically:
(a) where he has expressed his unwillingness to be reappointed as auditor in writing
(b) where he is disqualified u/s 226 (3)
(c) where a resolution has been passed removing him as auditor
(d) Where a notice of the intended resolution to remove him and appoint some one else in his place has been served on him and same could not be proceeded within the AGM due to death or such other incapacity of other person.

8. Nature of resolution [sec 224 (a)]

(1) Generally, an ordinary resolution is adequate to appoint /reappoint an auditor
(2) However, a special resolution requiring 3/4ths of the majority is required, where not less than 25% of the subscribed capital of co. is held below mentioned financial institutions;
A. A public financial institution, Govt co central / state Govt
B Any other financial institutions created by special act in which not less than 51% of subscribed share capital is held by the concerned state Govt.
C A nationalized bank / insurance company doing general insurance business

D Any combination of (a)to(c)

(3) For the purpose of this section, shareholding on the date of AGM has to be considered not on the date of issue of notice
(4) Where the co. has appointed the auditor by passing ordinary resolution instead of special resolution, that appointment shall be void ***ab initio*** in which case co. has to approach central Govt. for appointing the auditor

9. Obligation Regarding Appointment

(a) When a co. approaches person for being considered as an auditor, he shall provide certificate to the co. that he is not exceeding the audit ceiling prescribed by the co's act 1956.
(b) Within 7days of the holding of AGM, the co. shall notify the auditor the fact of appointment.
(c) In case no auditor was appointed in the AGM, the co. shall notify central govt within 7 days about the fact of non appointment
(d) As per section 224(1A), the incoming auditor shall notify to the ROC within 30 days in writing, his willingness or otherwise to accept the appointment
(e) The incoming auditor shall communicate with the outgoing auditor under the CA Act 1949

B. Remuneration of auditors [sec 224 (8)]

1. Composition

The remuneration of auditors comprises of
(a) Fees
(b) Out of pocket expenses

FEES:

Refers to the amount payable by the co. for the professional services rendered by the auditor. It is fixed on the basis of mutual agreement. ICAI recommends that the fees shall be based upon the no. of audit hours involved in the audit

OUT OF POCKET EXPENSES

The term out of pocket expenses refers to the incidental expenses incurred by the auditor for conducting the audit
e.g. (a) Traveling exp's
(b) Boarding and lodging charges
These are reimbursed to auditor based on actuals.

Fixation

The fees of the auditor shall be fixed by the respective appointing agency i.e. BOD in the case of first auditor, shareholders in other cases and central govt. if appointment covered by Sec 224 (3) and (4)

Exceptions

However, if the auditor is appointed by shareholders in GM, they may pass a resolution delegating the power of fixation of fees to BOD, in which case the latter can fix the remuneration

Disclosure

According to schedule VI part II of co's act 1956; payment to auditors shall be disclosed as follows;
(a) as auditor (b)as advisor (c) other capacity

Payment as advisor shall be further divided into:

(1) Income tax matters
(2) Co. law matters
(3) Management matters

C. Removal of auditor (Sec 225)

1. The removal of auditor shall be confirmed / authorized only by the shareholders in the GM
2. Ordinary resolution is sufficient to remove an auditor
3. The removal may be of the following types:

(a) Removal of first auditor
(b) Removal of regular auditor other than the first auditor

4. In case of removal of auditor of first auditor there is no need for central govt's prior permission
5. The removal of auditor other than first auditor can be further classified as
   - (a) Before the expiry of term of office
   - (b) On the expiry of term of office
6. Where the Co. wishes to remove the auditor before the expiry of term of office the following procedure shall be followed:
   - (a) The co. shall receive a notice from any member proposing to remove the auditor.
   - (b) The notice shall be considered as a special notice for 14 days and circulated to all the shareholders to consider the removal in the ensuring GM.
   - (c) On receipt of the copy of the notice, the outgoing auditor shall have right of submitting a written representation mentioning therein reasons as to why he should not be removed
   - (d) The representation shall be submitted at least 7 days prior to the date of GM
   - (e) In case representation is received too late by co. the auditor may request to get it read in the AGM
   - (f) The outgoing auditor should not make any derogatory remarks about the directors
   - (g) It is left to the shareholders whether the auditor should be removed or reappointed
7. In the case of removal on term of expiry of office, it shall arise when outgoing auditor vacates his office and is not reappointed. In such case also, all the above procedure shall apply except the prior permission of central Govt. is not required

D. Qualification, Disqualification of company auditor [sec 226]

A. Qualification [sec226 (1) and (2)

1. The auditor of a co. may be either, an individual or a firm
2. In the case of an individual, he should be a Chartered Accountant within the meaning of Chartered Accountants Act 1949 i.e. he should be holding certificate of practice.
3. In the case of firm of auditor's all the partners of a firm shall be chartered accountants practicing in India within chartered accountants Act1949 [sec226 (1)]
4. A person holding a certificate issued by central govt. under restricted state auditors rules prior to the enactment of part B state laws 1951 can also be auditor of the co. [sec226(2)]

B. Disqualification [sec2256 (3)]

The following persons are disqualified from being appointed as auditor of co.

- (a) Body Corporate
- (b) An officer / Employee of the co.
- (c) A partner/ Employee of an officer of co.
- (d) A person who is indebted to co. for an amount exceeding RS. 1000 either directly or indirectly or a person who has provided a special security /guarantee in favour of a third person who has borrowed in excess of Rs 1000 from the co.

(e) A person who is holder of the securities carrying voting power.
(f) A person who is disqualified from being appointed as auditor of co. is automatically disqualified from being appointed as auditor of the holding co. or any other subsidiary co. of the holding co.

Audit Ceiling Sec 224 (1B)

1. Ceiling refers to restriction on the no. of corporate audits that can be held by a Chartered accountant or firm of chartered accountants.
2. The above section was introduced by the co's amendment act 1974 and later on it was amended in 1988
3. For the purpose of ceiling the following classification can be considered
   (1) Individual practicing in his own name
   (2) A firm consisting of several partners practicing.

1. INDIVIDUAL

(a)Where the individual is practicing in his own name and is in whole time practice, he shall be covered by a ceiling of not more than 20 company audits out of which not more than 10 co's with more than Rs. 25 lakhs paid up share capital.

2. A FIRM OF ACCOUNTANTS:

(a) Where all the partners of the firm of the firm are in whole time practice, the ceiling shall be 20 audits per partner inclusive of not more than 10 co's with more than 25 lakhs paid up share capital

(b)Where the firm consists of any partner who is in whole time employment. For the purpose of ceiling, he shall not be counted.

e.g. A&CO has 3 partners the no of co. audits the firm shall enjoy 60 audits (i.e.3*20), out of which co. with more than 25 lakhs paid up share capital only 30(i.e.3*10)
In the above e.g. if one partner is in whole time employment. Then ceiling for the firm shall be 20 (i.e2*10)

2. OTHER ASPECTS:

(1)Where a person is in independent individual practice and also a partner of a firm the ceiling shall apply for him bath the above capacities
(2) For the purposes of ceiling the following audit shall be included
   (a) Public co's
   (b)Govt.
   (c) Section 25 co's
(3) For the purpose of the ceiling, the following shall be excluded
   (a) Branches within outside India
   (b) Govt. Corporations
   (c) Pvt ltd co's

<u>ICAI'S directive</u>

ICAI has issued a notification that a person whether in his individual capacity or as a partner or a partner of a firm shall not hold more than 30 co. audits including the private co's

<u>Object of ceiling</u>

The object of audit ceiling is to
a. Ensuring upholding the quality of corporate audits
b. To provide professional opportunities for young Chartered accountants

Overall Provision

However section 224(1) provides that a person in whole time employment shall not be appointed as auditor of the co. keeping in mind the above provision, in order to be the auditor of the co. one should be in whole time practice either in individual practice or in partnership.

Rights and Powers of a company Auditor:

The rights of a co. auditor can be discussed under

(a) Professional Rights
(b) Equity Rights

(a) Professional rights:

1**.** Right to receive information and explanation and from the co:

1. When the auditor conducts the audit, he requires various information and explanation for forming opinion on the true and fair view disclosed by financial statements
2. Normally, the above is available from
   (a) Books of a/c's
   (b) Vouchers
   (c) Other documentary evidence in support of transactions
3. Moreover, the officials of the co namely staff members and managers also provide oral/ written information to the auditor.
4. It should be noted that the auditor shall seek only such information which is required for conducting the audit.
5. In addition to above AAS-11 (representation by management) also requires an auditor to obtain a letter of representation from management duly signed by directors supporting the various matters included in the financial statements
6. In case an auditor does not obtain information & explanation which is material in nature he has right to draw the attention of shareholders in his report.

2. Right of access to books of accounts

1. While discharging his attest function, he has a duty to report to shareholders whether the B/S and P&L a/c's are in agreement with books of a/c's maintained.
2. It means he has an obligation to check the various books and records
3. Consequently it gives a right to an auditor for accessing to the books of accounts and records
4. The following are the books which the auditor can have access to:
   - Cash book, ledger , Journal, etc are books of a/c's
   - Statutory registers
   - Memorandum records
   - Statistical records
5. He also has to right to take extracts from the above records
6. While checking the records, he can place his signature/ identification marks therein.
7. The right of access also includes the records maintained in branches in other locations
8. This right can be exercised at reasonable time and not odd hours

3. Right to visit branches:

a. An auditor has right of visiting the branch offices of the co.
b. This right is available irrespective of the fact whether a branch auditor has been appointed u/s 228

c. According to AAS-10, using the work of other auditor, the co. auditor can also have the right of holding discussion with the branch auditor and branch manager and he may perform additional audit procedures by himself
d. This right is given to the auditor for enabling him to discharge his duties to share holders
e. The management of the entity shall not restrict a statutory auditor from visiting the branches

4. Right of Lien

1. The term lien refers to right of retaining physical possession of properties belonging to the debtor
2. When the auditor des not receive remuneration, he has a right to retain possession of books of accounts on which he has exercised due skill, care and diligence
3. The following are the conditions for exercising right of lien;
   (a) The lien shall cover only fees and not out of pocket exp's
   (b) The lien shall be exercised only on the books of a/c's and vouchers on which the auditor has exercised skill, care and diligence.
   (c) The lien shall not be exercised on statements, registers and records
   (d) The lien is a specific and particular lien and shall not be assigned in favor of a third party
   (e) The lien extinguishes when the client pays the amount due
   (f) The books of a/c's on which lien is exercised shall be relating to the year for which the client owes money.
   (g) The auditor should get hold of the books of a/c's on the basis of permission from the directors of the co.

5. Right to get notice of and attend AGM

(a) The auditor vacates his office in every AGM
(b) His report is addressed to shareholders of co. who meet at AGM and adopt a/c's report thereon
(c) The shareholders may raise various questions relating to financial statements for which the directors have to offer explanations
(d) However an auditor cannot participate in the deliberations of meeting unless he is required by law to do so

6. Right to sign the audit report:

The auditor has a right to issue the audit report under his signature. He also has to sign the B/S and P/L a/c not as an authority for an approval but as attesting agency. While signing the audit report on behalf the firm he also mention the fact that he is partner of the firm. There is no need to mention his membership no and other qualifications. However u/s 44 AB of the IT Act while issuing tax audit report, he should clearly mention his membership no. also

EQUITY RIGHTS

1. Right to receive remuneration (refer to earlier notes)
2. Right of indemnification i.e. the co. has an obligation to reimburse the loss suffered by auditor while representing as company auditor.

SPECIAL AUDIT SEC 233A

1. Meaning

The term special audit report to an audit conducted in addition to regular audit at the instance of central govt. In other words it is not a mandatory audit for every co. and depends on the central govt.'s directive to get the a/c's specially audited

2. Authority for appointment

Central Govt is empowered to appoint special auditor if in its opinion, such an audit is called for or required.

3. Circumstances for appointment

As per sec 233A (1) under the following circumstances, special audit may be called for:

(a) When the management of the affairs is prejudicial to the trade or industry to which the co. belongs
(b) When management of the affairs of the co. are not according to prudent commercial practice
(c) When the financial position of the co. endangers its solvency (insolvency of the co.)
(d)

4. Who can be a special auditor?

Sometimes the co. auditor himself may be the special auditor; however the special auditor shall be a Chartered Accountant whether in practice or not can be appointed as special auditor.

5. Scope

The scope of special auditor is determined by sec 227 of co's Act,(which is the same the regular auditor, however, Central Govt may direct the special auditor to extend his scope to other areas.

6. Rights and duties

He enjoys similar rights as co. auditor except he cannot attend AGM, he also owes similar duties as co. auditor except that his report shall be addressed to central Govt and not to shareholders

7. Remuneration

It is fixed by the central Govt covering both fees and out of pocket exp's. However the co. is responsible to pay the auditor from its resources.

8. Reporting

The special auditor addresses his report to the central govt. The copy of the report need not addressed to co.

9. Central Govt's Obligation

On the basis on special audit report, Central Govt shall take appropriate action as considered deemed fit .It can also ask the special auditor to clarify any matters of qualification included by the auditor. In any case Central Govt shall forward to the co: within 120 days a copy/extract of the report and May direct the co. to forward a copy thereof to all the shareholders or get the contents of the report read in the AGM.

BRANCH AUDIT

(a) A branch office is one where the substantial activities: (as debt) of the Head Office are carried out and it is also an office which is deemed to be a branch office by the head office
(b) Every branch office shall maintain proper books of a/c's for accounting the transactions which have taken place in the branch
(c) Every branch shall forward to H.O a return at least quarterly
(d) The branch office may be subjected to audit either by statutory auditor himself or by an independent auditor u/s 228

(e) While appointing co. auditor, if no separate resolution is passed appointing some other person as branch auditor, then the co auditor is deemed to be branch auditor also. In such case, the co. auditor can visit the branch and check the transactions entered in the branch books and finally consolidate the branch trial balance with H.O he will not prepare a separate report on audit of branches.

(f) On other hand, if a separate auditor is appointed as branch audit u/s 228 he will act independently and conduct the audit of the branches and forward his report to H.O auditor

<u>QUALIFICATION</u>

Sec 226 is applicable for branch auditor also

<u>APPOINMENT</u>

The branch auditor shall be appointed by the shareholders of the co. in the AGM and the nature of resolution to be passed shall be the same which is applicable for co. auditor, sometimes the shareholders may pass a resolution delegating the power to BOD to appoint the branch auditor in consultation with the statutory auditor.

<u>RIGHTS AND DUTIES</u>

The branch auditor enjoys similar rights and those similar duties as that of a company auditor except that

- He cannot visit other branches
- He cannot attend AGM
- He has submit his report to statutory auditor

<u>SCOPE</u>

The scope of the branch auditor is basically determined sec 227 of the co's Act 1956 but it is restricted to the operations of the branch. He shall covers same matters which are covered by the co. auditor in his report

<u>QUALIFICATIONS IN BRANCH AUDITORS REPORT</u>

The branch auditor may qualify his report and include same in his report to the statutory auditor. The latter may drop the qualifications based upon:

(a) Concept of materiality
(b) Availability of adequate information & explanation at the H.O

<u>EXEMPTION OF BRANCH AUDITOR</u>

Under the branch auditor exemption rules 1961, a branch may exempt from audit under the following conditions:

(a) Automatic exemption
(b) Exemption based on application to the Central Govt

<u>(a) Automatic Exemption</u>

According to the above rules, if the average quantum of activity of the branch does not exceed 2% of the turnover of the co. or Rs.200000 whichever is higher, the exemption is automatically granted. For this purpose, average quantum of activity refers to the highest of following 3 items:

(a) Aggregate value of the goods sold by branch
(b) Aggregate value of goods traded
(c) Aggregate expenses incurred for both capital revenue purposes

<u>(b) Application to central Govt</u>.

(i) Where proper arrangements have been made for scrutiny of branch accounts person competent to be the branch auditors

(ii) Where satisfactory arrangements are being made for review of branch a/c's by a person qualified to be the branch auditor even though he is the employee of the co.

(iii) Where no branch auditor is available, at reasonable cost considering the quantum of activity of the branch

(iv) Where it is considered & deemed fit by central Govt

3. COST AUDIT

(a) Cost audit refers to audit of the cost records maintained by manufacture processing co. as per the directives of central Govt.
(b) The Central Govt. notifies through gazette the companies which are covered compulsory cost audit. In which case, such co's shall get their cost a/c's audited every year until the central govt. revokes his order.
(c) The cost audit shall be done by Cost Accountants within the meaning of cost and works accounting 1959. sometimes a Chartered Accountants may required to audit the cost a/c's if the central govt. finds that there are no adequate cost accountants in practice (so for no such notification has been issued)
(d) The cost auditor shall be appointed within 45 days from the date of the gazette notification for the first time and from the date of closing of financial year in the subsequent times
(e) The cost shall be appointed by BOD who turn shall forward a copy of the resolution to the central govt. for its approval.
(f) The cost auditor is also subjected to audit ceiling under sec 224 (1B) [refer the notes given earlier]
(g) The cost auditor has the similar rights as co. auditor except that he cannot attend AGM
(h) He owes similar duties except that his report shall be forwarded to central govt with a copy to BOD's
(i) The cost auditors report shall cover the following :
    - Whether he has received proper information and explanation necessary for the purpose of audit
    - Whether proper cost records as required by the cost accounting record rules as applicable to the co. are maintained or not
    - Whether adequate returns from the branch offices has been received
    - Whether the cost records show the true and fair view of cost of production of each product.
(j) Apart from the above contents, the cost audit report shall also contain additional matters such as
    1. General information about the co
    2. Cost accounting system
    3. Qty details
    4. Major input material consumed
    5. Std. Vs Actual consumption of import materials
    6. Breakup of cost input material's imported
    7. Power of fuel utilities
    8. Fixed assets register and depreciation
    9. Gross block depreciation and lease rent
    10. Over heads
    11. Research and development expenses
    12. Royalty and know how charges
    13. Quality control expenses
    14. Pollution control expenses
    15. Abnormal non recurring cost
    16. Non moving stock
    17. Inventory valuation
    18. Physical verification of inventory
    19. Sales
    20. Financial position and ratio analysis
(k) The co. is obliged to provide within 90 days all the books and records to the cost auditor for his checking
(l) If the co. fails in this regard, within 10 days of the 90^{th} day, the cost auditor shall lodge a complaint with the central govt.
(m) The cost audit report shall be submitted within 180 days from the close of the accounting period.
(n) On the basis of qualification of cost auditor, the co. shall inform the central govt. within 30 days, their explanations with regard to cost auditor's qualifications.
(o) The Central Govt may also require the cost auditor to provide additional information in respect of qualifications.

AUDIT OPINION

Meaning

Audit opinion refers to the opinion of the auditor on the basis of exercising due skill, care diligence in auditing the a/c's of the co. In true sense, it is also known as auditor's verdict on the financial position of the co. Audit opinion is useful for the shareholders, directors, foreign collaborations, Govt. agencies.

Kinds of audit opinion

It may be divided into
(a) Unconditional opinion
(b) Conditional opinion

(a)Unconditional Opinion

This is also known as clean report or unqualified report or favorable report. The auditor issues such report when all the conditions in respect of true and fair value are complied with. He does not have any reservations with regard to various matters included in FS.

(b)Conditional Opinion

This can be further divided into:
1. Qualified report
2. Adverse Report
3. Disclaimer Report

1. QUALIFIED REPORT

An Auditor issues a qualified report when he is having certain reservations with regard to the item disclosed in financial statements. It is also know as positive report. This is because in the qualified report, an auditor confirms disclosure of true and fair view subject to certain reservations.

For example if the co. has short provided doubtful debts, the auditor will have to issue a qualified report in the following manner "subject to short provision of doubtful debts to the extent of Rs. We report that the a/c's show true and fair and view". In the above case, it may not be proper for the auditor to say that the a/c's do not show true and fair value because of short provision of debtors.

Other examples of qualification
1. Non-compliance with GAAP
2. Non- conformity with schedule VI requirements
3. The entity failing to make recurring provisions in the a/c's
4. The entity not reporting in the a/c's the effect of changes in the method of accounting

2. ADVERSE REPORT

This refers to a situation where an auditor issues a negative opinion where he categorically states that the financial statements do not disclose true and fair view. Such a report is given when auditor finds the concept of materiality has plays significant role in coming to the conclusion. Eg. Let us assume a co. has violated all the provisions of the statute and the GAAP. In such case it is not prudent for the auditor to say that the a/c's show true and fair view subject to … on the other hand, he should clearly say that the a/c's do not show true and fair view because of….
The point of distinction between the above two reports is that the former is a positive report and later a negative report.

3. DISCLAIMER OF REPORT

It is a report where auditor expresses inability to form an opinion due to non availability of books of a/c's records or due to limitation of scope imposed by a client
Eg : the books of a/c's of X ltd have been confiscated by CBI authorities. In such case, the auditor has to disclaim his opinion.

The disclaimer may be
(a) Partial
(b) Total

In the case of partial disclaimer he expresses his inability only with reference to a specific item whereas in the total disclaimer, the auditor expresses his inability to form any opinion on the entire FS.

AUDIT OF SHARE CAPITAL

Introduction

The share capital of the co. can be either equity or preference capital issued by a new formed existing co. The shares may be issued for both cash consideration and other than cash consideration. The SEBI is the controlling authority monitoring the issue of shares and other securities by companies

Audit program for verification of share capital

Issue of shares for cash consideration by a newly formed co.

The duties of auditor be summarized under
(a) General considerations
(b) Special considerations

(a) General Consideration

1. Review the guidelines issued by SEBI including amendments thereof regarding issue of shares
2. Check whether there is a proper internal control system with regard to receipt of cash and issue of shares
3. Check the memorandum of association and articles of association and verify the authorized capital and rules regarding the issue of shares
4. Verify whether prospectus has been issued and if so, whether it contains the required details
5. See whether the share capital a/c in G.L is reconciled with the balances extracted from register of members
6. check whether relevant provisions of the co's act 1956 has been following while issuing shares to public
7. Incase the co. is entered into underwriting agreements, check whether the terms and conditions of underwriting properly reflected in the prospectus and whether the amount due from the under writer has been properly accounted for.
8. Verify the return of allotment and annual return filed with the ROC containing the details of shares
9. trace the no. of shares held by directors into the register of director shareholding

(b) Special considerations

This can be discussed under
1. Application stage
2. Allotment stage
3. Call stage

1. Application Stage

a. Check whether the share application received from applicants are in the form prescribed by co's Act and trace particulars into the bank covering letters
b. Check the entries from the application to the application allotment register
c. Test check the entries from the application allot entries into the cash book
d. See the corresponding credits appearing in the bank statements
e. Ensure that app. Money represent at least 5% of the face value of the shares
f. Check whether application money kept in separate scheduled bank a/c and ensure no withdrawals from the a/c
g. Vouch the journal entry debiting to application a/c and crediting share capital a/c
h. Check the postings of the entries from cash book and journal into the ledger a/c's
i. In case application has been refunded, check cash book , payment side
j. Trace the marked and unmarked applications into the statement computing underwriter's liabilities

2. Allotment stage

a. Verify the board resolution making allotments
b. Check whether co. has received minimum subscription as required by sec 69, prior to allotment of shares
c. Examine the copies of letters of allotment and see whether the amount there in agrees with application allotment register
d. Vouch the entries receipt of allotment money in the cash book from application allotment register
e. Test check the entries appearing in the bank statements
f. Vouch the journal entry recording allotment money due by debiting share allotment and crediting share capital a/c
g. Vouch the journal entry adjusting the excess application money received towards allotment
h. Check postings from cash book and journal into ledger a/c's
i. If the share certificates have been issued, trace the particulars of the shares issued in the counterfoil of share certificates
j. Trace the entries in the register of members

3. Call stage

i. Check the board's resolution for making calls
ii. Verify copy call letter and trace the same into call register
iii. Check the adjustment of excess application money and allotment money received towards call amount due
iv. Trace entries from call register into cash book
v. Test check creditors appearing in the bank statement with regard to call money
vi. Vouch the journal entry regarding call amount due by debiting call a/c and crediting share capital a/c
vii. Check postings from cash book and journal to ledger a/c's
viii. Check whether separate registers maintained for calls in advance and calls in arrears
ix. Check postings from call register into register of members
x. See whether interest is charged on calls in arrears and interest paid on calls in advance if so authorized by AOA

Issue of shares for consideration other than cash

1. co. may issue shares for consideration other than cash as follows:
a. Vendor from whom business is acquired
b. Foreign collaborator
c. Promoters for discharging liabilities incurred by him
d. Bonus shares to equity shareholders

e. Underwriters in respect of commission due to them
f. For employees for sweat equity shares u/s 79A

2 verify the agreements with vendors and see whether consideration in this regard has been received

3. Vouch the board resolution authorizing purchase of business, underwriting of shares and collaboration agreement

4. See whether copy of agreement and collaborators are filed with ROC u/s 75(1) along with return of allotment

5. Ensure that the no. of share issued for consideration other than cash has been disclosed in liabilities side of the B/S under share capital separately

Special features relating to share capital

(a) Issue of shares at premium [sec 78]

1. A share is said to be issued at premium if the issue price is more than the face value e.g. Rs.10 share issued @ Rs. 15, Rs. 5 represents premium

2. The securities premium cannot be consider as revenue profit and hence cannot be used for declaration of dividend. Instead it should be credited to separate a/c and shown in reserves and surplus

3. The securities premium a/c may be utilized for the following
   (a) Writing off of preliminary expenses
   (b) Writing of discount on issue of shares and debentures
   (c) For payment of premium on redemption of preference shares
   (d) Issue of bonus shares to equity share holders

4. The auditor should vouch journal entry regarding share premium and see that it is used according to sec 78 (2) stated above

(b) Issue of shares at discount [sec 79]

1. A share is said to issued at discount when issue price is less than the face value
   e.g Rs.10 share issued at Rs 9. Rs. 1 represents discount
2. As per sec 79, the following procedures are to be followed:
   a. A co. should pass an ordinary resolution
   b. Permission from national co. tribunal must be obtained
   c. Shares should belong to a category already issued
   d. At least one should elapsed from date of commencement of business
   e. Issue should be made within 2 months from the date sanction from NCLT
   f. The rate of discount should not exceed 10% unless the high rate is authorized by NCLT
3. The amount of discount allowed on issue of shares should be amortized within a period of 3-5 years. Until the miscellaneous expenditure in asset side of B/S.
4. The auditor should verify the compliance with sec79 and also vouch the journal entry amortizing the discount

(c) Issue of sweat equity of shares

1. The concept of issue of sweat equity shares was introduced by co's amendment Act 1999 by inserting sec 79A which enables the co. To reward employees suitably

2. Sweat equity shares means Equity Shares issued by co. to the employees/directors at a discount or for consideration other than cash providing providing know how or making available the right in the nature of intellectual property or value additions.

3. Sec 79A prescribes the following conditions:
   a. It should be relating to the class of shares already issued by co.
   b. Should be authorized by co. in GM passing special resolution
   c. Resolution should clearly specifies the no. of shares current market price, consideration and class of employees/ Directors to whom shares are issued
   d. At least one year should have elapsed from date of commencement of business.

e. Where co.'s shares are listed in stock Exchange, the issue should be made in accordance with SEBI directives

(d) Redemption of preference shares [sec 80]

1. A co. cannot issue irredeemable preference shares
2. The redemption of preference shares made out of following sources:

a. Profits of co.
b. Proceeds of fresh issue of shares meant for redemption
c. Any premium payable on redemption of preference shares shall be met out of existing share premium a/c or out of the profits of the co.
d. To the extend of the face value of shares redeemed out of profits, an amount shall be credited to a separate a/c called capital redemption reserve a/c and it can be used only for issue of bonus shares to equity shareholders
e. Redemption can only in respect of fully paid up shares not partly paid up shares
f. The maximum period within which redemption can be made is 20 years

Audit of Issue of Bonus Shares

a. Bonus shares can be issued only to equity shareholders by capitalizing the reserves in accordance with SEBI guidelines
b. Verify the AOA and check whether it contains any provisions regarding issue of bonus shares
c. Verify minutes BOD recommending issue of bonus shares and see whether it is authorized by shareholders on GM
d. A co. can issue bonus shares to the maximum extent of 1:1
e. Check bonus shares issued only in respect of fully paid up shares and not partly paid up shares
f. See that bonus shares issued out of following reserves:
    (i) General Reserve
    (ii) Share premium received in cash
    (iii) P/L account of credit balance
g. Ensure that capital reserve and revenue reserve are not used for issue of bonus shares
h. Vouch journal entry
    1. General reserve Dr to Bonus share
    2. Bonus to shareholders to share capital
i. See whether share certificate issued to shareholders in respect of bonus shares
j. Ensure that Bonus shares not issued in lieu of divided
k. See whether proper disclosure made in B/s regarding the no. of shares issued as bonus shares indicating the sources of capitalization

Alteration of share capital

A co. may alter its share capital either by consolidation/ subdivision of shares if so authorized by articles by passing ordinary resolution for this purpose, there is no requirement of confirmation of the court. The auditor's duties are as follows:

1. Check whether AOA authorizes the alteration
2. verify the minutes of shareholders confirming alteration
3. obtain the allotment list containing new holdings of the shares by each member and verify the same with the entries
4. Inspect the directors resolution regarding consolidation, subdivision or conversion
5. check the cancelled share certificate and agree the same with counterfoils of new share certificates
6. Check whether the share capital a/c is correctly shown in B/s.
7. See whether ROC has been intimated as required by sec 95

Reduction of capital [sec 100-105]

1. Check whether AOA contains a provision for reducing the share capital
2. Check whether the shareholders has passed a special resolution agreeing to reduction of capital
3. Verify the court order confirming the reduction
4. Check whether copy of the special resolution and the court order are filed with ROC
5. check the ROC certificate confirming the reduction
6. Vouch the journal entry regarding the reduction of capital and using such an amount for writing down the value of assets
7. See whether revaluation of assets has been properly disclosed in B/S
8. Verify the register of members and see whether proper adjustments are made with regard to the paid up value of shares
9. Confirm that the words and reduced have been added to the name of co. in B/s required by order of the court.
10. Verify whether the MOA has been altered suitably.

Forfeiture and Re- Issue of shares

1. Check whether articles authorize BOD to forfeit the shares and the board has exercised the power in the best interest of the co.
2. Verify the amount of call out standing in respect of shares of shares forfeited from call in arrears register
3. Check whether procedure prescribed in AOA has been followed i.e. 14 days has been given to defaulting share holders.
4. Verify the journal entry debiting to share capital a/c and entry made to forfeited shares a/c and calls in arrears a/c
5. Forfeited shares a/c shall not been credited to P/L a/c since it is a capital nature. However it can be used for meeting any loss on a/c of Reissue of forfeited shares.
6. Check the board's resolution authorizing the reissue of forfeited shares
7. Vouch the amount collected from the person to whom shares have been reissued and see that the face value of shares is covered by considering both forfeited shares a/c and consideration receipt from the new share holder.
8. Check whether the surplus in shares Forfeited a/c is transferred to capital reserve a/c.

Audit of share transfer

The statutory auditor of a co. is not expected to carry out audit of share transfer because it does not affect the content of the B/S/ actually, the name of the transferee is entered in the place of transferor and co. does not obtain any consideration.

1. Check the AOA outlining the procedures to be followed for transfer.
2. Ascertain whether notices were sent to every joint holder of shares and see whether a no objection certificate has been obtain in this regard
3. In the case of a partly paid up shares, and the application for transfer was made by transferor, see whether a notice was sent to transferee and no objection certificate obtained from later.
4. Ensure that the share transfer forms used are in the prescribed form and whether it has been presented ROC whose stamp should be fixed therein
5. Check whether the transfer forms has been properly executed and bares the stamp duty.
6. Ensure that alterations in the share transfer form are duly initiated
7. see that the name and addresses of transferee is properly recorded in share transfer form
8. Compare signature of transferor in share transfer form with specimen signature available in the original application form
9. Ascertain that none of the transferees are disqualified from holding shares in co.

10. See whether there is proper internal control system by which all the staff members connected with transfer have initiated and signed the transfer form
11. Vouch the entry in the share transfer journal by reference to the transfer forms checking the following:
    (a) Name of transferor
    (b) Name and add of transferee
    (c) No. of classes of shares transferred
    (d) Distinctive no. of shares transferred
12. Verify the minutes of directors authorizing the transfer
13. Check postings of distinctive no. shares transferred and names of transferor/ee from share transfer journal to register of members
14. Verify the particulars entered into the counterfoil of the share certificate issued to transferee by referring to board minutes
15. In case only part of the have been transferred, verify the issue balance certificates to the transferor
16. Where duplicate share certificate has been issued in lieu of the original, which has been lost/destroyed, check the board resolution giving consent for the same.
17. Ensure the word duplicate has been mentioned in the counterfoil of the share certificate.
18. In case transfer of by directors , check whether proper entries are recorded in the register of director's share holding
19. Ensure there is proper internal control system for safe keeping of unused shares.
20. Incase of transmission of shares due to death, check the succession sent and a request from the legal representative to transfer the shares in his name
21. In case of transmission due to insolvency, verify the order of the court
22. Reconcile the amount of share transfer fees collected with the no. transfers lodged and see whether the share transfer fee is credited to P/L a/c.

Buy- Back of shares

(a) The co. amendment act 1999 contains detailed positions enabling the co. to buy back its own shares. The shares include both equity preference and sweat equity shares. In any case, since preference shares are redeemed, sec 77A is applicable only for equity shares only.
(b) Shares can be bought back by following sources
i. Free reserve
ii. Securities premium a/c
iii. Proceeds of any earlier other than one made specifically for buy back.
(c) Special resolution has been passed in GM authorizing the Buy- Back
(d) Buy back should be authorized by AOA
(e) The buy back can be up to 25% of the total paid up capital and free reserves including equity and preference
(f) The debt equity ratio should not be more than 2:1 after the buy back
(g) Shares under specified section should be fully paid up
(h) An explanatory statement shall accompany the notice of the meeting at which special resolution is proposed to be passed containing the following matters:

    (a) A full and complete disclosure of all maters of facts
    (b) Necessity for buy back
    (c) The classes of securities intended to purchased
    (d) Amount to be invested
    (e) Time limit for completion of buy back

(i) The buy back shall be completed within 12 months from the date of passing the special resolution
(j) The co. should file a solvency report duly certified by a CA with the SEBI before making the buy back
(k) The co. should physically destroy and extinguish all the securities bought back within 7 days of the last date of the completion of buy back

(l) A co. cannot make a further issue of same kind of shares or securities within period of 6 months
(m) The co. shall maintain a register showing the details of securities bought back
(n) Finally the co. shall file with ROC and SEBI a return contain a particulars relating to buy back within 30 days of completion thereof

Audit of debentures

1. See whether the BOD has exceeded borrowing powers conferred on them by sec 293
2. Ensure that the co. has complied with sec 117A by which a co. should file a debentures trust deed with the ROC and sec 117B creating debenture redemption reserve. It is also mandatory for appointment of trustees to protect the interest of debenture holders
3. Verify the prospectus and lieu of prospectus filed with ROC
4. check the applicants for debentures with application allotment register and verify the correctness of name and addresses of applicants and no. of debentures applied for
5. Check the BOD resolution for allotment of debentures
6. Vouch the amount collected as per the entries made in cash book with the counterfoils of receipts issued to applicants
7. Check the postings of allotment of debentures and amount received there from the application allotment into the register of debentures
8. Verify the entries in the counterfoil of debentures issued with the debenture register
9. Check whether the balances as per the register of debentures agree with the totals as per control a/c in general ledger
10. Examine the copy of the deb. Trust deed and note the conditions including creation of debenture redemption reserve
11. In the case of secured debentures, check whether the mortgage or charge has been properly created and the same registered with ROC.
12. Check the compliance with SEBI guidelines with regard to issue of debentures

Payment of interest out of capital during construction period

1. Sec 208 contains provisions in this regard
2. during construction period every co.; will have to prepare only a B/S because the entire construction during the period is for constructing the factory and other facilities
3. Considering the above , the companies ACT 1956 contemplates the payment of interest to shareholders on capital invested subject to full filling the following:
    i. The AOA should contain a provision in this regard
    ii. The central Govt's sanction should be obtained
    iii. A special resolution is required to be passed in GM if articles are silent about it
    iv. The rate of interest shall not exceed 4% or such other rate notified in gazette
    v. The interest shall be paid for a maximum period of 6 months after the end of the 6 months during which construction is completed.
4. The amount paid by way of it to shareholders shall be capitalized under various assets created during construction
5. Pending capitalization the amount shall be disclosed under the head miscellaneous expenditure in asset side of B/S.

DIVIDENDS

1. Examine the co's MOA and AOA for ascertaining dividend right for different classes of shares
2. Check whether the dividends are distributed out of (a) current profits (b) past profits.

3. According to sec 205 (1) dividend can be distributed out of only profits of co. after providing depreciation thereof In other words, with providing for depreciation, a cannot contemplate declaration of dividend. If it does so, it amounts to declaration of dividend out capital which is illegal.
4. Depreciation for the purpose of sec 205 (1) shall be computed in any one the methods recommended under the sec.
5. It is not merely sufficient that the co. provides for current year depreciation only whereas if there has been arrears of depreciation of earlier years the same should also be provided for current profits
6. Current profits should be determined after adjusting the following deductions:
    i. Income tax provisions
    ii. Dividends payable to preference share holders
    iii. Transfer to reserves mentioned in AOA and other statutes
7. The co. should also comply with transfer of profits to reserves rules 1975, by which certain percentage of the current profits should be transfer to reserves based on slab rates
8. Verify the shareholder's minutes for approval of dividends and see that the rate of dividend does not exceed one that recommended by directors
9. Check whether the amount of dividend is transferred to separate scheduled bank a/c within 5 days of date registration
10. Ensure that the dividends warrants are forwarded to shareholders within 30 days of the declaration
11. obtain the schedule of dividends and check the eligibility of shareholders to receive dividend by verifying the register of members
12. Vouch entries in the dividend bank a/c and check the reconciliation of such dividend bank a/c.
13. As per sec 205A the co. should transfer within 7 days from the expiry of the 30 days, unpaid dividend a/c to a separate schedule bank.
14. As per sec 205 C, if the dividend amount remains unclaimed, for over 7 years see whether such unclaimed balances are transferred to investor's education and protection fund established by central govt.
15. In the case of interim dividend, ensure that provisions of co.'s act are fully followed.

Distinction between transfer and transmission of shares

TRANSFER	TRANSMISSION
1. It occurs on basis of lodgment of share transmission forms by transfer or transferee. 2. It is for a valuable consideration to be received by transferor to transferee or it ca be by way of gift 3. It is subject to stamp duty	1. It occurs on operation of law on a/c of (a) death (b) Insolvency of present shareholder. 2. There is no need for any consideration for transmission of shares 3. Not subject to stamp duty

Vouching

Vouching is referred to as "***The art of examining vouchers"***. The objective of vouching is to establish the authenticity of the transactions recorded in the primary books of accounts. This is done by

a. Verifying transactions recorded in the books of account with relevant documentary evidence.
b. Verifying the authority on the basis of which the entry has been made
c. Confirming that the amount mentioned in the voucher has been posted to appropriate account

The following are the essential points to be kept in mind while examining a voucher:

a. Vouchers should be numbered
b. Voucher should be dated and fall within the accounting period
c. Vouchers should be Authorized
d. Should relate to clients business
e. Accounted under proper a/c that would clearly disclose the character of the receipts or payments posted
f. Alterations in the voucher should be authorized
g. Amount in words and figures should match.
h. Cancelled vouchers should be retained in the book
i. Unused vouchers should be kept under lock and key

After the examination is done each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

<u>Audit of Receipts:</u>

<u>General consideration:</u>

a) The auditor should examine the internal check in operation and bring to light the weakness in the system
b) Cash receipts are usually checked with counterfoils of the receipts issued but that alone will not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted.
c) Check who opens the letter, the relevant record kept, and whether all the cheques and postal orders are immediately endorsed to bankers and crossed account payee only.
d) Are receipts banked daily
e) Check whose duty is to enter cash, cheques and who deposited it in the bank
f) Who prepares receipts and who countersigns the same before these are issued to the parties from whom the amounts have been received
g) Whether printed receipts with counterfoils, numbered serially by a machine, are used and who maintains the stock of unused receipts
h) Are the receipt books kept in safe custody and are issued only after the current receipt book has been used up
i) What internal check is being exercised over the collection of cash sales and miscellaneous income
j) Are traveling salesman allowed to collect any advance against orders booked and what control exists over such collections
k) How often are the bank statements checked and compared with the cash book
l) Who controls the preparation and dispatch of monthly statements of accounts to customer
m) Are ledgers posted by the cashier or some other person

Audit of cash transactions:

General consideration:

In any business cash transactions account for largest bulk of transaction, cash being liquid asset is exposed to frauds of various types.

a) Check the system of accounting and internal control existing in the organization
b) Recording of each transaction should be checked with relevant voucher and documentary evidences
c) Check whether it is authorized by a competent official
d) Check the correctness of book-keeping records which involves checking the system of accounting which is regularly followed,
e) Check for errors, observance of accounting principles, evidence of transaction, validity of transactions and disclosure of the same in the final accounts

Vouching of trading transactions:-

It includes

a) Credit purchases
b) Credit sales

Audit of Credit purchases:

1) Composition:

a) It consists of purchase on credit basis from suppliers the following R.M. including components, stores, spare parts, finished goods, stationary and services.
b) It represents the liability to pay and arises at the times of purchase but crystallizes on the due date.

2) Audit Objective:-

The following are the objectives for which audit of purchases takes place

- Occurrence
- Measurement
- Completeness
- Presentation
- Disclosure

3) List of books and records to be examined:-

- Purchase day book / Purchase return book
- Purchase invoices
- Purchase orders
- GRN / Bin Card
- Incoming debit and credit notes
- Forward agreement
- Journal
- Control accounts in general ledgers

4) Audit Consideration:

1) PRELIMINARY CONSIDERATION

a) Check the date of the invoices and see whether it falls within the accounting period.
b) See whether the invoice has a continuous serial number
c) Check the arithmetic accuracy in the invoice
d) Check whether it is approved properly
e) See whether it deals with items relating to business
f) Ensure alterations in invoices are duly counter signed
g) Ensure the amount in words and figures tally
h) See whether it is properly accounted for through stock or purchases accounts
i) Check whether the invoice is addressed in the name of the client.

2) GENERAL CONSIDERATION

a) Review the I.C.S. regarding purchases
b) Check whether proper registers and accounts are maintained for controlling the purchases.
c) Ensure there is proper observance of accounting principles
d) If there are any statutory provisions involved there should be due compliance with those statutes.
e) Confirm the validity of transactions by making appropriate enquiries.
f) See whether it is disclosed properly in the accounts.

3) SPECIAL CONSIDERATION:-

a) Vouch purchase in invoices for the month selected with evidences such as purchase order, GRN, inspection report etc., and trace the same to purchase day book.
b) Carry out auditing in depth of selected purchase invoices from the beginning to the end of the transaction.
c) Check the special conditions in the purchase into the bin cards in stores ledger.
d) Trace the quantities purchased into the bin cards in stores ledger.
e) See whether the related freight expenses and incidental charges are debited to respective stock accounts.
f) Apply cut off test to ensure that all purchases for the period are accounted for.
g) In the case of purchase from foreign countries ensure application of AS-11 principles for translation of the invoice value.
h) Pay special attention to purchase form related parties with regard to the terms and conditions.
i) Where the purchases include quantities requisitioned by employees, see whether, their personal accounts are debited with the costs of those items.
j) Where the goods have been delivered directly at site check the acknowledgement of site personnel.
k) Compare the purchases of the last fortnight to the current year with the similar period

in the previous year.

l) Vouch purchases returns with the credit notes received from supplier and trace the items from credit notes register.

m) Compose the average cost of purchases of high value items of current period with previous period.

n) In the case of forward contracts, for purchases, check the agreement and note down the terms and conditions and verify the invoices with those contracts.

o) See whether customs duty paid on imported purchases are included under purchases account.

Vouching of Scrap Sale

1. Internal control of scrap satisfied
2. co. maintains a scrap register
3. scrap generated –daily production report
4. report to see efficiency of machine
5. quotations called for (auction**)** who ever bids most (highest) quotation received
6. Proper billing done on invoice
7. Compare sale of scrap this year from previous year increase in scrap- efficiency
8. Sale of scrap credited and shown as miscellaneous included in P/L a/c

Vouching of Sale of investments

1. Obtain a list of investment sold
2. Trace investments register
3. Approval of director [sec 292]
4. Market value- stock exchange quotations
5. Brokers sold not for sale of shares and debentures
6. P/L of sale of investments
7. Disclosed properly in P/L a/c
8. postings of control a/c in general ledger

Vouching of Refund of income tax

1. Provision
2. Bank a/c in the name govt.
3. Govt, refund order- cannot be transferred
4. Obtain a copy of refund order /advice
5. Bank, Pay etc.
6. It refund credited to P/L a/c

Vouching of Bad Debts Recovered

1. Record of all bad debts written off
2. Records, cash books, pay in slips, bank statements

Vouching of Traveling Expenses

1. Type of traveling
2. Travel rule prepared and approved by management- rules related to travel
3. Advance money
4. Foreign travel
5. Duration of travel
6. Other expenses related to travel- boarding, lodging
7. Purely personal- debit person’s a/c, not co’s

Vouching of Custom Duty

1. This is an indirect tax levied on the import of materials and assets
2. This may be incurred through a clearing and forwarding agent or directly
3. If it is through the former, check the bill submitted by the clearing and forwarding agent and also verifies the bill of entry.
4. Where it is incurred directly by the client, vouch with the copy of bill of entry and the bank challan for the payment of duty
5. In case the client applies for refund, see the corresponding applications
6. Ensure that customs duty paid is debited to the concerned raw material a/c asset a/c- as the case may be

Vouching of Excise Duty

1. This is an indirect tax and it's a levy on manufacture
2. Check whether the rates adopted for excise duty are as per the central excise Act and rules
3. Excise duty charged on the release of goods from the factory and hence check the gate pass issued under excise laws
4. Ensure that the bank challan is available confirming the payment of excise duty.
5. see whether the proper entries are made in the R.G.I register as per the statute
6. Excise duty paid shall be recovered from the customs

VERIFICATION

Railway Sidings

1. Physical verification is not a proper method to check the existence
2. Verify the permission obtained by railways for laying the tracks
3. Verify the agreement with railways and also check the bill submitted by railways for construction of sidings
4. The railway sidings are identified by lengths
5. Trace the railway sidings in the fixed asset register and check whether the balances as per the register tallies with control a/c in general ledger
6. Check whether proper depreciation has been provided on railway sidings
7. Ensure proper disclosure in B/s.

Assets Abroad

1. Obtain a list of assets situated in foreign countries in branches
2. See whether a FA register is maintained in the office and if so trace the items from the list to the register
3. Obtain a certificate from the branch manager of the entity confirming the existence of the assets
4. Incase branch is subjected to audit by a local auditor , verify the confirmation from the local auditor, regarding the existence of the assets
5. Trace the items of the fixed assets into the B/s of the Branch

Goodwill

1. It is an intangible assets and cannot be physically verified
2. According to AS 26 only purchased goodwill can be shown in B/S
3. Verify the agreements with vendors and check whether deducting the net book value of assets from purchase consideration has arrived at the goodwill
4. In the goodwill has been raised in books see whether it is written off in the same period
5. Vouch the journal entry amortizing the goodwill by debiting to P/L a/c
6. AS 26 recommends the maximum period of 5 years for amortizing the goodwill
7. Incase the goodwill earlier is written back in the a/c's vouch board resolution and journal entry in this regard.
8. See whether goodwill has been disclosed properly in B/S

Cash in hand

1. The cash in hand comprises of following
   (a) Main cash
   (b) Petty cash
   (c) Imp rest cash
   (d) Postage cash
   (e) Cash in transit
   (f) Cash at branches
2. The cash balances may include both currencies including foreign currencies and coins
3. Obtain a schedule of cash balances maintained by the co.
4. Obtain a denomination by certificate
5. Maintained a separate working paper noting therein the cash counted
6. Incase there is any excess / shortage of cash , ensure that the correct amount is recorded in cash balance and report matter to management
7. Check whether IOU'S disclosed as cash are debited to the personal a/c of the payee.
8. Incase of petty cash see whether the petty cash amount balances agree with the Imp rest amount
9. See whether the cash balance is properly disclosed in B/S.
10. Vouch the transactions in the cash book one week before the closing date.

INVENTORIES

(1) Composition:-

It includes

- Raw material components and packing materials.
- Finished good
- Work in progress (WIP)
- Consumable stores
- Spare parts
- Loose tools

(2) Significance:

a) It is an easy tool available at the hands of the management to commit fraud either by misappropriating or by manipulation.
b) Quite often, inventory is overvalued or undervalued with the idea of manipulating the profits.

(3) Responsibility:

a) Management is responsible for ensuring correctness of existence and valuation of inventory.
b) This is because
   - Management is conducting day to day affairs.
   - It is a accountable to shareholders
   - It possesses technical expertise regarding inventory items.
   - CARO 2003 requires auditor to mention whether management has conducted physical verification.

(4) Methods of stock taking: While discharging its function, management carries out stock taking in any of the following manner:

a) Continuous stocking taking
b) Year end stock taking

a. Continuous stock taking

1. It involves the management deputing a team of employees who are made responsible for physical verification of inventory on day to day basis.
2. The team is duty bound to verify each and every items and ascertain the reasons for discrepancies
3. Done throughout the period
4. Physical quantities are compared with bin card balances to arrive at difference.
5. Following are advantages.
    a. Coverage
    b. Moral check
    c. Timely adjustment of discrepancies
    d. Effectiveness of Inventory taking procedure due to specialization
    e. MIS
    f. Identification of obsolete stocks for taking follow up action
    g. No loss of production due to stoppage on account of stock taking
6. Following are limitations
    a. Costly
    b. Interference with day to day work of store keepers
    c. Suitable only of large organization
    d. Monotony
    e. Success depends upon up to datedness of records

b. Year end stock taking:-

1. Inventory is verified at the year end by stopping the production process
2. No separate team is created
3. Stock taking out by stores personnel with the help of accounts and internal audit personnel
4. Stock taking carried out at a stretch
   Advantages - limitation of continuous stock taking
   Disadvantage - refer to advantages of continuous stock taken

5. Locations:-

Inventory may be located

(a) Internal location

(b) External location

Internal Location:

a. Factory - all items of stock
b. Branches - stock in trade
c. Warehouse - all items except WIP

External locations:

1. Consignees - stock in trade
2. Customer on approval basis - stock in trade
3. Goods in transit - all items except WIP
4. Public warehouses - all items except WIP

6. Audit objective:

The following are the objectives of the auditor in carrying out audit of inventories:

i. Existence
ii. Rights and Obligations
iii. Completeness
iv. Valuation
v. Disclosure

7. Auditor Role / Position regarding inventory:

1. Leading case law - Kingston Cotton Mills Ltd.
2. Is not a technical expert and hence can accept certificate regarding inventory
3. Not to be suspicious about fraud
4. Should exercise reasonable skill, care and diligence.
5. Should carry out stock observation which means he can do some sample checking of the inventory.
6. Closely connected with Valuation of inventory as per AS-2(Revised).
7. Main objective is to express opinion on true and fair view of Financial statements.

8. Audit Considerations:- Continuous stock taking method:

1. Where this method is followed by clients, there is no need for year end stock observation programme.
2. During the course of audit, he can conduct some surprise check and verify the high value items physically.
3. If he is satisfied with the inventory, he can trace the bin card balances into the final inventory sheet accepting the same as correct.
4. If there are more discrepancies during the surprise check, he should insist on a separate year end stock taking to be done.

Year end stock taking procedure:

Duties of auditor can be explained as follows: -

1. He should evaluate the ICS regarding inventory
2. Obtain a copy of stock taking instructions issued by management to its personnel

3. Select high value items of inventory for physical counting.
4. Obtain a list of cut off documents duly signed by the management.
5. Visit the location and be present during stock taking
6. Count physically at least 5% of the items by opening the contents of boxes
7. Trace the quantity into bin cards
8. Note down the conditions of stocks and the obsolete nature of stocks in working papers
9. Trace the closing balances from bin card to inventory sheets
10. Obtain reasons for excesses and shortages of inventory
11. Ensure that there is no movements in stock during stock taking
12. Where the goods have been sold but not yet delivered, see that it is excluded from the inventory.
13. Obtain confirmation certificate from external parties who are holding inventory
14. Obtain management certificate that all inventory have been properly counted and included in inventory sheet.
15. Check whether the valuation of inventory is as per AS -2.
16. In case of change in method of valuation of stock, see whether the impact of the change is disclosed by way of note.
17. Compute G/P ratio, stock turnover ratio for current and previous period and see whether there are major variations.
18. Ensure inventory is disclosed as per the requirement of Schedule VI.

Contingent Liabilities

According to accounting standard 4, contingency refers to uncertainty. While preparing the balance sheet, an entity may have identified situations, which could become a liability in future based on occurrence of a future event. Such liabilities are known as contingent liabilities. The entity should disclose these liabilities that it should be provided for:

EXAMPLES:

1. Claims against the company not acknowledged as debts
2. Bills discounted with the bankers outstanding
3. Guarantees given on behalf of third parties
4. commitments of capital accounts not provided for
5. Arrears of cumulative preference dividend payable
6. Unpaid balance in respect of partly paid shareholders held as investments.

Progress Test – Auditing

Max Marks: 100 Time : 2 hours

Answer Questions 1 and 2 and any four from the rest.

1. Choose the correct alternative.

1. The AAS for audit evidence is a. AAS 3; b. AAS 22; c. AAS 5; d. AAS 17
2. The primary objective of an audit is a. Advise clients; b. Express opinion on financial statements; c. Prepare financial statements; d. none of these.
3. An auditor appointed in place of another auditor should inform about the appointment to the a. Previous auditor; b. Government; c. ICAI ; d. Registrar of Companies
4. The auditor has to approach everyone with suspicion a. True ; b. False ; c. Either a or b; d. Neither a nor b.
5. Audit is compulsory for a. Proprietary concerns ; b. Partnership firms; c. Companies; d. None of these.
6. -------------- implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him a. True and Fair; b. Materiality ; c. Analytical review ; d. Independence.
7. To formulate an audit programme, ----------- is very essential a. Audit report; b. Knowledge of the client's business; c. Evidence ; d. Working papers.
8. Fundamental accounting assumptions include a. Consistency; b. Accrual; c. Going concern; d. All of these.
9. The first auditor of a public limited company is appointed at the statutory meeting a. True; b. False; c. Partly true; d. None of these.
10. Cost audit report should be submitted within ------------ of the end of the relevant financial year a. 120 days; b. 6 months; c. 90 days; d. one year.
11. The auditor's report in respect of an audit u/s 233A of the Companies Act, 1956 has to be submitted to the a. Shareholders; b. Board of directors; c. Central Government; d. All of these.
12. An audit engagement letter should preferably be sent a. before the commencement of the audit; b. immediately after the commencement of the audit; c. at any time before the completion of the audit; d. after completion of the audit.
13. Which of these approaches is recognized as acceptable? 'a. Judgmental sampling; b. Statistical sampling; c. Both a and b; d. Statistical sampling for highly material items and judgmental sampling for other items.
14. Direct confirmation procedures can be applied to a. debtors only; b. creditors only; c. both; d. neither.
15. Internal auditors are appointed by a. The Statutory auditor; b. The management; c. The shareholders; d. The Institute of Chartered Accountants of India.
16. When effective internal control exists, the best evidence is a. Internal evidence; b. External evidence; c. Either a or b; d. None of these.
17. The relationship between Audit materiality and Audit risk is a. Direct; b. No relationship; c. Inverse; d. Either a or c.
18. Audit sampling means the application of audit procedures to ……………. of the items within an account balance or class of transactions a. 50%; b. More than 100 %; c. Less than 100%; d. More than 50%.
19. All of the following except one is a method of obtaining evidence a. Analytical review; b. Vouching; c. Observation; d. Inspection.
20. The responsibility for preparation and presentation of financial statements rests with a. Auditor; b. Shareholders; c. Management; d. Chief Financial Officer.
21. The auditor should select sample items in such a way that the same is a true representative of half of the population a. True; b. Half true; c. False; d. Half false.

22. Management representation can act as a substitute for other audit evidence that the auditor could reasonably expect to be available a. False; b. True; c. Partly true; d. None of these.
23. Working papers are the property of a. The client; b. The auditor; c. The assistant who prepared the working papers; d. None of these.
24. Casual vacancy in the office of an auditor can be filled up by a. Board of Directors; b. Company in general meeting; c. Either a or b; d. Managing Director.
25. An auditor may exercise lien on books and documents of the client for a. Non-payment of fees; b. Non-cooperation by the client; c. frauds committed by the management; d. not maintaining books at the Registered office of the company.
26. An auditor is bound by duty to attend general meeting of the company for which he is the statutory auditor a. True; b. False; c. Partly true; d. None of these.
27. An auditor may be removed from office before the expiry of his term a. by passing an ordinary resolution; b. by passing a special resolution; c. after obtaining the approval of the Central Government; d. Both a and c.
28. Charging an item of capital expenditure to revenue or by capitalizing revenue expenses is an instance of a. Fraud; b. Error; c. Either a or b; d. All of these.
29. Unless an auditor is able to discover all frauds and errors, he has not performed his main function a. True; b. False; c. Partly true; d. All of these.
30. The areas in which different accounting policies may be adopted are the following except a. Treatment of goodwill; b. Valuation of Inventories; c. Methods of depreciation; d. Accounting estimates.

(30*1 = 30)

2.

a. What procedure is to be followed if a company wishes to change its existing statutory auditor and appoint another firm of auditors? What are the duties cast on the new appointee in this matter?

b. In the annual general meeting of the company, no resolution has been passed for reappointing the retiring auditor nor a new auditor has been appointed in his place. Discuss.

(9+5 = 14)

3. a. Outline the principal aspects to be covered in an audit of financial statements.

b. What are the inherent limitations of audit?

(7+7 = 14)

4. a. Explain the concept of Auditor's independence.

b. How does an external auditor evaluate the internal audit function?

(8+6 = 14)

5. Explain in detail "Documentation" in the light of AAS 3. 14 marks

6. a. Discuss the qualifications and disqualifications for a person to be appointed as an auditor as envisaged by the Companies' Act, 1956.

b. What are the procedures that an auditor applies to obtain Audit evidence? Elaborate.

(7+7 = 14)

7. Give your views on the following situations.

a. K Ltd was incorporated on 01/01/2006. The board of directors of the company passes a resolution on 22/02/2006 appointing KK Associates, a firm of chartered accountants, as its auditors to hold office until the conclusion of the First Annual General Meeting.
b. Mr. Chandra is appointed as auditor of X Ltd. 'at its AGM. A few months later, he dies of heart attack. The board of directors appoints Mr. Balu as the auditor in place of Mr. Chandra.

c. The ICICI Bank ltd. Holds 25% of the subscribed share capital of M/s. M ltd. The company appoints Mr. Mukherjee as their auditors by passing an ordinary resolution.

(5+5+4 = 14)

8. a. Compliance with the accounting principles generally need not be insisted upon by the auditor. Discuss.

b. Discuss the concept of Audit risk.

(8+6 = 14)

Guideline answers

Q. No. 1

1	c	2	b	3	a	4	b	5	c	6	d
7	b	8	d	9	b	10	a	11	c	12	a
13	d	14	c	15	b	16	a	17	c	18	c
19	b	20	c	21	c	22	a	23	b	24	c
25	a	26	b	27	d	28	d	29	c	30	d

Q.No.2

a. Section 224(7) prescribes that the company in a general meeting may remove an auditor from office before the expiry of his term, obtaining the prior approval of the Central Government. However no permission is required to be sought to remove the First auditors appointed by the Board of Directors. A nomination notice from a member of the company of at least 14 days is required for the appointment of any other person in his place.

Section 225 lays down the procedure to remove an auditor after the expiry of his term. For appointing a person other than the retiring auditor or for proposing that the retiring auditor shall not be re-appointed, a special notice (14 days) is required for resolution to be moved at the AGM. On receiving such a notice, the company must forthwith send a copy thereof to the retiring auditor. If the retiring auditor makes a representation in writing, not exceeding a reasonable length, to the company and requests the company to notify such representation to the members, the company shall state the fact of the representation having been made and send a copy of the representation to every member to whom the notice of the meeting is sent. The auditor may require that the representation be read out at the meeting if it was not sent the members as aforesaid.

(5 Marks)

<u>Duties cast on the new Appointee</u>:

Accepting a position as an auditor, previously held by another Chartered Accountant, without communicating with him in writing, is a breach of professional conduct. Hence the incoming auditor is under an obligation to communicate the fact that he has been proposed as the auditor of the company and would like to know whether the outgoing auditor has any professional objection to his taking up the audit.

He should also ascertain before accepting an appointment as auditor of company, whether requirements of Sections 224 and 225 of the Act, in respect of appointment of auditors, have been duly complied with. Failure to do this will result in the Institute taking disciplinary action against the incoming auditor.

(4 Marks)

b. Where at an Annual General Meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. The company has the duty to give notice of the fact, that no auditor was appointed in the Annual General Meeting, to the Central Government within 7 days of the AGM.

(3 Marks)

Any failure to give notice to the Central Govt. shall result in a penalty of Rs.5,000 to every officer in default. The Auditor so appointed by Central Govt. shall hold the office till the conclusion of the next AGM.

(2 Marks)

Q. No. 3

a. The following are the principal aspects to be covered in an audit of financial statements.

i. An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by Compliance procedures and examination in depth. These steps are essential for the auditor to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

ii. Reviewing the systems and procedures to ascertain whether there are any inherent weaknesses that would allow frauds and errors going unnoticed.

iii. Verification of the authenticity and validity of transactions entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

iv. Confirm that the statutory requirements, if any, have been duly complied with.

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

vi. Ensure that the matching concept has been observed, that is, the amounts of various items of income and expenditure adjusted in the accounts relate to the relevant accounting period.

vii. Verification of the title, existence and value of the assets and liabilities appearing in the Balance Sheet.

viii. Confirmation that the financial statements are prepared in accordance with the books of accounts maintained as also by consistent application of accounting principles.

ix. Ensuring that the results shown by the profit and loss account and the financial position as shown by the balance sheet reflect a true and fair view of the affairs of the business.

x. Reporting to the appropriate person / body whether the statements of account examined do reveal a true and fair view of the affairs of the business.

(Any 7 points = 7 Marks)

b. **<u>Inherent limitations of Audit</u>**

An auditor's work involves exercise of judgement in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by the management in preparing the financial statements. In addition, most of the evidences available to the auditor can at best enable him to only draw reasonable conclusions therefrom. Again, such evidences are generally persuasive in nature and not conclusive. An opinion formed by the auditor based on such judgements and evidences carries with it an **Inherent Risk**. There is every likelihood that some material misstatements of the financial information resulting from fraud or error may not be detected.

(3 Marks)

Existence of an effective internal control system is the basis for the auditor to place reliance on the financial information. However, it may be possible that the system may fail to operate as designed. An internal control system also suffers from certain inherent limitations, for e.g. collusion between two employees, which may result in a fraud may not be prevented even in the case of existence of an effective system. Hence there is an element of **Control Risk**.

(2 Marks)

The efficiency and effectiveness of an internal control system is normally the deciding factor for the auditor to determine the nature, timing and extent of his substantive procedures. Even such an effective system may fail to detect a material misrepresentation in the financial statements. Such risk is known as **Detection Risk**. The knowledge that risks may arise in the audit of financial statements poses a serious limitation on audit.

(2 Marks)

Q.No.4

a. **Auditor's Independence**

Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individual to adopt an unbiased view. It is a mental state of freedom. Only so long as the auditor maintains a high standard of independence and impartiality, the audit report will continue to be accepted and respected by business, financial institutions, Government and investors.

Independence is a state of mind. Independence is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances. An auditor should be and appear to be independent in his approach towards his client. The relationship maintained by an auditor shall be such that no reasonable man doubt his objectivity and integrity.

(4 marks)

The Companies Act, 1956 has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking audit of limited companies, provisions relating to ceiling on the number of audits that can be undertaken by chartered accountants, provisions requiring special resolution for appointing auditors in certain cases, to name a few, are all designed to invest this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users.

In order to ensure independence, the law has also made certain provisions that put either prohibitions or regulations in the matter of appointment of auditors.

Accordingly a person is disqualified to act as an auditor from being appointed as such if he is:

a. An officer or an employee of the company
b. A partner or an employee of an officer or employee of the company.
c. A person who is indebted to the company for more than Rs.1000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs.1000.

d. A person holding any security of that company after one year from the date of commencement of the Companies (Amendment) Act, 2000

(4 marks)

b. The important aspects to be considered by the external auditor in evaluating the internal audit function are as follows:

i. **Position in the Organisation:** Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, he reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated.

ii. **Scope of Function:** The nature and depth of coverage of the internal audit function should be ascertained. The follow-up measures that the management takes in relation to the internal audit should also be evaluated.

iii. **Technical Competence:** The external auditor should ascertain that the internal audit work is performed by persons having adequate technical training and proficiency. A review of the professional qualifications and experience of the persons undertaking the internal audit work should be made.

iv. **Due Professional Care:** Whether the work of the internal auditor appears to be on the basis of proper planning and documentation is to be seen by the external auditor.

(6 Marks)

Q. No. 5

Auditing and Assurance Standards 3 – Documentation

Documentation, for the purposes of this Standard, refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

Use of Working papers

a. It aids in the planning and performance of the audit.
b. It aids in the supervision and review of the audit work.
c. It provides evidence of the audit work performed to support the auditor's opinion.

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

(4 Marks)

Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's needs in respect thereof. It should be sufficiently completed and detailed for an auditor to obtain an overall understanding of the audit. Of course, the extent of documentation is a matter of professional judgement since it is neither necessary not practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

The form and content of working papers are affected by matters such as the nature of engagement, form of the auditor's report, the nature and complexity of the client's business, the nature and condition of the client's records and degree of reliance on internal controls.

(3 Marks)

In the case of recurring audits, working paper files may be classified as

a. Permanent audit file; b. Current audit file.

a. The permanent audit file normally includes the following;
   - Constitutional documents of the organization.
   - Important legal documents, agreements and minutes relevant to the audit.
   - Record of the study, review and evaluation of the internal control system.
   - Financial statements of the previous years.
   - Analysis of significant ratios and trends.
   - Copies of management letter issued by the auditor, if any.
   - Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
   - Notes regarding significant accounting policies.
   - Significant audit observations of earlier years.

(3 Marks)

b. The Current audit file includes the following:
   - Correspondence relating to acceptance of annual reappointment.
   - Extracts of important matters in the minutes of Board meeting and General meeting, that are relevant to audit.
   - Evidence of the planning process of the audit and audit programme.
   - Analysis of transactions and balances.
   - Evidence that the work performed by assistants was supervised and reviewed.
   - Management representation letters obtained by the auditor.
   - Letters of confirmation received from the client and debtors/creditors.
   - Copies of the financial information being reported on and the related audit reports.

(3 Marks)

Working papers are the property of the auditor. He should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

(1 Mark)

Q. No. 6

a. A person shall not be qualified for appointment as an auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 - Sec 226(1)

A Chartered Accountant either in his individual capacity may act as the auditor or a firm of auditors may also act as an auditor provided all partners in the said firm are Chartered Accountants within the meaning of the Chartered Accountants Act, 1949.

(3 Marks)

Section 226(3) dealing with disqualification for appointment as auditors is as follows:

The following persons are not entitled to be appointed as auditors of a company

i. A body corporate.

ii. An officer or an employee of the company

iii. A partner or an employee of an officer or employee of the company.

iv. A person who is indebted to the company for more than Rs.1000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs.1000.

v. A person holding any security of that company after one year from the date of commencement of the Companies (Amendment) Act, 2000.

It is further laid down in sub-section (1) of section 226 that a person is not eligible for appointment as auditor of any company, if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.

(3 Marks)

Sub-section (5) of section 226 provides that if an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4) above, he shall be deemed to have automatically vacated his office.

(1 Mark)

b. An auditor obtains sufficient and appropriate audit evidence by applying the following audit procedures.
   i. Compliance procedures.
   ii. Substantive procedures.

(1 Mark)

   i. Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in operation. In obtaining audit evidence from compliance procedures, the auditor is concerned with assertions that the control exists, the control is operating effectively and the control has so operated throughout the period of intended reliance.

(2 Marks)

   ii. Substantive procedures are tests designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. They are of two types:

   a) Tests of details of transactions and balances
   b) Analysis of significant ratios and trends including the resulting investigation of unusual fluctuations and items.

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

   - Existence
   - Rights and Obligations
   - Occurrence
   - Completeness
   - Valuation
   - Measurement
   - Presentation

   The auditor obtains evidence in performing compliance and substantive procedures by one or more of the following methods.

   a. Inspection; b. Observation; c. Inquiry and Confirmation;
   d. Computation; e. Analytical Review.

(4 Marks)

Q. No. 7

a. The First auditors of a company can be appointed by the Board of directors within one month of date of registration of the company to hold office till the conclusion of the first AGM. If the Board fails to appoint the first auditor, the company in general meeting is empowered to make the appointment. (2 Marks)

   K ltd. was incorporated on 01/01/2006. Hence the last date to appoint the first auditors is 31/01/2006. However, the Board of directors of the company has passed a resolution on 22/02/2006 appointing M/s KK Associates as their first auditors. Such appointed is invalid because it is made after one month from the date of registration of the company. Alternatively, the company in general meeting could have made the appointment.

(2 Marks)

M/s. KK associates could not accept the assignment in view of this default on the part of the Board of Directors.

(1 Mark)

b. According to the provisions of the Companies Act, a casual vacancy in the office of the auditor can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. In case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor.

(2 Marks)

In the given case, Mr. Chandra, the auditor of X Ltd dies of heart attack, thereby causing a casual vacancy in the office of the auditor. This casual vacancy has arisen not on account of resignation of the auditor. The Board of Directors is, in such a case, empowered to fill such vacancy by appointing another auditor.

(2 Marks)

Hence the appointment of Mr. Balu, as auditors of X ltd by the Board is valid. Mr. Balu is entitled to hold office from the date of appointment till the conclusion of the immediately following AGM.

(1 Mark)

C Section 224A of the Companies Act provides for appointment or re-appointment of auditors in certain cases only by special resolution.

A company in which not less than 25% of the subscribed capital is held by

i. A public financial institution or a government company or the Central Government, or any State Govt., or
ii. Any financial or other institution established by any provincial or State Act in which a State Government, holds not less than 51% of the subscribed share capital or
iii. A nationalized bank or an insurance company carrying on general insurance business or
iv. Any combination of the above categories

shall appoint or re-appoint an auditor in the annual general meeting only by passing a special resolution.

(2 Marks)

In the given case, ICICI Bank ltd. holds 25% of the subscribed capital of the company. Hence for appointing an auditor, a special resolution should have been passed. Whereas the auditor has been appointed by an ordinary resolution. In such a situation, it shall be deemed that no auditor had been appointed and thereupon the Central Government's power to appoint the auditor pursuant to section 224(3) will become operative.

(2 Marks)

Q. No. 8

a. Accounting principles refer to the basic foundation upon which the entire process of accounting depends

The following are some of the examples of accounting principles

a) Making distinction between Capital and Revenue
b) Providing for Depreciation on depreciable assets
c) Valuation of Inventory at cost or net realizable whichever is lower.

The accounting principles are universal in nature. Every entity has to comply with their own principles while preparing financial statements. However, this should not be confused with accounting policies. Accounting policies are only methods and procedures which are implemented for complying with the principles.

As per AAS –1, an auditor should gain an understanding of the accounting system in determining the nature, timing and extent of his audit procedures. The auditor has to ensure that the financial information has been prepared by application of all the accounting principles. Based on his judgement, the auditor assesses the conclusions drawn, forms and expresses an opinion on the truthfulness and fairness of the financial statements.

(4 Marks)

An auditor should examine the accounts with a view that all assets, liabilities, income and expenses are stated as amounts which are in accordance with the accounting principles and policies which are relevant and no material amount, item or transaction has been omitted. In the context of audit of a company, section 211(5) of the Companies Act provides that the accounts of a company shall be deemed as not disclosing a true and fair view, if they are not prepared in accordance with accounting principles and policies.

In more specific terms, to ensure true and fair view, an auditor has to see

i. That the assets are neither undervalued nor overvalued, according to the applicable accounting principles
ii. No material asset is omitted.
iii. The change, if any, on the assets are disclosed
iv. Material liabilities should not be omitted.

Hence, from the above discussion, it becomes quite obvious that the auditor should ensure that the financial information has been prepared and presented based on the consistent application of accounting principles.

(4 Marks)

b. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information that is materially mis-stated. Such risk may exist at overall level or while verifying various transactions and balance sheet items.

<u>Audit risk at the financial statement level:</u>

Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such as assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessments can be made at the individual account balance or class of transactions level.

(2 Marks)

<u>Audit risk at the account balance and class of transactions level:</u>

The majority of audit procedures are directed to and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level.

(2 Marks)

The auditor uses his professional judgement to evaluate numerous factors, examples of which are:

At the Financial statement level:

- The integrity of management.

- Management experience, knowledge and changes during the period
- Unusual pressures on management
- The nature of entity's business

(1 Mark)

At the Account balance and class of transaction level:

- Financial statement of accounts likely to be susceptible to misstatement.
- The complexity of underlying transactions which might require the use of the work of an expert.
- The amount of judgement involved in determining account balances.
- Susceptibility of assets to loss or misappropriation
- The completion of unusual and complex transactions, particularly at or near year-end.

(1 Mark)

Progress Test – Auditing

Time : 2 hrs. **Marks:75**

Answer Questions No.1 and 2 and any three from the rest.

1. State with reasons, whether the following statements are true or false.
   a. Audit of accounts is compulsory for all business organizations.
   b. The Objective of audit is to express an opinion on the financial statements.
   c. The first auditor of a company is appointed by the Central Government.
   d. Vouching is done to strictly ensure that a transaction has taken place.
   e. Internal evidence is more reliable than external evidence.
   f. Self-balancing and sectional balancing ledgers are one and the same.
   g. If an auditor has certain reservations about the truthfulness and fairness of the financial statements, he issues a qualified report.
   h. When the client company employs a chartered accountant as an internal auditor, the external auditor should ignore the existence of internal audit.

(8*2=16)

2. a. Discuss the concept of true and fair.

b. Name five significant matters, which an auditor should consider in developing an overall plan for the purpose of audit.

(6+5=11)

3. Explain in detail the basic principles which govern an audit as per AAS-1.

16

4. a. Elaborate the methods of obtaining audit evidence.

   b. Discuss about the powers of auditors as envisaged by The Companies'Act,1956

(8+8=16)

5. a. Express your views on the following situations:

   i) The auditor of a limited company refused to deliver the books of accounts of that company which were given to him for the purpose of audit unless his audit fee is paid in full.

   ii) At the AGM of KN ltd., Mr.M is appointed as the auditor. He refuses to accept the audit. The company holds another general meeting and appoints a new auditor.

   b. Briefly describe the procedure to be followed for appointment of an auditor in place of retiring auditor.

(4+4+8=16)

6. Write short notes on any **four** of the following:
   a. Deferred Revenue expenditure
   b. Cut-off arrangement
   c. Audit programme
   d. Scrutiny of ledgers
   e. Fundamental accounting assumptions
   f. Stratified Sampling

(4*4=16)

Guideline Answers to Progress Test – Auditing

Q.No. 1.

a. Business may be carried by persons by various means, namely Proprietorship, Partnership, Company etc. Only in the case of Companies, The Companies Act makes it mandatory for its accounts to be audited by a qualified Chartered Accountant. Whereas in other cases, it is not so. However, the Income Tax Act, 1961 provides for compulsory audit of accounts in cases of persons carrying on business whose turnover for a previous year exceeds Rs.40 lacs and in cases of persons carrying on profession whose turnover exceeds Rs.10 lacs per annum. Hence the given statement is **FALSE.**

a. As per AAS – 2 on "Objective and Scope of the Audit of Financial Statements", the scope of an audit will be determined by the auditor having regard to the terms of engagement. The auditor's most important objective to is to form and express an opinion on the Financial statements and satisfy himself that such statements reflect a true and fair view of the financial position and operation results of the enterprise. In the light of the above, the given statement is **TRUE**.

c. The First auditor of a company is normally appointed by the Board of Directors within one month of the date of registration of the company. If the Board fails to do so, the company in general meeting is empowered to make the appointment. In view of this provision in the Companies Act, the given statement is **FALSE.**

d. The art of examining vouchers is referred to as vouching. It is done with an objective of establishing the authenticity of the transactions recorded. It does not merely end with satisfying that the transaction has taken place. It includes the following: verifying the transaction with the relevant documentary evidence, the authority based on which the entry has been made, disclosure in the final statement of accounts. Vouching is a wider term covering not only ensuring that the transaction has taken place. Hence the statement given is **FALSE**.

e. In general, external evidence is considered to be more reliable than internal evidence. This is because of the fact that, manipulation of information is either impossible or stand a remote chance in the case of external evidence. However internal evidence is more reliable when related internal control is satisfactory. The given statement is therefore, neither **TRUE** nor **FALSE**.

f. Sectional balancing is the system of maintaining a total account in the general ledger in respect of each sectional ledger like debtors, creditors, nominal accounts. Whereas self-balancing system is a further improved system which enables the preparation of independent trial balances for each separate ledgers by means of contra-adjustment accounts. These two, are therefore distinct from each other. In view of this understanding, the statement is **FALSE**.

g. Where an auditor has certain reservations and has found something that is contrary to the normal accounting principles consistently followed, he may not be in a position to express an opinion that the financial statements depict a true and fair view of the performance and position of the enterprise. In such a situation, he is entitled to give a qualified report stating the reasons therefore. Hence the given statement is **TRUE**.

h. The scope of an internal audit is normally specified by the management. Even if a Chartered Accountant is appointed as an internal auditor, the ultimate responsibility of expression of opinion is vested with the statutory auditor. Hence the external auditor should analyse the scope and functioning of the internal auditor and if he finds the work of the internal auditor satisfying and to his expectations, he may rely on the work of such internal auditor. Neither he can place complete reliance on the internal auditor nor can he fully ignore the existence of an internal audit. Therefore, the given statement appears to be **FALSE**.

Q. No. 2.

a. The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express an opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. What constitutes true and fair is a matter of an auditor's judgement in the particular circumstances of the case. It has not been defined in any legislation.

   However, in the context of audit of a company, Section 211(5) of the Companies Act provides that the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters that are required to be disclosed by virtue of provisions of Schedule VI to the Act. Hence, an auditor will have to see that the accounts are drawn up in accordance with the requirements of Sch. VI and whether all the matters required to be disclosed have been so disclosed. Section 209(3) of the Companies Act provides that a company shall not be deemed to be maintaining proper books of accounts to show a true and fair view if the books are not maintained under the accrual basis of accounting.

   Directors Responsibility Statement under section 217(2AA) requires that the Board's report shall state that they had selected such accounting policies and applied them consistently so as to give a true and fair view of the state of the company at the end of the financial year and of the profit or loss of the company for that period. The Auditor has to ensure whether such statement forms part of every Balance Sheet prepared and presented by the company.

   To be more precise, to ensure true and fair view, an auditor has to see (a) that the assets/liabilities are recorded according to the applicable accounting principles, (b) no material asset/liability has been omitted to be recorded, (c) the Profit and loss account and balance sheet are in accordance with the Sch. VI requirements. (d) accounting policies have been followed consistently (e) all unusual, exceptional or not-recurring items have been disclosed separately.

b. The following are the significant matters, which an auditor should consider in developing an overall plan.
   i. The terms of his engagement and statutory responsibilities.
   ii. The accounting policies adopted by the client and changes, if any in those policies.
   iii. The applicable legal or statutory requirements.
   iv. Identifying significant audit areas and setting materiality levels.
   v. Degree of reliance to be placed on accounting system and internal and other controls.
   vi. The nature and extent of audit evidence to be obtained.
   vii. The involvement of other auditors or experts necessary for the purposes of audit.

Q.No. 3

<u>AAS – 1, Basic principles governing an audit</u>

The following are the basic principles governing an audit

a. Integrity, objectivity and independence
b. Confidentiality
c. Skills and competence
d. Work performed by others.
e. Documentation
f. Planning
g. Audit Evidence

h. Accounting system and internal control
i. Audit conclusions and reporting.

Now, let us briefly discuss each and every principle.

a. Integrity, Objectivity and Independence

The auditor is expected to be a person of integrity. He should be straightforward, honest and sincere in his approach to his professional work. He must be fair and impartial. At no point of time, he shall allow himself to be prejudiced or be biased so as to override his objectivity. He shall not allow himself to be influenced by any pressure, directly or indirectly, from any persons from the management. He should be and appear to be independent to ensure that no bias creeps into his judgement.

b. Confidentiality

Any information that comes to the knowledge of an auditor during the course of his work should be kept strictly confidential. The auditor should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to do so.

c. Skills and Competence

The audit should be performed and the report prepared with due professional care by persons who have adequate training, expertise, experience and competence in auditing. This requires special skill and knowledge which is acquired through education, continuous awareness of latest developments on accounting and auditing matters and relevant regulations and statutory requirements.

d. Work performed by others.

In the course of conducting his work, an auditor may have to delegate work to his assistants or use work performed by other auditors. However, he continues to be responsible for forming and expressing his opinion on the financial statements. In such a situation, the auditor has to exercise adequate skill and care in relying on the work done by others. He should carefully direct, supervise and review the work so delegated. He should satisfy himself that the work performed by another auditor or experts is adequate for the purposes of his audit.

e. Documentation

Every information obtained through the course of audit should be properly documented. It may be an important evidence or a management representation. This will enable the auditor not only to review his work, but also acts as a proof of his having done the audit without negligence. Hence documentation assumes greater significance.

f. Planning

To conduct an effective audit in an efficient and proper manner, an auditor should plan his work. Such plan should be based on a knowledge of the client's business. The plans should be flexible enough to provide for alterations whenever needed.

g. Audit Evidence

The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial statements.

h. Accounting System and Internal Control

It is the responsibility of the management for maintaining an adequate accounting system which is considered appropriate in relation to the size and nature of the business. However, it is the duty of the auditor to familiarize himself with such systems and internal controls in place and assure himself that such system is adequate. He should also evaluate the internal controls which he wishes to rely upon in order to determine the nature, timing and extent of audit procedures.

i. Audit Conclusions and Reporting.

Based on the evidence obtained, and from his knowledge of the client's business the auditor should review and assess the conclusions drawn which forms the basis for forming and expressing an opinion on the financial statements. The report should contain a clear written opinion and in the prescribed form, if any under any law. The auditor may also give a qualified opinion or an adverse opinion or a disclaimer of opinion which he thinks fit. However, the audit report should contain the reasons therefor.

Q.No. 4

a. Methods of obtaining audit evidence

The following methods may be adopted by an auditor for obtaining audit evidence.

1. Inspection
2. Observation
3. Inquiry and Confirmation
4. Computation
5. Analytical Review

Inspection: It refers to examining records, documents or tangible assets. Depending on the nature, source and effectiveness of internal control, such inspection of documents and other records provide evidence of varying degrees to the auditor.

Observation: The auditor may simply look at a process or a procedure performed by others. Such observation may provide him with reasonable assurance that the internal control system is effectively and consistently in operation.

Inquiry & Confirmation: Putting right questions to right persons whether inside or outside the entity would fetch an auditor, the necessary evidence that he is looking for. The queries may either be formal written inquiries or just oral inquiries. This may provide the auditor with information that he did not previously possess or may provide him with corroborative evidence.

Computation: It consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations.

Analytical Review: Study of significant ratios and trends and investing for any unusual fluctuation and items would indicate to an auditor that some more evidence is required to be collected in order to ensure that the reasons for such fluctuations are genuine**.**

b. **Powers of Auditors**

Right of access to books, etc.: The auditor of a company, at all times, has the right to access all the books of accounts and vouchers and other records of the company whether kept at the head office or at such other as the company may decide. He is entitled to obtain from the officers of the company, such information and explanations as he thinks necessary for the performance of his duties as an auditor (Section 227(1)).

Right to require information and explanation from officers: This is an important right and wide power available to the auditor. If such power were not available, the auditor would not be able to obtain details of amount collected by persons close to the management, or of the benefits derived by the directors of a company. It is a matter of auditor's judgement to decide what information is required and for which explanation is sought. If an auditor is not provided with the information called for by him, he is entitled to give a Disclaimer of Opinion.

Right to attend general meeting: The auditor of a company is entitled to attend any general meeting of the company, also to receive all the notices and other communications relating to general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors. Though it is not a duty cast on the auditor to compulsorily attend general meeting, he may, if he has reasons to believe that certain critical information may be deliberately omitted or misinterpreted, attend the general meeting. Also, where the auditor is in receipt of some information which came to his knowledge subsequent to his signing the report, he may attend the general meeting and bring to the notice of the shareholders, such information and the effect, if any, it would have on the financial statements.

Q.No.5

a. I) According to the general principles of law, any person having the lawful possession of somebody else's property, on which has worked, may retain the property for non-payment of his dues on account of the work done on the property. Based on this, an auditor may exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents. However, this is subject to fulfillment of the following conditions:
   1. Document retained must belong to the client who owes the money.
   2. Such documents should have come into the possession of the auditor on the authority of the client.
   3. The auditor has done some work on such documents.

   However, u/s 209 of the Companies Act, books of account of a company must be kept at the registered office only. Hence, apparently this provision makes it impracticable for the auditor to have the possession of the books and documents. However, if the board passes a resolution and hands over the books of accounts to the auditor and makes the necessary notification to the Registrar, the auditor may in such circumstances, exercise the right of lien for non-payment of fees.

From the above, though it seems legally it is possible for an auditor to retain the books of accounts of his client for non-payment of fees, it may be highly impracticable.

ii. The shareholders in the AGM of the company generally appoint auditor of a company. - Section 224(1).

In turn, the auditor has to communicate his acceptance or refusal in writing. Once he gives his acceptance, he shall hold office from the conclusion of the AGM in which he is appointed till the conclusion of the next AGM. On the contrary, if he refuses to accept the audit, only the shareholders at a general meeting shall appoint another auditor.

In the given situation, KN ltd. has adopted the correct procedure in filling the void created in the office of the Auditor.

b. A retiring auditor cannot be deemed to be re-appointed automatically at the AGM. A specific resolution is required to re-appoint the auditors. This appointment is subject to the following conditions.:

1. The auditor proposed to be appointed must possess the qualification prescribed u/s 226.
2. The proposed auditor does not suffer from the disqualifications as prescribed in section 226(3) & (4).
3. A written certificate has been obtained from the proposed auditor to the effect that the appointment, if made, will be in accordance within the limits specified in section 224(1B).

An auditor, before accepting the appointment in place of an auditor who has retired should verify that the resolution appointing him as the auditor at the general meeting was duly moved and approved by the shareholders. In addition, he should communicate with the retiring auditor so as to ascertain from him whether there is any professional objection in his taking up the audit. He could also find out whether there exist any circumstances on account of which he should not accept the appointment.
Q.No. 6

a. Deferred Revenue Expenditure

It refers to an expenditure which is primarily of revenue nature but the benefit thereof is not exhausted in the year in which it is incurred. Such an expenditure should be written off over the period during which the benefit from it will accrue. Some examples of deferred revenue expenditure are given below:

1. Expenses on advertisement at the time of launch of a new product in the market.
2. Discount on issues of shares/debentures
3. Development expense in the case of mines and plantations.

However, there may be items in the Balance sheet which have been carried forward for writing off against future profit. These must not be confused with the deferred revenue expenditure.

b. Cut-off arrangement

Accounting is a continuous process. It is, therefore, highly imperative that the transactions of one period be segregated from those pertaining to the ensuing period. This is done in order to ensure determination of accurate results of the operations of each period. The technique that an auditor follows to achieve this end in known as “cut-off arrangement”. This arrangement is generally applied to accounts such as sales, purchases and stock. The auditor may examine a sample of documents evidencing the movement of stock in and out of stores, including documents pertaining to the period shortly before and after the cut off date and check whether stocks represented by those documents were included or excluded as appropriate.

c. Audit Programme

It refers to a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. Having regard to the nature, size and composition of the business, dependability of internal control and the given scope of work, the auditor should frame a programme suited to his needs. An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an opinion on such statements. Periodic review ensures that inadequacies or redundancies of the programme may be removed.

d. Scrutiny of ledgers.

While initiating the process of scrutiny of ledgers, one should be aware of the structure of every account in the ledger. Normally, every ledger starts with an opening balance which may be verified by reference to the last balance sheet/schedule. The debits or credits in every ledger should be verified based on the knowledge of the prime books of entry. For e.g., in the case of a Purchase ledger, credits are entered from the purchase register and debits from cash or bank book. On scrutiny of ledgers, some exceptional or extraordinary items may appear which would indicate that a further examination of such items becomes essential. Similarly, negative balances should attract the attention of the person scrutinizing the ledgers. The final balance in every ledger account could always be correlated with corroborative evidences. Such evidence may exist in the form of physical documents, which has to be carefully verified.

e. Fundamental accounting assumptions

There are 3 fundamental accounting assumptions; They are a. Going Concern b. Consistency c. Accrual.

Going Concern: It indicates that the business will be carried on forever. There have arisen no circumstances that would infer closure of the business. The financial statements are to be normally prepared and presented based on the concept of Going concern.

Consistency: In the preparation of financial statements, various accounting policies have to be applied. Such policies have to be consistently applied from year to year. Any change in accounting policies has to be properly disclosed and the effect it has on the financial statements should also be brought to the notice of the investors.

Accrual: Revenues and costs are recognized as they are earned or incurred and recorded in the financial statements in relation to the periods to which they relate.

If the fundamental accounting assumptions are followed, no disclosure is required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

f. Stratified Sampling

It refers to the method which involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and proportionate items are selected from each of this stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgement. Stratified sampling is nothing but an extension of simple random sampling. But it is based on some technique which ensures that the strata selected is truly representative of the whole population and inferences derived therefrom would surely allow to come to realistic conclusions.

PE-II

AUDITING

MARKS: 100 **TIME: 3 HRS**

Answer questions **1** and **2** and any four from the rest.

Marks

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

a) Three chartered accountants, X, Y and Z are directors of XYZ Ltd. A Ltd. proposes to appoint XYZ ltd as its auditor. 4

b) X is an individual chartered accountant in full-time practice. He is holding 19 company audits, out of which 10 companies have a paid-up capital of Rs.25 lakh or more. He is offered the audit of M ltd, which has a paid-up capital of Rs.45 lakh. Can X accept the audit? 5

c) A company does not have an internal audit department. The internal audit has been entrusted to a firm of chartered accountants. The paid-up capital of the company is Rs.50 lakh. 4

d) Mr.Kailash is appointed as auditor of K ltd. at its annual general meeting. A few months later, he dies in a plane crash. The board of directors appoints Z as the auditor in place of Mr.Kailash. 5

2 Give your comments on the following :

a) The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the AGM of the shareholders in which audited accounts were considered. 5

b) It is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems. 4

c) The purchase manager of the company refuses to provide you information about technical aspects of certain purchase contracts and tells you that he is not liable to answer your queries and that you seek information from the Finance Manager. 5

d) The fixed assets register of the company is not up-to-date. You also find that for the last 7 years, the management of the company has not physically verified the fixed assets. 4

P. T. O.

Marks

3 a) Explain the term "Auditor's Lien". 8

b) In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of AAS-20. 8

4 a) What is the ideal approach while carrying out audit of incomplete records? 8

b) Explain the duties of an auditor in detection of frauds and errors. 8

5 a) Discuss the relationship between internal audit and statutory audit 8

b) Distinguish between propriety and performance audits. In what circumstances should a statutory auditor conduct both types of audit? 8

6 How will you vouch and/or verify the following ;

a) Shares issued for consideration other than Cash 4
b) Work in progress 4
c) Patent rights 4
d) Contingent liabilities 4

7 a) Discuss the inherent limitations of an internal control system 8

b) Explain the concept of Auditor's Independence 8

8 Write short notes on the following

a) Intangible assets 4
b) Surprise check 4
c) Audit of Sanctions 4
d) Reserves vs. Provisions 4

Guideline answers for PE II Auditing for model exam

1. a. **Relevant Provisions of the Companies Act, 1956.**

Section 226(3) dealing with disqualification for appointment as auditors is as follows:
The following persons are not entitled to be appointed as auditors of a company

vi. A body corporate.

vii. An officer or an employee of the company

viii. A partner or an employee of an officer or employee of the company.

ix. A person who is indebted to the company for more than Rs.1000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs.1000.

x. A person holding any security of that company after one year from the date of commencement of the Companies (Amendment) Act, 2000.

(2 marks)

Facts given in the question

Three chartered accountants X, Y and Z are directors of XYZ Ltd. A company A Ltd. proposes to appoint XYZ Ltd. as their auditors. By virtue of Section 226(3), it may be clear that a body corporate should not be appointed as auditors of a company. M/s. XYZ Ltd. is a body corporate.

Conclusion

It is quite obvious from the above discussion, that the proposal to appoint M/s.XYZ Ltd as auditors of A Ltd. is inappropriate. Hence the proposal should be dropped.

(2 marks)

b. **Relevant Provisions of the Companies Act, 1956.**

Section 224(1B) provides that no company or its Board of Directors shall appoint or re-appoint any person or firm as auditors if such person or firm is at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. The Overall ceiling on number of audits for an auditor is 20 company audits. Within this limit of 20 company audits, there is a sub-limit of 10 company audits of Companies having a paid up share of Rs.25 lacs or more.

(2 marks)

Facts given in the question

Mr. X, an individual CA in practice is already holding 19 company audits, out of which 10 companies have a paid up capital of Rs.25 lakhs or more. He is now offered the audit of M/s. M ltd whose paid up capital is Rs. 45 lakhs. Though Mr. may be entitled to accept one more company audit, he could not accept the offer of M/s M ltd. because of the fact that he already holds 10 company audits, the paid up capital of such companies being Rs.25 lakhs or more.

(2 marks)

Conclusion

The ceiling on number of audits that an auditor can hold clearly prohibits Mr. X from accepting the offer of M/s. M Ltd. Hence he should not accept the audit and should clearly inform M/s. M ltd about his inability to accept the offer.

(1 mark)

c. **Relevant Provisions of the Companies Act, 1956.**

In case of Companies having Share capital and reserves at Rs. 50 lacs or more or if the average annual turnover has crossed Rs. 5 crores for last 3 financial years, CARO 2003 requires the statutory auditor to mention in his report whether the internal audit system in the company is commensurate with the size and nature of its business.

(1 mark)

Facts given in the question

A company does not have an internal audit department of its own, but has entrusted the assignment of internal audit to a firm of chartered accountants. The paid up capital of the company is Rs. 50 lakhs. It becomes mandatory on the part of the company to have an internal audit system since the paid up capital is Rs. 50 lacs. Such system need not be installed by means of a department within the company. There is no restriction on to whom such work may be given. In this situation, it is entrusted to a firm of chartered accountants.

(2 marks)

Conclusion

Considering the circumstances, the statutory auditor of the company has to determine whether such internal audit carried out by a firm of chartered accountants is commensurate with the size and nature of its business and report accordingly. If the auditor feels that it is not so, the fact has to be brought to the attention of shareholders as per CARO 2003.

(1 mark)

d. **Relevant Provisions of the Companies Act, 1956.**

Section 224(6) and (7) – Filling of a casual Vacancy.

The board of directors can fill a casual vacancy in the office of an auditor, provided such vacancy has not been caused by the resignation of the auditor. In case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor. This is done with a view to ensure that such filling of casual vacancy is in consonance with the principle of auditor's independence.

(2 marks)

Facts given in the question

Mr. Kailash who dies in a plane crash is being replaced by another auditor Mr. Z. This is a case of vacancy arising in the office of an auditor. Such vacancy has not arisen due to resignation of the auditor. The board of directors has filled up the casual vacancy.

(2 marks)

Conclusion

The vacancy in the office of the auditor has not been caused by the resignation of the auditor. Hence the Board of directors has the authority to fill up the vacancy. The Board of directors is right in doing so.

(1 mark)

2. a. **Relevant Provisions of the Companies Act, 1956.**

Section 231 – Right of an auditor to attend general meeting

The auditors of a company are entitled to attend any general meeting of the company, also to receive all the notices and other communication relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors. However such right is only permissive. It is not his duty to attend or to take part in the discussion.

(2 marks)

Facts given in the question

The board of directors of a company has filed a complaint with the ICAI against their statutory auditors for their failure to attend the AGM in which audited accounts were considered. It must be understood that section 231 is only a right, which the auditor exercise, in exceptional circumstances. It is not an obligation cast on the auditor to compulsorily attend the AGM of the shareholders, even if the audited accounts were considered in such meeting.

(2 marks)

Conclusion

From the above discussion, it becomes very clear that the board of directors of the particular company is not justified in filing a complaint with the ICAI. Such complaint is uncalled for and will be disregarded by the Committee of the ICAI. The board of directors should consider taking back the wrong complaint.

(1 mark)

b. The auditors have to exercise their professional judgement to come to a conclusion whether the sale proceeds of scrap are material enough to invite their attention to have a substantial audit procedure for verification of the same. The question indicates that the scrap does not have significant value.

Existence of a good accounting and costing systems helps the auditor to determine the nature, timing and extent of audit procedures and designing his audit procedures. However, it would be the duty on the part of the auditor to ensure that the systems could be relied upon. For this purpose, he has to review and evaluate such systems as to its efficiency and effectiveness. Whether such system is capable of bringing out all deficiencies that are material in value has to be properly analysed by the auditor. Only on such review and analysis, the auditor may be in a better position to place reliance on such systems.

Good accounting and costing system neither gives any assurance nor is capable of allowing the auditor from escaping any liability that may arise in future, if he could be pulled up for negligence. In order to safeguard him against possible risks, it is better if the auditor evaluates such risk and ensures that the risk level is within the affordable levels. (AAS – 6)

(1+2+1)

c. **Relevant Provisions of the Companies Act, 1956.**

Right to require information and explanation from officers.

The auditor has the right to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor. Because, in the absence of such power, the auditor would not be able to obtain details of any information that may help him in forming an opinion. Such information may not be known from an examination of the books of accounts. It is for the auditor to decide the matters in respect of which information and explanations are required by him. If the auditor is not provided the information required by him, his only remedy would be report to the members that he could not obtain all the information and explanations he had required for the performance of his duties as auditors.

Facts given in the question

The purchase manager of a company refuses to provide information on certain contracts. He tells the auditor that he is not liable to answer the queries and has to seek the information only from the Finance Manager. Purchase manager, being a responsible officer of the company is under an obligation to furnish the information sought by the auditor. It is not only the finance manager's obligation to furnish information sought by the auditor. The auditor may have considered such information to be relevant for him to form an opinion and express it in the report.

Conclusion

The purchase manager is not right in denying the information sought by the auditor. He should furnish all such information irrespective of whether it is technical in nature or not. If he still persists with refusal, the auditor has no other remedy but to report to the shareholders, that in the absence of such information, which he considers necessary, it would be difficult for him to form an opinion. The auditor may even consider giving a Disclaimer of opinion.

(2+2+1)

d. **Relevant Provisions of the Companies Act, 1956.**

CARO 2003, Reporting requirements on Fixed Assets.

An auditor of a company has to report whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets, whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and, if so, whether the same have been properly dealt with in the books of account.

Facts given in the question

The fixed assets register of the company is not up-to-date, nor has the management physically verified the fixed assets for the last 7 years. It is a clear case, which calls for reporting. It is the duty of the management to maintain a fixed assets register and be responsible for installation of systems to physically verify the fixed assets at reasonable intervals.

Conclusion

In view of the above discussion and reporting requirement, as an auditor of the company, the fact of such non-maintenance of fixed assets register should be brought to the attention of the shareholders. The auditor has also to disclose that no systems exist for periodical verification of such fixed assets.

(2+1+1)

3. a. In terms of general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. On this premise, an auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents.

The term 'lien' refers to the right of retaining possession of properties physically belonging to the debtor. When the auditor does not receive remuneration, he has a right to retain possession of the books of account on which he has exercised due skill, care and diligence.

The following are the conditions for exercising right of lien:

a. The lien shall cover only fees and not out of pocket expenses.
b. The lien shall be exercised only on the books of accounts and vouchers on which the auditor has exercised skill, care and diligence.
c. The lien shall not be exercised on statements, registers and records.
d. The lien is a specific and particular lien and shall not be assigned in favour of any other party.
e. The lien extinguishes when the client pays the amount due.
f. The books of accounts on which lien is exercised shall be relating to the year for which the client owes money.
g. The auditor should get hold of the books of accounts on the basis of permission from the directors of the company.

Under Section 209 of the Companies Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. However, books of accounts may be kept at a different place, pursuant to a Board resolution of which notice must be given to the Registrar of Companies. If in a company, Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar, the auditor may in such circumstances, exercise the right of lien for non-payment of fees.

(2+4+2)

3. b. AAS – 20 Knowledge of Business of the client.

The ICAI has made it obligatory for the Auditor to obtain knowledge of the business of the client prior to conducting audit. This process is a continuous one. It shall be the duty of both senior auditor and audit assistants to obtain knowledge of business before and during the audit. It is not a one-time activity. The auditor for conducting effective audit throughout the engagement should update further knowledge. The permanent file of the working papers should contain a note on the knowledge obtained updated.

The following are the sources of knowledge of business:

1. Knowledge about the industry to which the client belongs.
2. Discussions with directors, managers and personnel, internal audit staff.
3. Discussions with other auditors such as branch auditors, legal experts.
4. Business publications regarding the industry.
5. Legislations, regulations affecting the entity.
6. Reports furnished to regulatory authorities.
7. Internal management report forming part of MIS.
8. Minutes of directors, shareholders meeting.

Acquiring knowledge of the business of the client will help the auditor in the following ways:

1. Assessment of inherent and control risks
2. Developing Audit programme and audit plan.
3. Determination of materiality levels.
4. Assessment of audit evidence to establish the appropriateness and validity of the financial statement's assertions.
5. Identifying areas where special audit consideration and skills may be necessary.
6. Considering business risks and management's responses thereto.

7. Considering the appropriateness of accounting policies and financial statements disclosures.
8. Recognition of conflicting information.

(2+3+3)

4. a. Audit of incomplete records.

It may be necessitated under two circumstances. They are

a. Accounts are maintained under single entry basis
b. Accounting records may have been destroyed by fire, flood, etc. or seized by government authorities.

Under either of the circumstances, the audit objective would remain the same and thus, an auditor has to follow extensive audit procedure before expression of an opinion on such financial statements. The ideal approach that the auditor has to adopt is as follows.

1. Ascertain the exact status of accounting records available including memoranda records, if any.
2. Ensure that the management compiles / reconstructs accounting records to the extent practicable. In case of single entry, the accounts may be converted to double entry basis.
3. Perform compliance procedure to assess whether any control system is in operation.
4. Vouch transaction recorded in the books of account with reference to appropriate audit evidence. Confirmation of balances, Bank reconciliation statement may also be obtained to compare the evidence available.
5. Examine the system in operation in respect of custody of cash memos, receipts, cheque books etc.
6. Conduct surprise checks to verify cash in hand, stock at shop etc.
7. Verify fixed assets by observing physical verification.
8. Apply analytical review procedures in depth and notice deviations to investigate in detail. Ratio analysis shall be of particular importance since it would provide substantive audit evidence.
9. Formulate an appropriate audit opinion based on above findings.
10. A disclaimer of opinion may be appropriate in case there is any restriction on the scope of an audit.

(2+6)

4. b. AAS 4 – Detection of fraud and error – Duty of an Auditor

This standard deals at length with the auditor's responsibilities for the detection of material misstatements resulting from fraud and error when carrying out an audit of financial information and to provide guidance as to the procedures that the auditor should perform when he encounters circumstances that cause him to suspect, or when he determines, that fraud or error has occurred.

In general, the following principles are laid down in the AAS 4

a. In planning and performing his examination, the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error.
b. He should inquire of management as to any fraud or significant error that has occurred in the reporting period and modify his audit procedures, if necessary.
c. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud or error on the financial information.

d. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate.
e. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.
f. In case the auditor is unable to obtain evidence to confirm or dispel a suspicion of fraud, the auditor should consider relevant laws and regulations and may wish to obtain legal advice before rendering any report on the financial information or before withdrawing from the engagement.
g. The reporting responsibilities would also include communicating with the management.
h. The auditor should also consider the implications of the circumstances on the true and fair view that the financial statements ought to convey and frame his report accordingly.
i. Where a significant fraud has occurred, the auditor should consider the necessity for a disclosure of the fraud in the financial statements and if adequate disclosure is not made, the necessity for a suitable disclosure in his report.

(8 * 1 = 8)

5. a. The function of an internal auditor being an integral part of the system of internal control, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. The statutory auditor is under an obligation as per CARO 2003 under section 227(4A) of the companies Act to comment on the internal audit system. For this purpose, he should examine the organization of the internal audit department, the strength of the internal audit staff, their qualifications and powers within the organization. Also the scope of the internal audit should be ascertained by referring to audit programmes, reports submitted, points raised in audit and how these have been dealt with subsequently.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he often decides to curtail his audit programme by dispensing with some of the detailed checking already carried out by the internal audit department.

When the external auditor intends to rely upon the work of the internal auditor, it is desirable that he ascertains the internal auditor's tentative plan for the year and discusses it with him at as early a stage as possible to determine areas where he considers that he could rely upon the internal auditor's work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed, and review and reporting procedures.

(5 marks)

Coordination with the internal auditor is more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work.

It must however be mentioned that the area of co-operation between the statutory and the internal auditor is limited by the fact that the statutory auditor and the internal auditor owe their allegiance to separate authorities, the shareholders in one case and the management in the other. Therefore, the former is not protected against the liability for negligence which may arise in such a case.

(3 marks)

5. b. Propriety audit and Performance audit

Propriety Audit

The C & AG should bring out cases of improper avoidable expenditure even though they are as per the rules.

To protect the interest of public, mere regular audit of expenditure is inadequate.

It should be subject to principle of propriety i.e. whether it is wasteful in nature.

Audit should look into the wisdom, faithfulness & economy of govt. transactions.

No precise rules of propriety can be framed.

The following broad principles are normally followed:

a. Expenditure should not be prima facie more than the occasion demands.
b. The Government officials not to sanction expenditure that will directly or indirectly accrue advantage to them.
c. Public money should not be wrongly utilized for a particular person or section of community.

Performance Audit

It covers efficiency, economy and effectiveness audit.

Efficiency audit looks into whether the Government projects are executed & their operations are conducted as per the expected results.

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

Effectiveness audit refers to appraisal of the performance of the projects with reference to a predetermined target.

The procedure for performance audit includes the following:

a. Identification of the projects.
b. Preliminary studies
c. Planning & execution of audit
d. Reporting

The auditor determines the circumstances by exercising his professional judgement to come to a conclusion whether he has to perform both types of audit.

(4+4=8)

6. a. A company may issue shares for consideration other than cash for the following:

1. Vendor from whom business is acquired
2. Foreign collaborator
3. Promoter for discharging liabilities incurred by him.
4. Bonus shares to equity shareholders
5. Underwriters in respect of commission due to them.
6. For employees for Sweat equity shares u/s 79A.

Verify the agreements with vendors and see whether consideration in this regard has been received.

Vouch the board resolution authorizing purchase of business, underwriting of shares and collaboration agreement.

See whether copy of agreement with vendors and collaborators are filed with ROC u/s 75(1)(b) along with return of allotment.

Ensure that the no. of shares issued for consideration other than cash has been disclosed in liabilities side of balance sheet under share capital separately.

(4 * 1 = 4)

6. b. The auditor may involve a technical expert in verification of work-in-progress, if necessary.

Cost sheets in respect of individual items or lots of jobs or work orders may be obtained from the client and verified as follows:

1. Ascertain that the cost sheets are duly attested by the Works Engineer and Works Manager.
2. Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost-sheets by reference to the cost records.
3. Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimate of cost expected to be maintained under actual operating conditions during a limited future period.
4. Ensure that the allocation of overhead expenses has been made on reasonable basis and that the total of the overhead expenses does not include any amount in respect of selling, distribution and office expenses.
5. Compare the cost-sheet in detail with that of the previous year both in regard to the composition of cost and the value place on various components. It they vary materially, investigate the causes thereof.

(4 * 1 = 4)

6. c.

1. These are intangibles and hence cannot be physically verified.
2. Verify they are duly supported by documentary evidence.
3. Obtain a schedule of this asset and check the opening balance with previous year.
4. Where the entity has created its own patents, check whether amount capitalized is proper through R & D A/c.
5. Where patents have been purchased from market, see whether the patent certificates are registered in the name of the client.
6. Ensure that the patent registration charges are capitalized and the renewal fees charged to P & L a/c.
7. See that the patent amount is amortised over the legal or commercial life whichever is shorter.
8. Obtain a management representation letter confirming the life of the patents.
9. Check disclosure compliance with Schedule VI.

(8 * 0.5 = 4)

6. d. It refers to liabilities which are uncertain on the date of balance sheet since their outcome is dependent upon occurrence or non-occurrence of a future event. E.g. Claims against the company not acknowledged as debts, bills discounted by the company with the bankers outstanding.

The verification procedure is as follows:

2. Obtain a schedule of contingent liabilities duly certified by management.
3. Compare the current period schedule with the previous period and see whether there are major variations.

4. Obtain the management representation that all contingent liabilities have been properly disclosed.
5. Obtain the solicitor certificate regarding the statement of pending suit and possibility of occurrence of any liability thereof.
6. Review the correspondences with customers and suppliers for identifying the claims made by third parties.
7. The files relating to Income tax may be verified to ascertain whether there are demands made by the authorities of the company not acknowledged as debt.
8. Check the guarantee register, if any, maintained, and identify the guarantees that are outstanding.
9. Ensure that contingent liabilities are disclosed as footnotes in balance sheet.

(8 * 0.5 = 4)

7. a. Inherent limitations of an internal control system.

1. Management's perception related to cost, that returns might be inadequate with reference to the cost incurred.
2. Most controls do not tend to be directed at transactions of unusual nature.
3. The potential for human error.
4. The possibility of circumvention of controls through collusion with parties outside the entity or with employees of entity.
5. The possibility that a person responsible for exercising control could abuse that authority, for example, a member of management overriding a control.
6. The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.
7. Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.
8. The organizational structure of the entity may not be such as to provide for an effective internal control system.

(8 * 1 = 8)

7. b. <u>Auditor's Independence</u>

Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individual to adopt an unbiased view. It is a mental state of freedom. Only so long as the auditor maintains a high standard of independence and impartiality, the audit report will continue to be accepted and respected by business, financial institutions, Government and investors.

Independence is a state of mind. Independence is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances. An auditor should be and appear to be independent in his approach towards his client. The relationship maintained by an auditor shall be such that no reasonable man doubts his objectivity and integrity.

(4 marks)

The Companies Act, 1956 has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking audit of limited companies, provisions relating to ceiling on the number of audits that can be undertaken by chartered accountants, provisions requiring special resolution for appointing auditors in certain cases, to name a few, are all designed to invest this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users.

In order to ensure independence, the law has also made certain provisions that put either prohibitions or regulations in the matter of appointment of auditors.

Accordingly a person is disqualified to act as an auditor from being appointed as such if he:

a. An officer or an employee of the company
b. A partner or an employee of an officer or employee of the company.
c. A person who is indebted to the company for more than Rs.1000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs.1000.
d. A person holding any security of that company after of one year from the date of commencement of the Companies (Amendment) Act, 2000

(4 marks)

8. a. Intangible assets

An Intangible asset is defined as an identifiable non-monetary asset, without physical substance, held for use in the production of supply of goods or services, for rental to others, or for administrative purposes (Accounting standard – 26)

Some common examples of Intangible asset include computer software, patents, copyrights, fishing licenses, marketing rights and brands.

The term "identifiable item" is to be viewed in the context of three intrinsic features. They are (i) Identifiability (ii) control over a source and (iii) expectation of future economic benefit flowing to the entity.

(2 marks)

Intangible assets are to be amortized over the period of its useful life. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. However, there can be situations where control over the future economic benefit from an intangible asset is achieved through legal rights that have been granted for a finite period. In such cases, the useful life of the intangible asset should not exceed the period of the legal right, unless:

a. The legal rights are renewable,
b. Renewal is virtually certain.

In determining the amount to be charged in each accounting period, another important factor that has to be considered is the estimate of residual life.

(2 marks)

8. b. Surprise Check

Surprise checks constitute an important part of normal audit procedures. An element of surprise can significantly improve the effectiveness of an audit and therefore, wherever practicable, such procedures should be incorporated into the audit programme.

The element of surprise in an audit can be both with regard to the time of the audit as also the selection of items that are subjected to audit. These are mainly intended to ascertain whether the internal control system is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. Surprise checks are a useful method of determining whether or not errors or frauds exist, and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

Surprise checks are also particularly relevant in respect of certain items, for example, cash, investments, stores and stock etc. The need for and frequency of surprise checks is normally a matter to be decided by the auditor having regard to the circumstances for each audit.

(1+2+1)

8. c. Audit of Sanctions

The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.

The audit of sanctions is directed in respect of ensuring the following:

1. That the expenditure is properly covered by a sanction
2. That the sanctioning authority is competent for the purpose by virtue of the powers vested in it.
3. That the sanctioning authority has derived such authority by virtue of rules or orders made relevant for the purpose.
4. That the rules of delegation of financial powers made are by an authority competent to do so.

(4 * 1 = 4)

8. d.

<u>Distinction between Reserves and Provisions</u>

	Reserves	**Provisions**
1	Appropriation of profit to be shown in P&L Appropriation a/c.	Charge against the profit.
2	Created for unknown future contingency	Created for known accrued liability
3	Can be created only if there is a profit	It has nothing to do with profit. In fact, the profit or loss is arrived after taking into a/c the provision.
4	Available for dividend if they are free in nature.	Question of declaring dividend does not arise since provision is for meeting a liability.

(4 * 1 = 4)

(Figures in brackets on the right hand side indicates allocation of marks)