

CA - IPCC COURSE MATERIAL

BOOK NO – 6 AUDITING & ASSURANCE 36e

(NEW EDITION THOROUGHLY REVISED & UPDATED UPTO JULY 2016. APPLICABLE FOR NOV.2016 & MAY 2017 IPCC EXAMINATIONS. THIS MATERIAL IS SYNCHRONISED WITH APRIL 2016 EDITION OF ICAI SM AND PM)



CHAPTER WISE ANALYSIS OF PREVIOUS EXAMINATIONS OF IPCC IN THE SUBJECT OF AUDITING (THEORY)

No.	Chapter/Topic Name	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	INTRODUCTION TO AUDITING	10	-	-	16	5	16	8	8	5	8	4	16	14	2
2.	CONCEPTS OF AUDITING	-	-	-	-	6	4	16	8	-	10	4	6	12	4
3.	AUDIT EVIDENCE	-	-	6	8	-	-	8	5	9	2	10	8	15	-
4.	AUDIT PREPARATION	9	5	-	4	8	8	4	5	-	4	2	8	4	17
5.	CAPITAL & REVENUE EXPENDITURE	-	-	-	8	-	5	-	-	-	6	4	-	-	-
6.	COMPANY AUDITOR	-	-	-	-	5	6	10	-	6	11	10	10	24	-
7.	MISCELLANEOUS MATTERS IN COMPANY AUDIT	-	5	4	8	-	14	10	8	5	-	5	-	-	12
8.	SPECIAL AUDIT	5	-	12	20	8	8	-	8	24	16	8	10	-	12
9.	GOVERNMENT AUDIT	5	5	-	-	8	-	10	4	-	2	4	2	-	-
10.	EDP AUDIT	2	10	-	-	8	-	-	4	-	4	-	-	-	9
11.	AUDIT OF SHARE CAPITAL	5	5	-	8	8	-	13	4	4	4	4	-	-	4
12.	AUDIT OF DEBENTURES	-	-	-	4	8	8	-	-	-	-	-	-	-	-
13.	AUDIT OF CASH TRANSACTIONS	-	5	-	-	5	6	8	-	8	9	8	12	22	12
14.	AUDIT OF TRADING TRANSACTIONS	18	-	4	20	-	-	4	4	-	-	-	-	-	-
15.	VERIFICATION & VALUATION OF ASSETS	5	-	-	-	18	4	4	18	8	8	13	4	4	4
16.	VERIFICATION OF LIABILITIES	5	-	-	-	-	-	5	-	-	-	-	-	4	-
17.	INTERNAL CONTROL	5	-	4	-	8	8	5	4	-	-	-	10	-	12
18.	CARO 2015	-	-	-	-	8	8	-	2	-	2	-	-	-	-
19.	MISCELLANEOUS TOPICS	-	-	-	-	-	-	-	-	-	17	12	-	-	12
20.	STANDARDS ON AUDITING	6	5	-	-	5	-	-	14	-	21	30	22	21	14

CHAPTER WISE ANALYSIS OF PREVIOUS EXAMINATIONS OF IPCC IN THE SUBJECT OF AUDITING (PRACTICAL QUESTIONS)

No.	Chapter/Topic Name	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	INTRODUCTION TO AUDITING	-	2	-	-	-	-	-	-	-	-	-	-	5	-
2.	CONCEPTS OF AUDITING	-	-	-	-	-	-	-	-	2	-	-	-	-	-
3.	AUDIT EVIDENCE	-	2	-	-	-	-	-	2	-	-	-	-	-	2
4.	AUDIT PREPARATION	6	-	6	-	-	-	-	-	-	-	-	-	6	-
5.	CAPITAL & REVENUE EXPENDITURE	-	-	-	-	-	-	-	2	-	-	-	-	-	-
6.	COMPANY AUDITOR	21	10	9	-	-	-	-	2	8	-	-	2	10	6
7.	MISCELLANEOUS MATTERS IN COMPANY AUDIT	4	10	14	-	-	-	-	2	4	-	-	-	-	-
8.	SPECIAL AUDIT	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	GOVERNMENT AUDIT	2	2	-	-	-	-	-	-	-	-	-	-	-	-
10.	EDP AUDIT	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	AUDIT OF SHARE CAPITAL	-	2	-	-	-	-	-	-	5	-	-	-	-	-
12.	AUDIT OF DEBENTURES	7	2	-	-	-	-	-	-	-	-	-	-	-	-
13.	AUDIT OF CASH TRANSACTIONS	3	-	-	-	-	-	-	-	-	-	-	-	-	-
14.	AUDIT OF TRADING TRANSACTIONS	-	10	4	-	-	-	-	-	-	-	-	-	-	-
15.	VERIFICATION & VALUATION OF ASSETS	3	2	4	-	-	8	-	-	-	-	-	-	-	-
16.	VERIFICATION OF LIABILITIES	-	-	-	-	-	-	-	-	2	-	-	-	-	-
17.	INTERNAL CONTROL	-	-	-	-	-	-	-	6	8	-	-	-	-	-
18.	CARO 2015	2	6	-	-	-	-	-	2	-	-	-	-	-	-
19.	MISCELLANEOUS TOPICS	-	-	4	-	-	-	-	-	-	-	-	-	-	-
20.	STANDARDS ON AUDITING	14	7	45	20	8	25	16	4	17	-	-	-	-	-

INDEX FOR AUDITING & ASSURANCE

S.No.	Chapter Name	No. of Theory Questions	No. of Practical Questions	Pages
	Previous Question papers			8 – 10
1.	Introduction to Auditing	22	3	11 – 28
2.	Concepts of Auditing	16	1	29 – 40
3.	Audit Evidence	10	6	41 – 49
4.	Audit Preparation	12	2	50 – 58
5.	Capital & Revenue Expenditure	11	2	59 – 65
6.	Company Auditor	23	44	66 – 95
7.	Miscellaneous Matters in Company Audit	15	7	96 – 106
8.	Special Audit	17	11	107 – 128
9.	Government Audit	7	3	129 – 135
10.	EDP Audit	12	-	136 – 145
11.	Audit of Share Capital	8	7	146 – 151
12.	Audit of Debentures and Dividends	4	1	152 – 154
13.	Audit of Cash Transactions	44	6	155 – 175
14.	Audit of Trading Transactions	13	11	176 – 189
15.	Verification & Valuation of Assets	48	18	190 – 215
16.	Verification of liabilities	14	10	216 – 224
17.	Internal Control	16	8	225 – 238
18.	CARO 2015	-	-	239 – 241
19.	Miscellaneous Topics	25	-	242 – 253
20.	Standards on Auditing	-	-	254 – 354
Total		317	140	

HOURS ALLOTMENT FOR PREPARATION OF AUDITING & ASSURANCE

S.No.	Chapter Name	1 st Revision for Weekend Exams	2 nd Revision for Revision Exams	3 rd Revision for Pre Final Exam	4 th Revision on Day Before Exam
1.	Introduction to Auditing	1 – 1.5	2 – 3	30 min	15 min
2.	Concepts of Auditing	1 – 1.5	2 – 3	30 min	15 min
3.	Audit Evidence	1.5 – 2	2 – 3	45 min	20 min
4.	Audit Preparation	1.5 – 2	2 – 3	45 min	20 min
5.	Capital & Revenue Expenditure	0.5 – 1	1	15 min	10 min
6.	Company Auditor	4 – 5	7 – 8	2 – 3	60 min
7.	Miscellaneous Matters Company Audit	2 – 3	3 – 4	1 – 1.5	30 min
8.	Special Audit	3 – 4	5 – 6	1.5 – 2	45 min
9.	Government Audit	1 – 1.5	2 – 3	45 min	20 min
10.	EDP Audit	2 – 3	3 – 4	1 – 1.5	30 min
11.	Audit of Share Capital	1 – 1.5	1 – 1.5	30 min	15 min
12.	Audit of Debentures and Dividends	0.5 – 1	0.5 – 1	15 min	10 min
13.	Audit of Cash Transactions	3 – 4	5 – 6	1 – 1.5	45 min
14.	Audit of Trading Transactions	1 – 1.5	1 – 1.5	15 min	10 min
15.	Verification & Valuation of Assets	3 – 4	5 – 6	1 – 1.5	45 min
16.	Verification of Liabilities	1.5 – 2	1.5 – 2	30 min	15 min
17.	Internal Control	2 – 3	3 – 4	1 – 1.5	45 min
18.	CARO 2015	-	-	-	-
19.	Miscellaneous Topics	0.5 – 1	0.5 – 1	30 min	10 min
20.	Standards on Auditing	12 – 15	20 – 25	7 – 9	4 – 5

IN THIS BOOK, THE CONTENT GIVEN IN ITALICS IS FOR ACADEMIC INTEREST ONLY. STUDENTS NEED NOT MEMORISE AND REPRODUCE THE SAME IN THE EXAMS.

HIGHLIGHTS OF THIS MATERIAL

1. **QUESTION PAPERS OF RECENT 2 EXAMS:** At the beginning of this material we have included the question papers of recent 2 exams. This will help to analyse the previous exam trends in a better manner and to assess whether our material is able to cater the needs of the examinations or not.
2. **EXAMINATION TRENDS:** At the beginning of each chapter we have given a table called **QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS**. This analysis will help you to judge the relative importance of each question in each chapter. Based on that analysis you can easily pay more attention on relatively more important questions.

Similarly at the beginning of the material we have included a table called **CHAPTER WISE ANALYSIS OF PREVIOUS EXAMINATIONS**. This analysis will help you to judge the relative importance of each chapter and you can pay more attention on relatively more important chapters.

3. **ONE STOP SOLUTION:** All Questions in SM, PM, latest RTPs and latest MTPs have been covered in our material alongwith previous examination questions of IPCC. Our material is like a one stop solution. In the public exam you can expect atleast 90% of the Questions to come from our material.

For each question we have given the reference of Study Material (SM), Practice Manual (PM), RTPs, MTPs & previous examinations of IPCC. This will help you to assess the relative importance of each question from examination point of view.

4. **RECENT AMENDMENTS:** All the recent amendments are being highlighted with GREY background and all such amendments are important from examination point of view. With this students can pay more attention on such areas.
5. **PURPOSE OF ABC ANALYSIS:** All the questions are categorized into ABC which shows the importance of the question from examination point of view. This analysis helps the student to devote the time on the important areas at the time of exams. However, it is advisable to read even "C" category questions atleast once. In other words, don't ignore C category questions completely.

On the other hand, if you have enough time to prepare then it is recommended to thoroughly read C category questions also. The decision to leave B category or C category questions is purely left to your discretion and it is advisable for you to take the decision based on the availability of time and your caliber.

In simple words, if you have enough time and if you are capable enough then read all the questions. Otherwise leave C category questions. If you are ready to take still more risk then you can leave B category questions too. Everything depends upon – availability of time, your caliber and the amount of risk that you are ready to take.

6. **APPROACH TO PRACTICAL QUESTIONS:** First get a complete grip on theory conceptually and then read practical questions, but simply don't mug up the practical questions. This is to ensure that you feel comfortable at the examination. As the CA course is a professional course you won't always get the same questions every time, therefore in order to clear the exams you must be conceptually strong.
7. **ANSWERING PRACTICAL QUESTIONS:** Students are advised to answer the practical questions in the same format as given in the material (Facts, Provision, Analysis, Conclusion i.e. FPAC).

8. **REFERENCE OF PRACTICAL QUESTIONS:** At the end of each Theory question, we have given the reference of practical question to be read correspondingly. Immediately after completion of each theory question it is advisable to refer the corresponding Practical Questions, as per the reference given by us.
9. **SIGNIFICANCE OF TEXT GIVEN IN 'ITALICS' IN SOME PLACES:** The text given in *italics* indicate that the matter need not be written, if that question is asked for lesser marks i.e. as a short answer. However, if the question is asked for more number of marks then the entire answer must be written. In simple words, in the examination, write the content given in italics only if time and marks permit.
10. **FEW QUESTIONS ARE TO BE PREPARED ON YOUR OWN:** Few theory questions and practical questions are marked as "FOR STUDENT'S SELF STUDY". Those questions will not be discussed by the faculty in the classroom. Generally questions of very easy nature are classified under this category. Students shall not get confused that all the questions given under this category are unimportant. Some of the questions classified under this category might be even important. We have done this to ensure that syllabus is completed in time.
11. **PURPOSE OF "SIMILAR QUESTIONS":** At the end of each question there are some similar questions and the purpose of giving similar questions is to make students understand the different ways of asking the same question. For your convenience we have also given hints for answering such similar questions in the exam.
12. **QUESTIONS FOR ACADEMIC INTEREST ONLY:** Questions classified under this heading are not important from examination point of view and they are given only for your academic knowledge and are not important from examination point of view. If time permits then it is advisable to prepare those questions also. If time does not permit then students can leave those questions as choice. So, it is upto you to decide based on your preparation schedule.

Are you appearing for Group 1 alone or aiming for a rank in IPCC exams?: If you want to attempt for Group 1 alone or aiming for a rank in IPCC exams then you shall not take risk. So, for such kind of students it is advisable to read the full content of the material.

THE END

IPCC MAY 2016 QUESTION PAPER – PAPER – 6

AUDITING AND ASSURANCE

Question No. 1 is compulsory

Answer any five questions from the remaining six questions.

In case, any candidate answers extra question(s)/sub-questions(s) over and above the required number, then only the requisite number of questions first answered in the answer book shall be valued and subsequent extra questions shall be ignored.

1. Discuss the following:
 - a) With reference to SA-550, "Identification of significant related party transaction outside the entity's normal course of business". **5M**
 - b) With reference to SA-530, meaning of audit sampling and requirements relating to sample design, sample size and selection of items for testing. **5M**
 - c) How does an audit programme help to plan and perform the audit? **5M**
 - d) What are the specific risks related to internal control in an IT environment? **5M**
2. State with reasons (in short) whether the following statements are correct or incorrect (Answer any **eight**): **8X2=16M**
 - a) The scope of work of an internal auditor may extend even beyond the financial accounting.
 - b) An auditor has nothing to do with prudence or profitability of a company.
 - c) Evaluating responses to enquiries is an integral part of the inquiry process.
 - d) Internal control questionnaires are a good source of identifying weakness in internal control system.
 - e) Cluster sampling is less effective than random sampling.
 - f) Errors of duplication affects the Trial Balance.
 - g) Substantive procedures do not test the balances of accounts.
 - h) The first auditors of a Government company was appointed by the Board of Directors.
 - i) The members of XYZ Ltd. preferred a complaint against the auditor stating that he has failed to send the auditor's report to them.
 - j) Mr. Pawan, a practicing Chartered Accountant, is appointed as "Tax-Consultant" of ABC Ltd. in which his father. Mr. Singh is the Managing Director.
3. How you will vouch/verify the following? **4X4=16M**
 - a) Preliminary Expenses
 - b) Customs & Excise Duties
 - c) Floating assets
 - d) Recovery of bad debts written- off.
4.
 - a) Mention the disclosure requirement of current investments as per Schedule III of the Companies Act, 2013. **6M**
 - b) What are the significant matters observed during the course of audit, a record of which should be kept in the Audit Note Book? **6M**
 - c) Write short note on the use of flowcharts in evaluation of internal control. **4M**

- 5.
- a) Mention any six special points which you as an auditor would look into while auditing the books of a partnership firm. **6M**
 - b) Draft an audit programme for conducting audit of accounts of a local body. **6M**
 - c) What precautions should be taken by an auditor while applying test check techniques? **4M**
- 6.
- a) What are the matters to be included in Director's Responsibility statement? **6M**
 - b) Discuss the provisions of Section 134 of the Companies Act, 2013 regarding the authentication of financial statements. **6M**
 - c) State the factors to be considered to verify the validity of any transaction. **4M**
7. Write short notes on any **four** of the following: **4X4=16M**
- a) Provisions for applicability of internal audit as per Companies Act, 2013.
 - b) Prohibition to buy-back its own securities in certain circumstances.
 - c) Advantages of CAAT.
 - d) Changes in accounting policies.
- Recognition of interest on deposits.

IPCC NOV 2015 QUESTION PAPER – PAPER – 6

AUDITING AND ASSURANCE

Question No.1 is compulsory.

Attempt any five questions from the remaining six questions

1. **Discuss the following:** **5 X 4 = 20M**
- a) With reference to SA 320 indicate the factors which may affect the identification of an appropriate bench mark in determining materiality for the financial statement as a whole.
 - b) The assertions used by the auditor to consider potential misstatements about account balances at the period end.
 - c) 'p' an auditor decides not to send a new audit engagement letter to G Ltd. every year. Whether he is right in his approach ? state the circumstances where sending new engagement letter, would be appropriate,
 - d) State the principle aspects to be covered in an audit concerning financial statement of account.
2. **State with reasons (in short) weather the following statements are correct or incorrect (Answer any eight)** **8 x 2 = 16M**
- i) Z refused to show the minute books to the auditors.
 - ii) The auditor has to report to central Govt. with in 90 days of his knowledge of an offence involving fraud.
 - iii) Manner of rotation of auditor will not be applicable to company A, which is having paid up share capital of Rs. 15 crores and having public borrowing from nationalized bank of Rs. 50 crore because it is a private Limited company.
 - iv) The auditor should study the memorandum and Articles of association to see the validity of his appointment.
 - v) Teeming and lading is one of the techniques of inflating cash payments.

vi) Managing director of A Ltd. himself appointed the first auditor of the company.

vii) A chartered accountant. N, a member of the institute of chartered accountants of England and Wales, is qualified to be appointed as auditor of Indian companies.

3. How will you vouch or verify the following: 4 x 4 = 16M

- a) Refund of General insurance premium paid.
- b) Payment of Taxes
- c) Sale proceeds of junk material
- d) Intangible assets

4.

- a) Mention the points/areas in which all the joint auditors are jointly and severally responsible. **6M**
- b) Mr.A was appointed statutory auditor of P Ltd., but he was not able to gather the sufficient audit evidences. **6M**
- c) Discuss the recognition principles of contingent liability. **4M**

5.

- a) Discuss about the provisions for removal of auditor before expiry of term. **6M**
- b) As the statutory auditor of A Ltd., you have observed that the gross profit of the company has decreased in comparison to last years. Mention the possible factors which may be responsible for decrease in gross profit. **6M**
- c) State the precautions to be taken to avoid the disadvantages of a continuous audit. **4M**

6.

- a) The form, contents and extent of audit documents depend on certain factors. Explain with reference to SA 230. **4M**
- b) Why tests of control are performed? Also explain what does they include. **4M**
- c) State the standards Issued by AASB which are collectively known as engagement standards. **4M**
- d) State the factors which are to be considered in determining materiality. **4M**

7. Write short notes on any four of the following : 4 x 4 = 16M

- a) Remuneration paid to directors in case of a public limited company.
- b) Payment for acquisition of assets.
- c) A qualified opinion.
- d) Fraudulent financial reporting
- e) Surprise checks.

THE END

1. INTRODUCTION TO AUDITING

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	2	-	-
3.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-	6	-	-
5.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	C	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	2	2	-	-	-	2
7.	B	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-
8.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-
9.	B	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	A	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	5	-	-
11.	A	-	10	-	-	-	5	-	10	-	-	8	-	-	-	8	-	6	-	-	-	-
12.	A	-	-	-	-	-	-	5	-	8	-	-	5	4	-	-	-	-	5	-	5	-
13.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-
14.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-
16.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-
17.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-
18.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	6	-	-
19.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
20.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
21.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
22.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Definition of Auditing: Most authoritative definition on auditing is “An audit is an independent examination of financial information of any entity, whether profits oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to express an opinion thereon. (These matches with the famous definition given by Mr. Dick see).

Q.No.1. Write short notes on general purpose Financial Statements. (B) (N 05 – 5M, PM)

- Financial statements** consist of the following:
 - Statement of performance - Profit and Loss Account (income statement),
 - Statement of Financial Position - Balance Sheet,
 - Statement of Movement of Funds - Funds Flow and Cash Flow statement.
 - They may also include supplementary schedules and information based on such statements and expected to be read with such statements.
 - Statements changes in Equity.
- However, Financial Statements do not include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

3. Many users rely on the financial statements as their major source of financial information. Therefore, such financial statements should be prepared and presented with their needs in view.
4. Accounting standards are applicable to all general purpose financial statements.

Entities interested in financial information:

Users	Purpose
Management	For day-to-day decision-making and <u>performance evaluation</u> .
Proprietor / Shareholders	To analyse performance, <u>profitability</u> and financial position. Note: Prospective investors are interested in the track record of the company.
Lenders - Banks & Fin. Institutions	To determine the financial position and <u>strength</u> of the Company, Debt Service Coverage, etc.
Suppliers	To determine the <u>credit worthiness</u> of the company.
Customers	To know the <u>general business viability</u> before entering into long-term contracts and arrangements.
Government	• To ensure prompt collection of Direct and Indirect Tax revenues. • To evaluate performance and contribution to social objectives.
Research scholars	For study, <u>research</u> and analysis purpose.
Employees	Job security, bonus.

5. **Need for Audit:**

- a) The external agencies who use the Financial Statements need an assurance that Financial Statements:
 - i) have been prepared and presented correctly, and
 - ii) Reflect the “true and fair” view of the enterprise.
- b) Hence, an independent examination of the financial statements is needed. This gives rise to the need for Auditing.

Similar Question: What do you understand by financial statements? Who are the entities interested in them? (N 05 – 4M)

Ans: Same as above.

Q.No.2. State the objectives of an Audit? (A)

(M 15, N 14 - 2M)

As per SA -200, the primary objective of audit is to enable an auditor to express an opinion on Financial Statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements.

1. **Main objective:** The main objective of auditing is to report whether the financial statements are showing true and fair view or not. This is done by comparing the B/S and profit and loss a/c with the books of accounts.
2. **Other objectives:**
 - a) Detection and prevention of frauds, and
 - b) Detection and prevention of errors.

The same was also upheld in the **LONDON AND GENERAL BANK LTD. CASE**.

The London and General Bank Ltd [1895]	It is no part of Auditor's duty to give advice either to Directors or Shareholders as to what they ought to do. An auditor has nothing to do with the profitability or unprofitability, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that.

Why discovery of all frauds and errors cannot be made the main objective of audit?:

- a) *If an audit is conducted with the objective of discovering all frauds, it would take lot of time. It is not possible to complete the audit within the time limit.*
- b) *Further, a detailed examination of all the books would be required. This increases the cost of the audit which is to be borne by the shareholders.*
- c) *Even if such an examination is done there is no guarantee that all frauds will be found.*
- d) *Suppose, a sole trader sets out from his shop. On the way, he borrows money of Rs.1,00,000 from a friend. He purchases goods for cash for Rs.1,00,000 and sells them for Rs.2,00,000. Thereafter, he returns Rs.1,00,000 to his friend and makes a profit of Rs.1,00,000. In this case the auditor can't detect this unless the sole trader informs him of these transactions, because neither the amounts have been received nor paid by cheque nor the purchases entered in the stock records nor any bill or receipt has been obtained.*

Similar Questions: Auditor is not an insurer

(N 08 - 2M)

Ans: True – Refer to the main objective as per SA – 200 and LONDON GENERAL BANK CASE.

Q.No.3. What are the auditor's responsibilities for Non-Detection of Frauds and Errors?

(A)

(N 04 – 8M, M 15 – 5M, PM)

- a) **Responsibility:** The responsibility for the prevention and detection of fraud and error is of the management through the implementation of an internal control system. The presence of such a system reduces but does not eliminate the possibility of fraud and error.
 - b) **Auditor's efforts:** One of the audit objectives is to detect the fraud or error resulted in the accounts. To ensure that fraud or error has not occurred or even it was occurred it will be detected by him during the course of his audit, the auditor adopts the several audit techniques. Consequently, the auditor gets reasonably satisfied that fraud or error has not occurred or even it was occurred, the effect of fraud or error is properly corrected.
 - c) **Limitations of audit:** Due to the inherent limitations of an audit there is a possibility that mis-statements in the financial statements resulting from fraud or error may not be detected.
 - d) **Subsequent discovery:** The subsequent discovery of fraud or error does not indicate that the auditor has discharged his job negligently. (*)
 - e) **Question:** The question whether the auditor has followed the basic principles governing an audit is answered by the adequacy of the audit procedures used by him and the suitability of the auditor's report based on the results of these procedures.
 - f) **Liability:** The liability of the auditor for failure to detect fraud or error arises only when such failure is clearly due to not exercising reasonable care and skill.
- * In spite of good efforts put by auditor in identifying the frauds, if he fails in doing so, it will not be construed as audit failure. The same is upheld by **KINGSTON COTTON MILLS CO.'s CASE.**

Similar question: After the statutory audit has been completed a fraud has been detected at the office of the Auditee (Or) some misstatements remained unreported by auditors. Comment.

Ans: Same as above.

Similar question: Is detection of fraud and error duty of an auditor?

(M 15 – 5M)

Ans: Same as above.

REFER PRACTICAL QUESTIONS: 1 & 3.

Q.No.4. What are the inherent Limitations of an Audit? (A)	(M 11 - 8M, PM, N14 RTP)

1. **Meaning:** *The process of auditing suffers from certain inherent limitations i.e. the limitations/problems which cannot be overcome irrespective of the extent of audit procedures.*

As per SA 200, opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which the management has conducted the affairs of the enterprise.

2. **Inherent limitations of an audit:**

- a) Auditor cannot obtain absolute assurance. (In other words, he cannot reduce audit risk to Zero).
- b) This is due to inherent limitations of an audit due to which auditor obtains persuasive evidence rather than conclusive evidence.
- c) It arises from: Nature of financial reporting, audit procedures, Limitation w.r.t. time & cost.

i) **Nature of financial reporting**

- Preparation of financial statements involves judgment by management.
- For Example, accounting estimates.
- There may be subjective decisions.
- Moreover, auditor has to consider whether these estimates appear to be reasonable.
- Evidences w.r.t. such items can only be persuasive.

ii) **Nature of audit procedures:**

- Management or others may not provide complete information.
- Moreover frauds may involve carefully designed schemes to conceal it. Thus auditor may not detect them.

iii) **Limitation w.r.t. time and cost:**

- Users expect that the auditor will form an opinion on financial statements within reasonable time and cost.
- Thus auditor resorts to test procedures (not 100% checking).
- Moreover, he directs more efforts to risky areas.'

- d) *Due to aforesaid inherent limitations, there is unavoidable risk that some material misstatement may remain undetected.*

- e) **Limitations of Internal Control System:** *The extent of audit procedures to be performed depends upon the effective working of the Internal Control System. Even the Internal Control System is also having some limitations:*

- i) The potentiality for human error.
- ii) The possibility of dilution of controls through collusion.
- iii) The possibility that a person exercising control could abuse (misuse) that authority.
- iv) The possibility that control procedures may become outdated.
- v) Manipulation by management with respect to transactions required in the preparation of financial statements.

Similar Questions:

Q.No.1. Do you agree with the view that there are inherent limitations of audit (N 01 - 8M)

Ans: same as above.

Q.No.2. Briefly explain inherent limitations of an audit. (M 03 - 4M, N 05 – 8M)

Ans: same as above

Q No.3. 'Doing a statutory audit is full of risk'. Narrate the factors which cause the risk?

(M15, MTP1, 2 -5M, N14 MTP2 - 4M)

Ans: same as above

Q.No.5. "The process of auditing is such that it suffers from certain limitations which cannot be overcome irrespective of the nature and extent of audit procedures." Explain. (N15 RTP)

Q.No.5. Define the terms fraud and error. (C)

Standard on Auditing-240 defines the terms fraud and error as follows.

Fraud: An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud may involve :

- a) fraudulent financial reporting process which can be done through manipulation of books, records and documents, omission of certain transactions, misapplication of accounting principles (Of course when these are done intentionally) (N15 MTP1 - 4M)
- b) Misappropriation of assets. (E.g.: fictitious purchases shown to misappropriate cash).

Auditor's ability to detect fraud depends up on:

- a) The skillfulness of the perpetrator (the more skilful the perpetrator, the more it is difficult to detect fraud).
- b) The frequency of fraud (the more frequently the fraud is committed, more will be the chances of detection).
- c) The extent of manipulation (if extent of manipulation is small, it is difficult to detect fraud).
- d) The degree of collusion involved (Collusion makes detection difficult).
- e) The relative size of individual amounts manipulated (the smaller the individual amounts, the more difficult to detect as it is likely to be neglected).
- f) The seniority of the persons involved. (The more senior the persons involved, the more difficult to detect).

Note: Relevant Standard on auditing is SA - 240.

Error: On the other hand the term "error" refers to unintentional mistakes in financial statements such as:

- a) Clerical errors, like errors of omission, errors of commission, errors of duplication and compensating errors.
- b) Misapplication of accounting policies (Called errors of principle).

Q.No.6. Types of errors in accounts. (B) (FOR STUDENTS SELF STUDY) (M 14 – 2M)

1. Errors of omission:

- a) **Partial Omission:** One aspect of transaction, either debit or credit, is omitted to be recorded. In this case trial balance will not agree.
- b) **Complete Omission:** Both aspects of the transaction i.e. debit and credit are omitted to be recorded. Trial Balance will still agree.
- c) **Detection:** Partial omission, if not deliberately concealed, can be detected by regular audit procedures, e.g. vouching, analytical reviews, ledger scrutiny, checking of posting, casting, carry forward of balances etc. Complete omission is comparatively difficult to detect.

2. Errors of commission: Errors of commission involve the following.

(N 98 - 4M, M 09 - 5M, PM)

- a) **Wrong posting of amount:** For example, a purchase of Rs.10,000 was entered in the purchase book as Rs.1,000. Another e.g. is a cash receipt of Rs.1581 from a customer is wrongly posted to his account as Rs.1851. Such errors would not affect the trial balance.
- b) **Posting on wrong side:** For example, a cash receipt from a customer is posted to the debit of his account instead of crediting the same. Such an error results in difference in trial balance and the amount will be exactly double the amount of transaction.
- c) **Posting in wrong a/c:** For example, Goods were sold to X for Rs.20,000. This amount is posted to the debit of Y instead of X. Such errors would not affect the trial balance.
- d) **Detection:** Errors of Commission, which are not deliberately concealed, can be detected through normal audit procedures, e.g. vouching, analytical posting checking, casting checking carry forward of balances checking etc.

3. Error of duplication:

- a) Such errors occur if the same transaction is recorded twice in the books of accounts. For example sales of Rs.1,00,000 may be recorded twice in the accounts.
- b) **Effect on agreement of trial balance:** There is no effect.

4. Compensating error / Concealed error:

- a) Compensating errors are those errors which offset against each other. For example, a cash purchase of Rs.100 may be wrongly entered in the cash book as Rs.1,000 whereas another purchase of Rs 1,000 may be wrongly entered as Rs.100.
- b) **Effect on agreement of trial balance:** There is no effect.
- c) **Detection:** Such errors are generally deliberately concealed and hence difficult to detect. Audit procedures like analytical review procedures, posting checking, ledger scrutiny etc., can partly help to locate these errors.

5. Error of Principle:

- a) Normally such errors occur when wrong accounting principles are followed. For example, wages paid for erecting of a machine are debited to wages a/c instead of machinery a/c.
- b) **Effect on agreement of trial balance:** They will not affect the agreement of trial balance. But these errors affect the profit and loss a/c and the balance sheet materially.
- c) **Detection:** These errors are detected by audit procedures like analytical review procedures, ledger scrutiny, analysis of comparative financial statements, etc.

- 6. **Error of procedure:** The errors that occur in the implementation of procedures may be termed as procedural errors. For example: the organisation has a policy of authorizing every cash payment in excess of Rs 5,000/- by Director of Finance. However some payments have been made in excess of the said limit without obtaining his authorization. Due to these errors there will be no impact on the trial balance. However, this needs to be seen with a view to check whether the non compliance (fraud by employees) is intentional or unintentional.

Similar Questions: Errors of Commission

(N 98, M 01 - 4M)

Ans: Same as above

REFER PRACTICAL QUESTIONS: 2

Q.No.7. Statutory audit vs. Non statutory audit. (B)

(N 11 – 5M)

Statutory audit:

- 1. **Meaning:** An audit which is made compulsory under any statute is called statutory audit. Various aspects concerning the audit such as scope of audit, qualifications of an auditor and his rights, duties are mentioned in that statute itself.

2. Some examples are:

- a) The Companies Act, 2013 - Statutory audit of companies.
- b) The Banking Regulation Act, 1949 - Statutory audit of banks.
- c) The Insurance Act, 1938 - Statutory audit of insurance companies.
- d) Indian Electricity Act, 1910 – Statutory audit of electricity companies.
- e) Indian Trusts Act and State enactments - public charitable trust.
- f) Multi State Co-operative Society Act – Co-operative Society.

Non statutory audit (or) Voluntary audit:

- 1. It is done not because the law requires it but the owners desire the books to be audited. With this they can get reliable financial statements. The scope of audit is decided by the Management and the ICAI pronouncements.
- 2. **Some examples are:** Proprietary concerns, Partnership firms.

Similar Questions: Discuss the types of audits required under law.

(PM, N14RTP, N14 MTP2 - 4M)

Ans: Same as above

Similar Questions: “Audit is not legally obligatory for all types of business organisations or institutions” Discuss. (N15 RTP)

Q.No.8. What are the aspects to be covered in an audit. (B)	(M 94 - 8M, N15 - 5M)

- a) Checking the arithmetical accuracy of the books of accounts.
- b) Vouching the authenticity of the transactions entered into during the course of business by the examination of various supporting evidences.
- c) Ascertaining that proper distinction has been made between capital and revenue items.
- d) Comparison of the Balance Sheet and Profit and Loss items with the books of accounts to confirm whether they are in accordance therewith.
- e) Checking whether the Balance sheet and P&L account are showing true and fair view.
- f) Verification and valuation of assets & liabilities.
- g) In case of company audit, confirming whether the legal requirements have been complied with.
- h) Cut-off - Ascertaining that amounts of various incomes and expenditures adjusted in the accounts correspond to the accounting period. (i.e. ascertaining whether proper adjustments for accrued / prepaid expenses and income received in advance / outstanding was made).
- i) Examination of the internal control system.
- j) Reporting to the appropriate authority (i.e. audit report).

Similar Questions:

Q.No.1. Overall Audit Approach

(M 08 - 8M, PM)

Ans: Same as above.

Q.No.2. State the matters which statutory auditor should look before framing opinion on accounts on finalisation of accounts. (M 96 - 8M)

Ans: Same as above.

Q.No.3. Functions of an Audit.

Ans: Same as above.

Q.No.4. What the auditor is supposed to do to satisfy himself that nothing contained in the statements will mislead anybody? (N15RTP)

Q.No.9. Discuss the concept of independence of an auditor. (B)

(N 89, M 91, 93, 06 - 5M, PM)

Meaning: The term independence means that the judgment of a person is not subordinate to the wishes and directions of other person who have engaged him i.e. the audit decisions should be taken without giving importance to his personal wishes.

SA-200: This is one of the basic principles governing an audit, according to SA-200.

Advantage / Objective: The main objective of an independent audit is to produce reliable financial statements. The ultimate test for accepting the auditor's opinion on the financial information by shareholders, banks, tax authorities, labour unions etc. would depend upon the fact that whether an auditor acted independently or not while expressing his opinion. (i.e. Society at large believes the financial information as the auditor acts independently)

INDEPENDENCE OF AUDITOR - A LEGAL POINT OF VIEW

Companies Act:

Refer Qualifications & Disqualifications of Auditor (Q No.1,2 in Chapter – 6)

Chartered Accountants Act: It consists of following provisions to safeguard the independence

- a) Prohibiting the auditors from accepting fees as a percentage of profits.
- b) Prohibiting the auditors from accepting fees, based on contingency.
- c) Prohibiting the auditors from expressing his opinion on financial statements of any business in which he has "substantial interest".
- d) Prohibiting the auditors from expressing his opinion on financial statements of any business in which his relatives have substantial interest.

Similar Questions: Q.No.1. What do you mean by independence of an auditor? What are the advantages of it? (or) **(M 08 - 5M)**

Q.No.10. What are the advantages of independent audit? (A)

(N 81, 91, M 93 - 5M, M 12 - 8M, M 15 - 4M, PM)

1. It produces reliable financial statements of accounts.
2. It protects the interest of persons who are not participating in the management of the entity.
3. It acts as a moral check on the employees from committing frauds.
4. Audited financial statements are helpful in:
 - a) Settling liability for taxes,
 - b) Bargaining loans and
 - c) For determining the purchase consideration of a business.
5. These are useful to settle trade disputes for higher wages or bonus.
6. These are useful to settle claims in case of damages suffered by fire accidents, etc.
7. It also helps the client in deciding whether the necessary books and records have been properly kept.
8. Auditor reviews the operation of various controls in the organisation and reports weaknesses in them.
9. Government may require audited financial statements before it gives subsidies, etc.

Similar Questions:

Q.No.1. What is the importance of having the accounts audited by independent professional auditors? **(PM)**

Q.No.2. “Having accounts audited by independent auditor, among other advantages, act as a oral check on the employees from committed fraud”. Explain stating the advantages of independent audit. (M15 RTP)

Q.No.11. What are the responsibilities of auditor as per SA-200 [revised]? (A)

1. **Ethical requirements:** He shall comply with ethical requirements including independence. He is required to comply with code of ethics issued by ICAI.
 - a) **Integrity & Objectivity:** He should be straight-forward and sincere in his approach to the professional work. He should be fair without any bias or prejudice.
 - b) **Independence:** The term independence means that the judgment of a person is not subordinate to the wishes and directions of other person who have engaged him i.e. the audit decisions should be taken without giving importance to his personal wishes.
 - c) **Confidentiality:** The auditor should not leak the information collected by him, during the course of his professional work, to any third party without specific authority from the client.
 - d) **Professional competence & due care:** The auditor requires specialised skill and competence which are acquired through a combination of general education, technical knowledge obtained through study and practical experience.
 - e) **Professional behavior:** Auditor supposed to maintain Professional behavior.
2. **Professional Skepticism:** He should recognize the conditions indicating possible misstatements. It includes being alert to: Contradictory evidences, Conditions indicating possible frauds & questioning reliability. Moreover, it requires critical assessment of audit evidences gathered. By maintaining professional skepticism, overall risk can be reduced. (M14 - 6M)
3. **Professional Judgment:** It is necessary to make proper decisions during audit. For example decisions about:- Materiality, Audit risk, N T E of audit Procedure, Sufficiency & appropriateness of evidence etc. While making professional judgment he considers level of consultation, if required
4. **Sufficient & appropriate Audit Evidence and Audit Risk:**
 - a) Sufficiency refers to quantum of evidence whereas appropriateness refers to its quality.
 - b) He should consider SA 500.
 - c) It is required to reduce audit risk to an acceptable low level.
 - d) It consists of risk of material misstatements and detection risk
 - e) However, due to inherent limitations of audit, risk cannot be reduced to Zero.
5. **Conduct of Audit in accordance with SAs:** He shall comply with SAs relevant to audit. The auditor shall understand entire SA to apply it properly. He shall represent compliance with SAs in auditors report only if he has complied with requirements of all relevant SAs. If auditor fails to achieve an objective in relevant SAs then.
 - a) Modify the audit report, or Withdraw from the engagement.
 - b) It is significant matter requiring documentation as well.

Similar Questions:

Q.No.1. What are the basic principles governing an audit as laid down in SA – 200

Ans: Same as above. (M 13 - 8M, N 00, N 03, N 06, N 08, N 09 - 8M)

Q.No.2. Auditor's professional responsibilities are governed by basic principles which should be complied with whenever an audit is carried out. (N 02 – 10M)

Ans: Same as above.

Q.No.3. “All those personal qualities that go to make a good businessman contribute to the making of a good auditor.” Explain. (N15 RTP)

Q.No.12. Letter of Engagement. (A)

(N 91, 92, M 03, 08, 09 - 4M, N15 – 5M)

1. Letter of Engagement:

- a) Letter of engagement refers to the letter written by the Auditor to the Client, documenting and confirming his acceptance to the appointment, the objective, scope and extent of his responsibilities to his Client.
- b) The Auditor and the Client should agree on the terms of engagement. The agreed terms should be recorded in an audit engagement letter or other suitable form of contract.
- c) In the interest of both Client and Auditor, the Auditor should send an Engagement Letter, preferably before the commencement of engagement, to avoid any misunderstanding with respect to engagement.

2. Purpose:

(PM)

- a) Define the duties and responsibilities.
 - b) Remembering that client is responsible for preparing the accounts, introduction and maintenance of internal control system, etc.
 - c) Remembering the client that the audit may not necessarily discover fraud or error.
 - d) Set out the basis of audit fees.
 - e) Indicate the time within which the audit is expected to be completed.
 - f) This will help in avoiding misunderstanding between client and auditor in future.
3. The issuing of this letter in case of non-statutory audit is highly recommended, as the possibility of misunderstanding is more.
4. In case of statutory audit, though the scope of audit is specified in the act, it is desirable to issue such a letter.

5. Contents:

- a) Object of audit of financial statements.
 - b) List of Management's responsibilities for:
 - i) Preparation of financial statements.
 - ii) Selection of appropriate accounting policies and compliance with Accounting Standards.
 - iii) Maintenance of adequate records and internal controls.
 - c) The scope of audit like period, the areas going to be covered. For example, the auditor may state that his appointment is for the audit of the balance sheet as at March 31, 20xx and the profit and loss account for the year ending March 31, 20xx.
 - d) Nature and form of audit reports.
 - e) The audit evidence is more prima facie in nature rather than conclusive.
 - f) Accessibility required with regard to books, documents, etc.
 - g) Details relating to duration of audit, fees and other incidental expenses.
 - h) That the auditor is expecting a management letter from the management.
 - i) Expert's services expected to be used.
 - j) Arrangements for communication with previous auditor. (Clause 8, Part-I, Schedule-I)
 - k) Possibility of audit process being subjected to peer review under the C.A. Act, 1949.
6. **Recurring audit:** Normally there is no need to issue it. However, in the following cases, it shall be issued: **(N14 – 5M)**
- a) Where there is an indication that the client has not understood the audit engagement letter issued during the previous year.

- b) Where there are revised terms of engagement.
- c) Where there is a change of management.
- d) Where there is a change in the size or nature of business.
- e) Where there are new legal requirements and professional requirements of ICAI.

7. Acceptance of changes in terms of engagement:

- a) **Agreement on new terms:** If the Auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complies with the SAs applicable to the changed engagements then in order to avoid confusion, the Report issued would be as per the revised terms. In order to avoid confusion, the Report would not include reference to
 - i) The original engagement, or
 - ii) Any procedures that may have been performed in the original engagement.
- b) **Non Agreement on new terms:**
 - i) The Auditor should not agree to a change of the engagement, if there is no reasonable justification for doing so.
 - ii) If the Auditor does not agree to a change of the engagement and is not permitted to continue the original engagement, the Auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as the Board of Directors or Shareholders.

8. Acknowledgement:

Purpose of Acknowledgement: Generally, the Engagement Letter issued by the Auditor may be acknowledged by the Auditee and returned to the Auditor, to establish.

- a) That the Client understands of the terms of engagement is in accordance with the Engagement Letter issued by the Auditor.
- b) That the Auditor has complied with the requirements of SA-210 in so far as they are related to sending the Audit Engagement Letter.

Note: Relevant standard on auditing is SA-210.

Similar Questions:

Q.No.1. State the purpose of a 'Letter of Engagement'.

Ans: Refer Para 2.

Q.No.2. "An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so." Discuss. (M15, PM, N15 RTP)

Ans: Refer Para 7.

Q.No.13. Difference between Audit & Investigation. (B)	(M 99, 08 - 4M, N 12 - 8M, PM)

Basis	Audit	Investigation
Compulsory	It is compulsory in the case of companies.	It is not compulsory, unless it is required by the management (Non statutory investigation) or it is required by C.G. under companies Act (Statutory Investigation).
Appointment	Appointment of auditor is done by shareholders.	Management - In case of non statutory investigation and In case of statutory investigation - Central government

Object	The object is to give an opinion whether financial statements are showing true and fair view.	The object is to find out in detail the facts in respect of a particular area.
Scope	Determined by the act.	Determined by the appointing authority.
Remuneration	Fixed by the shareholders.	Fixed by respective appointing authority.
Qualification	Should be a qualified C.A.	No specific qualification is required.
Inter-relation	Audit includes investigation because while auditing all the areas are covered.	Whereas investigation does not include audit because it is restricted to a specific area.
Period	It covers a period of 12 months.	No time frame covered by the investigation studies.
Submission of report	Shall be submitted to the shareholders.	Report shall be submitted to the respective appointing authority.
Nature of evidence	Auditor looks for prima-facie evidence.	Investigator looks for conclusive evidence.

Q.No.14. What are the qualities of an ideal auditor? (B)

(N 04 - 4M, PM)

PROFESSIONAL /TECHNICAL QUALITIES

- Expert knowledge in accounting:**
 - He should be an expert in understanding various accounting systems.
 - He should have a good knowledge on treatment of various events / transactions and its affect on various parts of the financial statements.
- Expert knowledge in auditing:** This is the most important quality. Unless an auditor thoroughly knows the techniques to be adopted in an audit, he can not discharge his duties efficiently.
- Knowledge about the business practices and transactions.**
- Knowledge of the required acts:** He should have an expert knowledge of various laws which are related to his professional duties. He can't be an expert of all laws. However, he should have adequate knowledge of the laws relating to business, banking, companies, tax etc.
- Continuing awareness of latest developments:** Several developments affect the work of the auditor. For example, the recent growth in the use of computers for maintaining accounting records had a significant affect on auditing techniques. Another example is, any changes in law may affect the auditor's duties and responsibilities.

PERSONAL QUALITIES

- Integrity:** It refers to the honesty of an auditor. He should not issue audit report containing untrue statements.
- Objectivity:** It refers to unbiased, being unaffected by personal feelings or prejudices.
- Independence in decision making:** He should be independent in decision making with regard to audit matters i.e. the audit decisions should be taken without giving importance to his personal wishes.
- Confidentiality:** The nature of audit work is confidential. He should not reveal anything about his client to others without the consent of the client.
- Analytical in approach:** He should be highly analytical in approach. If the facts placed before him are not properly analysed, the conclusions reached by him will not be proper.

6. **Ethics:** He must sincerely follow the professional ethics framed by ICAI.
7. **Firmness and patience:** He must be firm and patient.
8. **Application of practical approach:** He must be practical in his approach while doing audit or giving advice to his clients.
9. **Common sense:** Above all, he should have common sense.

Similar Questions:

Q.No.1. Discuss prerequisites and fundamental principles to be possessed by an auditor.

(M 11 – 8M)

Q.No.2. “Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities.” Explain briefly stating the qualities of Auditors.

Q.No.15. Explain the relationship of auditing with other disciplines. (B)

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

1. **Auditing and Accounting:** It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work. **(N15 RTP)**
2. **Auditing and Law:** The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.
3. **Auditing and Economics:** As, it is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountant's concept of income, still, there are lot of similar grounds on which the accounting has flourished. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and Government regulations. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

Similar Questions: “Auditor is expected to be familiar with the overall economic environment in which his client is operating.” Discuss.

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

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

(N13 - 5M, PM, M15 MTP1 - 5M) (M15 MTP2 - 5M)

Q.No.16. Write about self revealing errors and not self-revealing errors? (B)
(N14, PM, N15 MTP2 - 4M)

Self-revealing errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts. A few illustrations of such errors are given hereunder, showing how they become apparent.

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

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

Many other errors, however, are not revealed by either of these possibilities. If an item of expense which should have been charged to repairs account has been charged by mistake to the building account or if the amount of depreciation is calculated incorrectly, there is nothing in the book-keeping system which will bring the error to notice. Such errors are **non self revealing errors**.

Suppose a debit entry is omitted to be posted in the ledger and there are one or more of such omissions of credit entries which exactly compensate the effect of the former omission, then another self-revealing error turns to be not so. Such mistakes may remain undetected indefinitely unless measures aimed at discovering such errors are applied.

Q.No.17. Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI – Discuss. (B)
(N15 – 4M, PM)

Engagement Standards: The following standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards.

- i) Standards on Auditing (SAs), to be applied in the audit of historical financial information.
- ii) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.
- iii) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.
- iv) Agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

Q.No.18. What are the objectives and functions of Auditing and Assurance Standard Board (AASB)? (B) (M 15 – 6M)

Objectives and Functions of the Auditing and Assurance Standards Board:

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

- a) To Review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.
- b) To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.
- c) To Review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their Revision, if necessary.
- d) To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.
- e) To Review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their Revision, if necessary.
- f) To formulate General Clarifications, where necessary, on issues arising from Standards.
- g) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

Q.No.19. Write about fraud risk factors. (B) (N15 – 4M)

Fraud risk factors are the indicators of existence of fraud. Even though they does not confirm about the existence of the fraud, they have often been present in the circumstances where frauds have occurred. The fraud risk factors may be classified based on three conditions -

Conditions	<i>Fraudulent Financial Reporting</i>	<i>Misappropriation of Assets</i>
Incentives/ Pressures	• <i>High degree of competition</i> • <i>High vulnerability to rapid changes</i> • <i>Significant decline in customer demand</i>	• <i>Known or anticipated future employee layoffs</i> • <i>Promotions and compensations inconsistent with expectations</i>
Opportunities	• <i>Significant related party transactions</i> • <i>Usage of accounting estimates</i> • <i>Significant transaction with entities in tax heavens.</i>	• <i>Easily convertible assets</i> • <i>Assets of smaller in size</i> • <i>Lack of internal controls</i>

Attitudes and rationalizations	• <i>Doubts about integrity of management</i> • <i>Excessive interest by management in increasing share prices</i> • <i>Violation of laws and regulations</i>	• <i>Behavior indicating dissatisfaction with entity</i> • <i>Tolerance of petty thefts</i>

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.20. Explain the relationship of auditing with other disciplines. (C)

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

1. **Auditing and Statistics & Mathematics:** With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.
2. **Auditing and Data Processing:** Today, organisations are witnessing revolution in the field of data processing of accounts. Many organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy. With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms. In fact, EDP auditing in itself is developing as a discipline in itself.
3. **Auditing and Financial Management:** Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sector occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.
4. **Auditing and Production:** Regarding production function, it may be stated that a good auditor is one who understands the client and his business. While carrying out the audit activity, the auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products; joint-products may also require to be done. The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require understanding the cost system in operation in the factory and assessing whether the same is adequate for the particular company. The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work. On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.

Q.No.21. Write a short note on conditions or events, which increase the risk of fraud or error. (M 98 - 8M)

The following events may increase the risk of fraud or error:

- 1. Faults in internal controls:** Weaknesses in the design of internal control system and non-compliance with laid down control procedures. For e.g. a single person being responsible for receipt of all posts / mails and marking it to the relevant sections or two persons responsible for receipt of all posts / mails but the same is not followed in practice. single person responsible for making payments and receipts and recording entries in cash book
- 2. Doubts about the integrity or competence of the management:** Domination by one person, high rate of employee turnover, frequent change of Legal Counsels or Auditors, significant and prolonged understaffing in accounts department, etc.
- 3. Unusual pressures within the entity:** Industry is doing well but the company's performance is poor, heavy dependence on a single line of product, inadequate working capital, need to show more profit to support share market price, etc.
- 4. Unusual transactions:** Transactions with related parties, excessive payment for certain services to Lawyers, etc.
- 5. Problems in obtaining sufficient and appropriate audit evidence:** Inadequate documentation, significant difference between the figures as per accounting records and confirmation received from third parties, etc.

Similar Questions: Mention briefly the conditions or events, which increase the risk of fraud or error leading to material mis-statement in financial statements. (N 01 - 8M)

Ans: Same as above.

Q.No.22. "If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognized by the Courts as is obvious from a study of the various judgments." Discuss the tests applied by the courts to judicially view the auditor's performance.

If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognized by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

- Whether the auditor has exercised reasonable care and skill in carrying out his work;
- Whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;
- Whether the auditor had any reason to suspect the existence of the errors and frauds; and
- Whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

PRACTICAL QUESTIONS

Q.NO.1. AUDITOR IS RESPONSIBLE FOR EXPRESSING OPINION ON FINANCIAL STATEMENTS IN STATUTORY AUDIT. COMMENT.

The objective of the audit of the financial statements prepared within a Framework of recognized accounting policies and practices and relevant statutory requirements if any, is to enable an auditor to express an opinion on such financial statements.

As per the requirements of section 143 of the Companies Act, 2013, the Auditor is required to express his opinion on (i) whether books of account As required by law have been kept by the company so far as it appears from The examination of the books and proper returns adequate for the purpose of audit have been received from branches not visited by them (ii) Whether the accounts give the information required by the act in the manner so required (iii) whether the accounts give a fair view in case of the balance sheet, the state of the companies affairs and in case of the profit and loss account of the profit and loss for the year.

The auditor is responsible for forming and expressing his opinion on the financial statements. However, the responsibility for their preparation is that of the management of the enterprise. Management responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application accounting policies. Audit of financial statements does not relieve the management of its responsibilities.

Q.NO.2. PROCEDURAL ERROR ARISES AS A RESULT OF TRANSACTIONS HAVING BEEN RECORDED IN A FUNDAMENTALLY INCORRECT MANNER.

False: When transactions are recorded in fundamentally incorrect manner it is known as error of principle. Example: A distinction not being made between capital and revenue income or expenditure.

Q.NO.3. "THE AUDIT OF FINANCIAL STATEMENTS RELIEVES MANAGEMENT OF ITS RESPONSIBILITIES".

Facts of the Case: The audit of financial statements relieves management of its responsibilities.

Provision / Analysis: It is the management which is entrusted with the responsibility by the shareholders to manage the enterprise in the most efficient and effective manner. Management's responsibilities include maintaining an adequate accounting system, proper internal control system, selection and application of accounting policies and safeguarding the assets of the enterprise.

The auditor is responsible for forming and expressing his opinion on the financial statements. However, it is the primary responsibility of the management to maintain books of accounts and prepare financial statements in a manner so that same portray a true and fair picture of the enterprise.

Conclusion: The basic responsibilities of the management are much broader which in any case cannot be reduced by audit.

THE END

2. CONCEPTS OF AUDITING

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	-	-	5	2	-	-	2	-	-	-	-	-	4	-	-	-	-	-	2	-	-
2.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	B	-	-	-	-	2	-	-	-	-	-	-	-	-	-	7	-	2	-	-	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	4	-
5.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	4	-
7.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	4	-	-
8.	B	-	-	-	5	-	-	2	-	-	-	-	-	-	4	-	2	-	-	-	-	-
9.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-
10.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	4	-
12.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	6	-	2	-	-	-	-	-
13.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
14.	B	-	-	-	5	-	-	-	-	-	-	-	-	6	10	-	-	-	-	-	-	-
15.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	-	-	-	4
16.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What are the different auditing techniques? (B)
(M 06, 07, 12 - 4M, M 15-2M, PM, N14 MTP1- 4M)

The term audit techniques mean the tools adopted by the auditor to check the true and fair view shown by the financial statements. The following are the examples of auditing techniques:

- a) **Vouching:** Vouching consists of comparing the entries in the books with the particulars in the voucher as regards date, amount, name of the party etc. (checking the validity and authenticity of the transactions).
- b) **Posting:** Means checking the process of recording the transaction in the appropriate books, records and documents.
- c) **Casting:** Means checking the totaling of accounts selected on test basis.
- d) **Confirmation:** Means the process of obtaining response either in written or oral forms.
- e) **Physical examination:** Means the process of examining in personal.
- f) **Year-end scrutiny:** Means checking the accounts and the transactions at the end of the period with a view to find out the genuineness of the transactions.
- g) **Tracing:** Means checking the amounts from one statement to another.
- h) Scanning.
- i) Reconciliations

Q.No.2. Principles vs. Techniques of auditing. (B)

(M 89, N - 94, M 98 - 4M)

1. Meaning:

- a) Principles of auditing means fundamental considerations/rules that should be followed by an auditor while doing audit. SA 200 on "Overall objective of an independent auditor and conduct of an audit in accordance with SA" listed the following as basic principles (Responsibilities): Integrity & objectivity, Independence, Confidentiality, Due care and Competence, Audit evidence, Conduct of an audit in accordance with SA's.
- b) The term auditing techniques means the tools adopted by the auditor to check the true and fair view shown by the financial statements. These are Vouching, Posting, Casting, Confirmation, Physical examination, Year-end scrutiny, Test check, Tracing, scanning etc.

2. Universal Vs. Vary: Principles are universal i.e., they are common to all audits. For example some of the audit principles like evidence, independence etc. are common to all audits. Whereas the audit techniques to be applied depends upon the auditors professional judgment. For example, whether to verify the debtors by inspection of books or by direct confirmation would be decided by the auditor.

3. Organisation to Organisation: Audit techniques change from organisation to organisation depending upon the nature of business but the principles of auditing will not change.

Q.No.3. Distinguish between audit procedures and audit techniques. (B)

(M 06, 08, 14 - 2M)

Particulars	Audit Procedures	Audit Techniques
Meaning	They represent the <u>broad frame</u> of the manner of handling the audit work, procedure may comprise a number of techniques.	Techniques refer to the methods employed for carrying out the procedure. For example, in vouching procedure, the techniques employed are inspection and checking, computation of documentary evidence.
Types	a) Compliance procedures b) Substantive procedures i) Vouching and verification ii) Analytical review procedure	Audit Techniques are generally inter-dependent. A combination of techniques is applied in a particular procedure. For example, in verification of assets, the audit techniques involved are physical examination, confirmation from third parties, etc.

Q.No.4. Write a short note on surprise check. (A)

(M 13 - 5M, M 05, N15 - 4M, PM, N15 RTP, N15 MTP2 - 4M)

- a) **Meaning:** It means surprise visit by the auditor to verify the various aspects relating to audit i.e. an auditor visits the client's office without prior intimation to check the various aspects relating to audit.
- b) **Moral check:** Such visits by the auditor acts as moral check on employees.
- c) **Time & Areas:** The element of surprise in an audit can be both with regard to the time of the audit and the areas which are subjected to audit.
- d) **Frequency of surprise checks:** It is a matter to be decided having regard to the circumstances of each audit. However, wherever possible a surprise check should be made at least once in the course of an audit.
- e) **When suitable:** They are suitable in cases where the auditor is not satisfied with internal control system or where the company is a very large one or the company has numerous branches, etc.

f) **Areas:** Generally, this is adopted in the following areas

- i) Verification of cash and investments.
- ii) Test verification of stores and stocks and the records relating thereto.
- iii) Verification of books of primary entry.
- iv) Verification of statutory registers.

g) **Communicate to management:** The results of surprise check should be communicated to the management by a report so that corrective action can be taken by the management.

Similar Question: Is surprised checks desirable in audit, if so give important recommendations. (M13)

Ans: Same as above.

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

Ans: Refer Point – f.

Q.No.5. What is meant by final audit? What are its advantages and disadvantages? (B)

Meaning:

- a) Final audit begins after the end of the year and is continued till the audit is completed.
- b) All the checking of records is done at one time.
- c) It is also called Annual or completed audit.
- d) *Example, if an auditor has to audit the financial statements relating to the year ending Mar 31st 2011, the auditor will commence the audit work only after Mar31st, 2011 and will continue it till work gets completed.*

Suitability: It is suitable for small organisations only. In case of big organisations such audit cannot be conducted due to the existence of large number of transactions.

Merits:

- a) Since it is done at one time the auditor will not lose the continuity of his work.
- b) A thorough/efficient audit can be performed since it is carried out at a time.
- c) Such audit does not disturbs the work of the client's staff, as the records relating to period under audit are already got completed and handed over to the auditor for audit.
- d) It is cheaper.
- e) The possibilities of alteration of figures by the client's staff are avoided since the audit is carried out at a time.

Demerits:

- a) It is not suitable for big companies.
- b) Complete checking is not possible since the time available for audit is less.
- c) Since the auditor goes for test checking errors and frauds can exist even after audit.
- d) It is not much effective in improving the check over the client's staff.
- e) Frauds and errors are detected at the year end.

Q.No.6. what is meant by continuous audit? What are its advantages and disadvantages? (B) (N 92, 98, M 96 - 4M, M 13 - 8M, PM)

Meaning:

- a) It refers to the audit conducted continuously like monthly, quarterly etc.

- b) The auditor visits the client's office at regular intervals and checks the books etc.
- c) In such audit, detailed examination is possible since audit is conducted in a phased manner.
- d) It is also known as detailed audit.
- e) *Example, if an auditor has to audit the financial statements relating to the year ending March 31st, 2011, he may take up the audit work immediately after his appointment as auditor in 2010.*

Suitability:

- a) If it is necessary to audit the final accounts within a short gap after the close of the year.
- b) Where the business is very large.
- c) Where proper internal control system is not in existence and the chances of errors or frauds exist.
- d) Where the management wishes to review the audited financial position monthly or quarterly.

Merits:

- a) Detailed checking of books etc. is possible since time available for audit is very high.
- b) The auditor can work efficiently.
- c) The regular presence of auditor acts as a check on the client's staff & reduces frauds.
- d) Rectification of errors is done at the earliest.
- e) The management will get the reliable financial information at any time.

Demerits:

- a) There are more chances for alteration of the amounts in books by the client's staff.
- b) Frequent contact of the client staff & audit staff may provide scope for frauds.
- c) The auditor is likely to lose the continuity of work.
- d) It is expensive.
- e) It causes more inconvenience to the client staff since auditor frequently visits their office.

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

- a) During the course of each visit, work should be completed upto a definite stage so as to avoid loose ends.
- b) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.
- c) The visits should be at irregular intervals of time so that the client's staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.
- d) The nominal accounts should be checked only at the time of final closing.
- e) The client's staff should be instructed not to alter or correct audited figures. The auditor should also devise a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client's staff.

Similar Question: Continuous audit / Concurrent audit provides a supplementary management tool?
(N01 – 6M)

Ans: Same as above.

Similar Question: State the precautions to be taken to avoid the disadvantage of a continuous audit.
(N15 – 4M)

Ans: Refer above precautions.

Q.No.7. What are the fundamental accounting assumptions? (B)

(M 01, 08, N 03, 05 - 6M, M 15 – 2M, RTP)

1. The following have been generally accepted as fundamental accounting assumptions:

- a) **Going Concern:** The enterprise is normally viewed as a going concern, i.e., as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations. **(PM)**
- b) **Consistency:** It is assumed that accounting policies are consistent from one period to another.
- c) **Accrual:** Revenues and costs are accrued, i.e., recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

2. Disclosure:

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

Q.No.8. Write about examination / auditing in depth. (B)

(N 94, 95, 97- 5M, PM, M15 MTP2 - 4M)

- 1. It means a detailed step-by-step examination of selected transactions tracing all the events from the beginning to the end of that transaction.
- 2. While conducting an auditing in depth the auditor checks all the accounting and operational aspects of a transaction from the beginning to the end.
- 3. This enables him to gain a complete understanding of the nature of the transaction, the stages involved in its processing and the controls at each stage.
- 4. An in-depth audit of transactions selected at random gives the auditor more valuable audit evidence than a prima facie examination of all the transactions.
- 5. **Example 1:** *In case purchases are taken for auditing in depth, the auditor will examine:*
 - a) *Purchase Requisition,*
 - b) *Invitation of quotations and analysis of the same,*
 - c) *Official Purchase order,*
 - d) *Receipt of goods, together with delivery challans*
 - e) *Admission of goods to stores after verification of quality, quantity etc.,*
 - f) *Entry in store records,*
 - g) *Receipt of supplier's Invoice,*
 - h) *Entries in Purchase day book,*
 - i) *Postings to purchase ledger and purchase ledger control account,*
 - j) *Payment of Cheque in settlement of invoice & Entry for payment in Cash/Bank book,*
 - k) *Posting from Cash book to Ledger Account.*

Similar Questions:

Q.No.1. Walk Through Test

(N 07, 12 – 5M)

Ans: Same as above.

Q.No.9. Write about analytical review test? What is meant by 'analytical review procedures'? (A) (N 98, 04, 07 - 6M, M 14 - 8M, PM)

According to SA 520 Analytical review test means "analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts".

According to SA 520 analytical procedures include:

Types of ratios:

- a) Ratio refers to the mathematical relationship between two items. The ratios with respect to financial analysis are of two types.
- b) Financial Ratios which explain the relationship between two financial elements. (For example Gross profit ratio)
- c) On the other hand non financial ratios are those ratios which explain the relationship between a financial and a non financial element (Average salary per employee, Average turnover per employee) or two non financial elements (Example: Input output ratio).

Types of analysis:

- a) **Inter-firm analysis:** Comparison of ratios of two identical firms operating on same parameters.
- b) **Inter-period analysis:** Comparison of ratios of two different periods of the same entity.
- c) **Budgetary analysis:** Comparison of budgets against the Actuals.

Purposes:

- 1. Usually these ratios are calculated to know any deviations between the current period and previous periods. For e.g., a comparison of debtors' turnover ratio for the current year to that of prior year's would help the auditor in assessing the accuracy of the amount of debtors stated in the Balance Sheet.
- 2. **The purposes of Analytical review procedures are:**
 - a) **At planning stage** - for determining the nature, timing and extent of audit procedures.
 - b) **During the course of audit** - as substantive procedures.
 - c) **At the final stage** - as an overall review of the financial statements.

Analytical procedures help the auditor to locate areas where detailed examination is required.

Extent of reliance: The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, working of internal control system etc.

Similar Questions: Explain, what do you mean by Analytical procedures. How such procedures are helpful in auditing? (PM, M15RTP)

Similar Questions: Write a short note on "Analytical review". (PM)

Q.No.10. To what extent analytical procedures can be relied upon? Write short note on the extent of reliance on analytical procedures. (A) (N 03 - 4M, PM, N14 MTP2 - 5M)

Reliance on Analytical procedures depends on the following factors:

1. Materiality of items involved:

- a) When a item is material, analytical reviews alone will not be sufficient in forming the audit conclusion.
- b) Where certain individual items of income or expenditure are not material, comparison with previous year data may provide sufficient audit assurance.

2. Other audit procedures:

- a) When other audit procedures are directed in the same area, analytical reviews may provide confirmatory evidence. Ex: in reviewing the realisability of Debtors, the Auditor may analyse subsequent Cash Receipts / Vouchers.
- b) It might confirm or dispel questions raised from analytical procedures. e.g. scrutiny of Ageing schedule of debtors, provision for bad debts, etc.

3. Accuracy of prediction:

- a) If the expected results of analytical procedures can be predicated with reasonable accuracy, such procedures will be more reliable.
- b) *For example, the Gross Profit percentage over various periods would be consistent and gives more audit reliance than R & D Expenditure, or Advertisement Expenditure, etc.*

4. Nature of Risks:

- a) The effect of analytical procedures also depends on the assessment of inherent and control risks.
- b) If internal control over sales order processing is weak, control risk will be high, more reliance will have to be placed on tests of details of transactions and balances.
- c) However, reliance on the results of Analytical Procedures will depends on the Auditor's assessment of the risk that the Analytical Procedures may identify relationship as expected when a material mis-statement exists.

5. Efficacy of controls:

- a) The Auditor will need to consider testing the controls, if any, over the preparation of information used in applying Analytical Procedures.
- b) When such controls are effective, the Auditor will have greater confidence in the reliability of the information and, therefore, in the results of Analytical Procedures.
- c) The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls.
- d) **Example:** *In establishing controls over processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the Auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.*

Q.No.11. Materiality being fundamental to the process of accounting is an important and relevant consideration for the auditor". Discuss. (A) (PM)

1. **Meaning:** The term 'materiality' means 'significant / important'. An item may be considered as material if its misstatement or omission will misrepresent the view given by the financial statements.
2. **How to decide:** The decision of materiality is a professional judgment of auditor. The auditor should consider the following while deciding upon the materiality. **(N15 – 4M)**
 - a) Sometimes the financial reporting framework may prescribe the materiality levels. In those cases the auditor should follow those materiality levels. For example while verifying cash payments the auditor needs to ensure that there are no cash payments in excess of Rs 20,000/- as per Section 40 A (3) of Income Tax Act.
 - b) If the financial reporting framework is silent with respect to materiality then the auditor should decide upon the materiality applying his professional judgment based up on
 - i) Size of the relative item.
 - ii) Impact of the relative item on financial statements.
 - iii) Nature of the relative item.

3. **Usage of materiality at different stages of audit:** The auditor uses the materiality at two stages during the course of audit.

At Planning Stage:

- a) The auditor decides upon Nature, Extent and Timing of audit procedures considering the materiality levels fixed by him.
- b) At this stage the auditor may even consider different materiality levels for different aspects of verification.
- c) *For example, the auditor has decided that the materiality level is Rs.5,00,000/- and when verifying the cash payments he does not have a single payment exceeding Rs.20,000/-. In this case the auditor will consider a separate materiality for verifying cash payments.*
- d) *This concept of separate materiality for individual aspects of verification is known as PERFORMANCE MATERIALITY.*

At evaluation stage: The auditor, after obtaining the evidence from his audit procedures while evaluating the misstatements and their impact on financial statements, considers the impact of those identified misstatements on overall financial statements. While evaluating the impact on financial statements the auditor considers the consolidated effect of all the misstatements identified during the audit but not the individual misstatements.

Accepted criteria (or) Guiding factors for judging materiality:

- a) Materiality is a relative term. For example, Rs.1,000 may be a material amount for a small concern, but this may not be material for a large company.
- b) Several individual immaterial / unimportant items together may become a material amount in total.
- c) Even a small amount may become material if its disclosure is essential statutorily. For example, a payment of Rs.100 to Directors as remuneration in excess of statutory limits will be material.
- d) In setting off the transactions / items, care must be taken so that items which are independently material are not set-off against each other. For example, the surplus arising from a change in the accounting policy may not be set off against a non recurring loss.
- e) Sometimes the % comparisons will be helpful to judge the materiality of an item. The Companies Act itself has stated it as an indicator of materiality. **As per SA 320, this percentage criteria for determining materiality levels is known as Benchmarking.** For example, Part II of Schedule III of the Companies Act requires that any item exceeding 1% of the total revenue of the company or Rs.1,00,000 whichever is higher, shall not be shown under miscellaneous expenses i.e. such a transaction shall be shown under a separate head of account in financial statements.
- f) An item may not be important in current year but it was important when compared with previous year then that item would become material / important this year also.
- g) A small mistake / fraud may be considered material if it converts a small profit into loss or vice-versa.

Similar Questions:

Q.No.1. "Materiality is a relative term which varies under different circumstances." Discuss

Ans: Same as above.

(N 07 – 4M)

Q.No.2. Explain concept of 'Materiality'.

Q.No.3. Explain concept of materiality and factors which act as guiding factors to this concept.

(PM, N14RTP)

REFER PRACTICAL QUESTION - 1

Q.No.12. Under what circumstances / conditions the financial statements are considered to present a “true and fair” state of affairs? (A) (M 05 - 8M, PM, N15 RTP)

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

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

Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

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

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

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

- a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;
- b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
- c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;
- d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

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

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

SA 700 “Forming an Opinion and Reporting on Financial Statements”, requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India

Similar Questions:

Q.No.1. Write short note on True & Fair View

(N 12 – 6M)

Ans: Same as above.

Q.No.13. What are the major considerations which govern the selection of accounting policies? (B)
(M 99 - 4M)

1. The **primary consideration** in the selection of accounting policies by the management is that the financial statements should present **true and fair view** of the state of affairs.
2. **Secondary considerations:**
 - a) **Prudence (i.e. Conservatism principle):** Anticipate no profits but anticipate every loss. Since uncertainty is attached to future events, profits are not anticipated but recognised only when realized and provision is made for all known liabilities and losses.
 - b) **Substance over form:** The accounting treatment and presentation in financial statements shall be governed by their substance and not by the legal form.
 - c) **Materiality:** Financial statements should disclose all material items.

Q.No.14. Areas in which accounting policies are encountered? (B)
(N 07 - 5M, N 12-10M, PM, N15 MTP2 - 5M)

Areas in which different accounting policies may be encountered are:

1. Valuation of inventories – FIFO, LIFO, weighted average etc.
2. Method of depreciation, depletion and amortization – SLM, WDV method.
3. Treatment of expenditure during construction i.e. write off, capitalization, deferment.
4. Recognition of profit on long term contracts – year to year, % completion etc.
5. Valuation of fixed assets – historical cost, revaluation price, exchange fluctuation etc.
6. Conversion or translation of foreign currency items – average rate, actual, buying rate etc.
7. Treatment of goodwill – write off, retain.
8. Valuation of investment – at cost, market or net realizable value etc.
9. Treatment of retirement benefits – Actuarial, funded through trust, insurance policy etc.
10. Treatment of contingent liabilities.

Q.No.15. Write short note on changes in accounting policies. (B) (N 07 - 4M, M 16 – 4M)

1. Consistency is the fundamental accounting assumption. Therefore the accounting policies should consistently applied and followed from years to years.
2. Change in accounting policy is permitted only if
 - a) Such change is to bring accounts in line with Accounting Standards or
 - b) Such change is to bring accounts in line with Provisions of law or
 - c) For better presentation of financial statements.
3. When change in accounting policies of method is effected, the fact of such change and its impact on accounts must be disclosed.

4. If change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Similar Questions: Under what circumstances change in accounting policies is permissible? (PM)

ACADEMIC INTEREST ONLY

Q.No.16. Disclosure of accounting policies used in the preparation of the financial statements increases / enhances the intelligibility (clearness, transparency) of financial statements” explains. (N 02, M 03 - 4M)

1. **Management responsibility:** The selection of suitable accounting policies is the responsibility of the management.
2. **Disclosure of accounting policies:**
 - a) The Purpose of AS 1 is to promote better understanding of financial statements by establishing through an accounting standard and the disclosure of significant accounting policies and the manner in which such accounting policies are disclosed in the financial statements.
 - b) The information contained in the financial statements is very much effected by the accounting policies followed, therefore the disclosure of them is necessary for proper understanding of the entities performance.
 - c) There is no single list of accounting policies which can be universally applied (i.e. by all enterprises in all situations).
 - d) As different enterprises may adopt different accounting policies, disclosure of accounting policies adopted is necessary to facilitate meaningful comparison between financial statements of different enterprises.
 - e) Even in the case of the same enterprise, to ascertain whether the enterprise has improved its performance over the time, its figures for different years have to be compared.
 - f) If the accounting policies/changes in accounting policies are not disclosed, it would be not possible to judge whether the increase/decrease in profits is due to changes in performance or changes in accounting policies.
 - g) To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.
 - h) It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes which form part of financial statements.
 - i) Any change in accounting policy, which has a material effect, should be disclosed.
 - j) The amount by which any item is in the financial statement is affected by such change should also be disclosed to the extent ascertainable.
 - k) Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
 - l) If a change is made in the accounting policies, which had not material effect on the financial statements for the current period, which is reasonably expected to have material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

PRACTICAL QUESTIONS

Q.NO.1. AN ASSISTANT OF X & CO., CHARTERED ACCOUNTANTS DETECTED AN ERROR OF RS.5 FOR INTEREST PAYMENT WHICH OCCURRED NUMBER OF TIMES. THE GENERAL MANAGER (FINANCE) OF T LTD. ADVISED HIM NOT TO REQUEST FOR PASSING ANY ADJUSTMENT ENTRY AS INDIVIDUALLY THE ERRORS WERE OF SMALL AMOUNTS. THE COMPANY HAD 2,000 DEPOSIT ACCOUNTS AND INTEREST WAS PAID QUARTERLY.

Facts of the case: The General Manager of a company requested a CA, not to pay any adjustment entry regarding an error which occurred number of times.

Provision of Law: SA 320 materiality in planning and performing an audit

Analysis: The term 'materiality' means significant / important. An item may be considered material if its misstatement or omission will misrepresent the view given by the financial statements. The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. Therefore, the auditor while carrying out his audit function needs to consider the possibility of misstatements of relatively small amounts, that cumulatively could have a material effect on the financial statements.

In the given case, an error of Rs.5 for interest payment occurred number of times since the company had 2000 deposit accounts and interest was paid quarterly. Even though it is small individually, it will have material effect due to the number of transactions.

Conclusion: The request made by the manager is not acceptable and adjustment entry shall be passed.

THE END

3. AUDIT EVIDENCE

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	B	-	-	-	-	-	4	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	B	-	-	-	-	-	-	-	-	-	6	-	-	-	-	-	-	-	-	-	6	-
5.	A	-	-	-	-	5	-	-	-	-	-	-	4	-	-	-	5	-	-	-	-	-
6.	A	-	-	-	-	8	-	10	-	5	-	-	-	-	-	-	-	-	4	-	10	-
7.	A	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-	4	-	-
8.	A	-	-	2	2	2	2	-	-	-	-	-	-	-	-	-	-	-	6	-	-	-
9.	B	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	4	-	-
10.	B	-	-	-	-	-	-	-	5	-	-	-	-	-	4	-	2	-	-	-	-	-

Q.No.1. What is meant by audit evidence and what is the need of it? (A)
(M 01, N 07 - 4M, PM, N14RTP, N14 MTP1 - 2M)

Meaning: It means the information received by the auditor either through the client or from outsiders in support of the conclusions reached by him on which he bases his opinion on financial statements.

Need to obtain evidence:

- SA 200:** It states that “the auditor should obtain sufficient & appropriate audit evidence by performing compliance and substantive procedures to enable him to draw reasonable conclusions before he expresses his opinion on the financial statements”.
- According to SA 500 sufficiency refers to the quantum of audit evidence obtained while appropriateness relates to its relevance and reliability.
- The auditor should evaluate whether he has obtained sufficient appropriate audit evidence before he drawn his conclusions there from.
- The evidence should enable the auditor to form an opinion on the financial information.
- The auditor's main duty is to express his opinion on the true and fair view shown by the financial statements. For this he has to base on audit evidences. If he expresses opinion on the basis of inappropriate and insufficient audit evidence, he may lose reliability and may be liable for legal punishment.

Q.No.2. Write about types of Audit Evidence? (B)

Based on Source:

- Internal evidence:** Evidence, which is created within the entity being audited, is called internal evidence. *E.g.:* Sales invoice, GRN, Inspection report, Debit and Credit notes, Internal confirmations, etc.
- External evidence:** Evidence, which is created outside the entity being audited, is called external evidence. *E.g.:* Purchase invoice, Debit notes and Credit notes, Quotations, External confirmations, etc.

Based on Impact:

- a) **Persuasive:** Leads to a conclusion by implication.
- b) **Confirmatory:** Provides additional corroborative information.
- c) **Conclusive:** Provides complete assurance, free of risks.

Based on Form / nature:

- a) **Documentary:** Ex: Management Certificates, Vouchers and Bills.
- b) **Oral:** Ex: Answers to Internal Control Questionnaires.
- c) **Visual:** Ex: Physical inspection of Fixed Assets, Cash, etc.

Q.No.3. Distinguish between Internal & External Evidence. (B)

(N 89, 08, M 94, 95, 98 - 6M, PM)

Particulars	Internal Evidence	External Evidence
Meaning	Internal Evidence is one that has been created, used and retained within the Client's organisation	External Evidence originates outside the Client's organization
Examples	Duplicate copy of Sales Invoices, Employees' Time Reports, Inventory Reports, Wage Sheets, Counterfoils of Receipts, Purchase Requisitions, Minutes Books, etc.	Payee's Receipt, Purchase Invoice of Supplier, Lease Agreement, Bank Statements, Insurance Policies, Agreements , etc.
Use for accounting	These may not always constitute a direct accounting source document, e.g. purchase Requisitions, Minutes Books	These documents are generally prepared in the ordinary course of business activities and form part of its records, whether of accounting or non-accounting nature.
Auditor's Role	It is provided to the Auditor by the sources internal to the organisation	It may sometimes be obtained directly by the Auditor, e.g. certificate regarding bank balance, possession of securities, confirmation of balances of Debtors, Creditors, Lenders, Borrowers, etc.
Reliability	It is not as reliable as external evidence	It is considered more reliable than internal evidence.

Q.No.4. Explain various factors, which influence the auditors judgement as to what is sufficient and appropriate audit evidence. (B)

(M 90 - 4M, N15 – 6M, PM, M15 RTP)

1. The chances of misstatements in financial statements which depends upon:

- a) The adequacy of internal control.
- b) The nature & size of business carried on by the entity.
- c) Situations which may cause an unusual influence on management.
- d) The financial position of the entity.

2. The materiality of the item.

3. The experience gained during previous audits.

4. The trend indicated by accounting ratios and analysis.

Similar Questions:

Q.No.1. What factors affect choice of Audit Evidence

(M 07 – 4M)

Ans: Same as above.

Q.No.5. Discuss the reliability standards (levels) of audit evidence. (A)

(N13 - 5M, N 95 - 8M, PM, N14 RTP)

Reliability Standards:

- a) External evidence (E.g. 3rd party confirmations) is more reliable than internal evidence (Source).
- b) Internal evidence is more reliable when related internal control system is working satisfactorily (Nature).
- c) Evidence obtained by the auditor himself is more reliable than obtained from the entity.
- d) Documentary evidences i.e. evidences in the form of documents are more reliable than oral evidences (form).
- e) If the evidence received from different sources/forms is consistent (i.e. One evidence supports the other), there is a high level of reliance.
- f) Original evidence is more than Photocopies.

Similar Questions:

Q.No.1. Discuss the principles, which are useful in assessing the reliability of audit evidence.

Ans: Same as above.

(M 08 – 8M)

Q.No.2. The reliability of audit evidence is influenced by its source, nature and circumstances under which it is obtained.

Ans: Same as above.

REFER PRACTICAL QUESTIONS – 1, 2

Q.No.6. What are the assertions with which an auditor is concerned with while obtaining audit evidence from substantive procedures? (A)(N 98, 99 - 8M, M 11 - 8M, N15 – 9M, PM)

1. Compliance procedures/ Tests of controls:

- a) **Meaning:** These are the audit procedures/tests done by the auditor to get the evidences about the functioning of the internal control systems.
- b) **Looks for:** The auditor tests/looks for: **(EEC)**
 - i) That the internal control system exists,
 - ii) That the internal control system is operating efficiently and
 - iii) That the internal control system is in continuity throughout the period under audit.

2. Substantive procedures/Tests of accuracy, validity etc.:

(M 13 - 2M, M 08, N 08 - 6M, PM, N14 MTP2 - 4M)

- a) **Meaning:** These are the audit procedures/tests done by the auditor to get the evidences as to the completeness, accuracy and validity etc. of the information produced by accounting system. These are mainly of two types:
 - i) Test of details of transactions and balances (Vouching and verification).
 - ii) Analysis of significant ratios and trends including resulting enquiry of unusual fluctuations and items (Analytical review procedure).
- b. **Looks for:** In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:
 - i) **Assertions about classes of transactions and events for the period under audit:**
 - **Occurrence**—transactions and events that have been recorded have occurred and pertain to the entity.
 - **Completeness**—all transactions and events that should have been recorded have been recorded.

- **Accuracy**—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - **Cut-off**—transactions and events have been recorded in the correct accounting period.
 - **Classification**—transactions and events have been recorded in the proper accounts.
- ii) **Assertions about account balances at the period end:**
- **Existence**—assets, liabilities, and equity interests exist.
 - **Rights and obligations**—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - **Completeness**—all assets, liabilities and equity interests that should have been recorded have been recorded.
 - **Valuation and allocation**—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- iii) **Assertions about presentation and disclosure:**
- **Occurrence and rights and obligations**—disclosed events, transactions, and other matters have occurred and pertain to the entity.
 - **Completeness**—all disclosures that should have been included in the financial statements have been included.
 - **Classification and understandability**—financial information is appropriately presented and described, and disclosures are clearly expressed.
 - **Accuracy and valuation**—financial and other information are disclosed fairly and at appropriate amounts

Similar Questions:

Q.No.1. In auditing, the auditor checks the specific assertions of the items appearing in the financial statements and opines about the overall assertions they signify. Explain specific assertions and overall assertions in this context. **(N14 MTP2 - 4M)**

REFER PRACTICAL QUESTION – 4

Q.No.7. Write about different methods to obtain audit evidence? (Or)
What are the audit procedures to obtain audit evidence? (A)
(M 90, 00, 03, N 92, 97 - 8M, M 13-5M, M 15-4M, PM, N14 RTP, N15 MTP1, 2 - 5M, N14 MTP1-6M)

1. **Inspection:** Inspection includes examining books, documents and tangible assets.
 - a) **Inspection of books and documents** provides evidence of different degrees of reliability depending on their source and form 3 major categories of documentary evidences which provide different degrees of reliability are:
 - i) Documentary evidence created by the entity and held by the third parties,
 - ii) Documentary evidence created by third parties & held by the entity &
 - iii) Documentary evidence created and held by the entity.
 - b) **Inspection of tangible assets** provides reliable evidence with respect to their existence.
2. **Observation** consists of looking at a process or procedure being performed by others.
3. **Inquiry** consists of getting the information from related persons inside or outside the entity. Inquiry may be in the form of written or oral questions addressed to inside or outside parties.

4. **Confirmation** consists of the response to an enquiry. For example, the auditor normally requests confirmation of debtors.
5. **Recalculation** consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electrically.
6. **Re performance** involves the auditor's independent execution of procedures or controls that were originally performed as part of the entities internal control.
7. **Analytical review** consists of studying significant ratios and trends and investigating unusual fluctuations in them.

Q.No.8. Audit risks & its assessment. (A)	(M 04 - 4M, M 07 - 8M, PM)

1. **Meaning of audit risk:** It is the risk that an auditor may give an inappropriate opinion on the financial statements which is materially misstated.
2. An auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated.
3. Such risk may exist at overall level, while verifying various transactions and balance sheet items.
4. There is unavoidable risk that even some material misstatements may remain undiscovered due to the inherent limitations of audit & internal control system.
5. Absolute certainty in auditing is rarely attainable.
6. **Audit risk consists of the following 3 components:**
 - a) Risk that errors will occur called **inherent risk**. *Inherent risk is the susceptibility of account balance or class of transaction to misstatement or assume that there were no related internal controls.*
 - b) Risk that the client's internal control system may not prevent misstatements in the financial statements. *It means the probability or the chances that internal controls will fail/flop. The **control risk** can exist because of the inherent limitations of internal control system. To assess control risk, auditor should consider adequacy of control design as well as test adherence to control procedure.*
 - c) Risk of non-detection of errors or frauds called **detection risk**. *Detection risk is the risk that an auditor's procedures will not detect an error or fraud or misstatement that exists in account balance or class of transactions. i.e., some detection risk would always be present.*
7. The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted.
8. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce an acceptable level of detection risk, thereby reducing audit risk to an acceptable low level.
9. The combination of inherent risk and control risk is called misstatement risk.
10. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level.

Similar Questions: Write short notes on Audit Risk and inter-relationship of its components.

(PM) (N14 - 6M)

REFER PRACTICAL QUESTION – 3

Q.No.9. Write about reliance on “3rd party confirmations” as audit evidence. (B)
(FOR STUDENTS SELF STUDY)

As per SA 505 “External Confirmations”, external confirmation is an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

The reliability of audit evidences depends on its source- internal or external and on its form - visual documentary or oral. Third party confirmations are a kind of external source of evidence.

Obtained from	Obtained for
Sundry debtors	For confirming the amount of debt.
Sundry creditors	For confirming the amount of credit.
Banks	For confirming the amount of bank balance.
Share brokers	For confirming the share certificates held, the cost & sale value of shares etc.
Warehouse keeper	For confirming stock value in the warehouse.
Experts	For confirming the issue which needs expert knowledge.
Lawyers	For confirming the contingent liabilities.
Consignee	For confirming the on consignment.
Insurance company	For confirming Insurance coverage.

SA 500 on audit evidence says that external evidence (e.g. confirmation received from a third party) is usually more reliable than internal evidence, since they are created outside the organisation on which the client and its staff have no control.

Note: Relevant Standard on auditing is SA 505.

Similar Questions: What is meant by external confirmation? Mention four situations where external confirmation may be useful for auditors. **(M 15 – 4M, PM)**

REFER PRACTICAL QUESTION – 1

Q.No.10. Write short note on inherent risk at the level of financial statements and at the account balances level & at the class of transactions level. (B)
(M 05, N 09 - 5M, N 12 - 4M, PM, N15 RTP)

1. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
2. While developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements.
3. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions & assertions made in the financial statements.
4. In order to assess inherent risk, the auditor has to use his professional judgment, having regard to his experience of previous audit engagements of the entity, controls established by the management, and any significant changes that might have taken place since his last assessment.
5. Possibilities of inherent risk are to the following factors:

At the level of financial statements: (Dealt in detailed at the time of SAs)

- a) *Integrity of Management*
- b) *Experience and knowledge of management, and changes in management during the period.*

- c) *Unusual pressure on management.*
- d) *The nature of the entity's business*
- e) *Economic and competitive factors affecting the industry, changes in technology, consumer demand, etc.*

At the level of account balances and class of transactions: *(Dalt in detailed at the time of SAs)*

- a) *Quality of accounting system, i.e., financial statements susceptibility to misstatements.*
- b) *Complexity of transactions requiring the work of an expert.*
- c) *The degree of judgment involved in determining account balances.*
- d) *Susceptibility of assets to loss or misappropriation.*
- e) *Transactions not subject to ordinary processing.*

PRACTICAL QUESTIONS

Q.NO.1. THE COMPANY PRODUCED PHOTOCOPIES OF FIXED DEPOSIT RECEIPTS (FDR) AS THE ORIGINAL FIXED DEPOSIT RECEIPTS WERE KEPT IN THE IRON SAFE OF THE DIRECTOR OF FINANCE WHO WAS PRESENTLY OUT OF THE COUNTRY ON COMPANY BUSINESS. COMMENT.

Facts of the Case: A company produced photocopies of FDR as the originals were in the iron safe of director who was presently out of the country.

Provisions of Law: SA 500 – Audit Evidence

SA 200 – Overall objectives of the independent auditor and conduct of an audit in accordance with standards on auditing

Analysis and Conclusion: SA 200 states that “the auditor should obtain sufficient and appropriate audit evidence performing compliance and substantive procedures to enable him to draw reasonable conclusions before he express his opinion on the financial statements”.

According to SA 500, sufficiency refers to the quantum of audit evidence obtained while appropriateness relates to its relevance and reliability.

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

The auditor is generally required to inspect and physically verify the fixed deposit receipts representing the assets on the last day of the accounting period. But the company produced photocopies of the FDR's. Thus, the photocopies of the receipts cannot serve the desires purpose. Reliance can be placed by the auditor on such evidence, provided photocopies are certified as true copies by the management as also backed by a letter from director (Finance) may also be asked to confirm in writing from abroad in that respect and the same shall be produced to auditor as soon as he returns from business trip and also depending upon the internal controls in the company.

Q.NO.2. X LTD HOLDS 4 TO 5 BOARD MEETINGS PER YEAR. THE DIRECTORS ARE REIMBURSED TO THE EXTENT OF ACTUAL AIR FAIR, AND IN ADDITION AN ALLOWANCE OF RS. 300 PER DAY IS PAID FOR COVERING HOTEL BILLS ETC. THE AUDITOR OF THE COMPANY SEEKS THE ACTUAL BILLS/VOUCHERS AS EVIDENCE IN RESPECT OF STAY CHARGES. THE DIRECTOR CONTENTION IS THAT THE BOARD ATTENDANCE REGISTER CONTAINING THE SIGNATURE OF DIRECTOR IS SUFFICIENT EVIDENCE. GIVE YOUR VIEWS AS A CHARTERED ACCOUNTANT.

Facts of the Case: A company made a reimbursement in directors to the extent of actual air fair and a fixed allowance for covering hotel bills. Now the director seeks the actual bills of stay charges.

Provisions of Law: SA 500 – Audit Evidence

SA 200 – Overall objectives of the independent auditor and conduct of an audit in accordance with standards on auditing

Analysis: SA 200 states that “the auditor should obtain sufficient and appropriate audit evidence performing compliance and substantive procedures to enable him to draw reasonable conclusions before he express his opinion on the financial statements”.

According to SA 500, sufficiency refers to the quantum of audit evidence obtained while appropriateness relates to its relevance and reliability.

If the actual charges are to be reimbursed then the bills are to be provided for reimbursement purposes. This is because reimbursement is done on actual basis. In case the charges are covered by a fixed allowance payable by the company, then there is a need to submit actual bills.

In the given case, the actual air fair is reimbursed to the directors. So, the directors have to provide actual bills for reimbursement purposes. But the hotel charges are covered by a fixed allowed payable by the company, hence there is no need for the directors to submit actual bills.

Conclusion: The supporting evidences of hotel bills of directors are not required.

Q.NO.3. WHEN INHERENT, CONTROL RISKS ARE LOW, AN AUDITOR CAN ACCEPT A LOWER DETECTIONS RISK.

False: When Inherent and control risk are low auditor may enjoy higher level of detection risk. Because detection risk has an inverse relationship with that of combined assessment of inherent and control risk.

Q.NO.4. WHAT ARE THE OBVIOUS ASSERTIONS IN THE FOLLOWING ITEMS APPEARING IN THE FINANCIAL STATEMENTS?

- a. PROFIT AND LOSS STATEMENT -TRAVELLING EXPENDITURE RS 50,000
b. BALANCE SHEET – DEBTORS RS. 2,00,000 (PM, N14 RTP)

a) **Travelling Expenditure: Rs 50,000/-**

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

b) **Debtors: Rs.2,00,000/-**

- i) These include all sales transactions occurred during the year.
- ii) These have been recorded properly and occurred during the year.
- iii) These constitute assets of the entity.
- iv) These have been shown at proper value i.e. after showing the deduction on account of provision for bad and doubtful debts.

Q.No.5. INQUIRY IS ONE OF THE AUDIT PROCEDURE TO OBTAIN AUDIT EVIDENCE.

(M 13, M 16 – 2M)

Inquiry and confirmation:

- a) Inquiry involves seeking of appropriate information from knowledgeable persons inside or outside the entity.
- b) Inquiries may be
 - i) Formal written inquiries addressed to third parties, or
 - ii) Informal oral inquiries addressed to persons inside the entity.
- c) Responses to inquiries provide the auditor with **(a)** information, which he did not previously possesses or, **(b)** corroborative evidence of existing information.
- d) Confirmation is the response to an inquiry to corroborate information contained in the accounting records. **E.G.:** The auditor may obtain confirmation of account balances by direct communication from debtors.

Q.NO.6. THE AUDITOR OF A LIMITED COMPANY HAS GIVEN A CLEAN REPORT ON THE FINANCIAL STATEMENT ON THE BASIS OF XEROX COPIES OF THE BOOKS OF ACCOUNTS, VOUCHERS AND OTHER RECORDS WHICH WERE TAKEN AWAY BY THE INCOME TAX DEPARTMENT IN SEARCH UNDER SECTION 132 OF THE I.T. ACT, 1961. COMMENT.

Refer Q.No.5

The degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the Xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly. Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

THE END

4. AUDIT PREPARATION

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	4	-	-	-	-	-	-	-	-	-	-	4	-	-	5	-	-	-	-	5
2.	B	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	6
3.	A	-	-	6	-	-	2	-	2	5	4	-	4	-	8	5	4	-	-	10	6	-
4.	B	-	-	2	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	B	-	-	-	6	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4
6.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-
10.	A	-	-	-	5	-	-	-	-	-	-	4	4	-	-	-	-	4	-	4	-	2
11.	A	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Write about audit programme? (A) (N 88, 92, 06, 07, M 12 - 4M, M 16 – 5M PM)

Meaning: The term “Audit Programme” means a document in writing drafted before the commencement of audit consisting of the plan of audit prepared by the auditor containing the various procedures and techniques to be applied in respect of the audit of accounts of an entity. For the purpose of framing an audit programme the following points should be kept in view:

1. Audit objective
2. Audit procedure to be applied
3. Extent of check
4. Timing of check
5. Allocation of work amongst the team members
6. Special instructions based on past experience of the auditee.

Classification of Audit Programme:

1. Standard audit programme:

- a) The term “standard audit programme” refers to a programme consisting of standard auditing procedures and techniques.
- b) *Such programme consists of techniques/procedures which are generally applied to different clients.*
- c) *They are not tailor-made for a specific client.*
- d) *Hence the audit assistant may not find some of the aspects covered therein as relevant with regard to a specific client.*
- e) *In such case the concerned audit assistant shall mark the column as ‘not applicable’.*

2. **Special audit programme:** This refers to the programme consisting of specific auditing techniques/procedures which are applicable for a particular client.

Advantages (Help) of Audit Programme:

(N 07 - 8M, M15 MTP1-6M)

- a) The division of work among thre assistants can be easily made.
- b) Chances of duplication of work are eliminated.

- c) It provides sufficient guidance to audit staff regarding the various areas to be covered, extent of checking etc.
- d) By carefully dividing the work, the auditor is in a position to decide about the selection of different levels of staff.
- e) It enables the auditor to monitor the conduct of audit by constantly reviewing the programme.
- f) Since the assistants are signing the programme, there is a sufficient evidence to fix the responsibility on audit staff.
- g) There may be occasions when the auditor has to shift some staff from one particular audit. In such cases, by referring to audit programme the auditor will be in a position to ensure continuation of audit.
- h) The audit programme is useful as evidence in the court, in case the client files a case against the auditor on the ground of negligent audit performance.
- i) The audit programme of one year helps in preparing the audit programme of subsequent year.
- j) Before signing the final audit report, the auditor can easily find out whether all the audit work has been completed or not.

Limitations:

(N13, PM, N15 RTP, N15 MTP1, 2 - 5M, N14 MTP1 - 4M)

- a) It may become mechanical for audit assistants and they may lose interest.
- b) In case the audit programme is not complete some items may not get checked.
- c) If the client's system of business line has changed but the programme has not been tailored to the changes, it may fail to serve the intended purpose & audit failure may result.
- d) Standard audit programme may consist of procedures which may not be suitable or appropriate to the circumstances of the client
- e) It provides an easy way out for inefficient staff on the ground that no instruction is contained therein.

Precautions:

(M 81, 91)

- a) The audit assistants should be consulted while preparing the audit programme.
- b) The auditor should thoroughly review the internal control system of the client's & find out the areas of weaknesses and design his audit programme accordingly so that these areas may be covered thoroughly.
- c) The audit programme should also be changed if the auditor finds that some new business or new systems has been adopted by his client.
- d) The auditor should change the audit programme from time to time so that it does not become stereotyped.
- e) There should be frequent audit assistants meetings so that all audit staff can exchange their experiences with others.

Note: Relevant standard on Auditing is SA 300 (Audit planning).

Q.No.2. What are the contents of an audit note book? Give a specimen page of an audit note book with four imaginary entries therein. (B)

(M 89, 91, 93, 08 - 6M, M 16 - 6M, PM, N14 MTP2 - 4M)

Contents & Importance:

- a) The audit notebook contains auditor's specific observations on matters in respect of which satisfactory explanation was not readily or immediately available.
- b) In the course of follow-up of the observations recorded in the audit note book, many of them get settled with explanations and evidences produced by the management latter, while deleting any such observation, the auditor also records against each of such observation the reasons for deletion.

- c) Thereafter, the auditor is left with only the unsettled observations and considers them from various relevant angles for preparing the audit report.
- d) It is useful as evidence in the court, in case client files a case against the auditor.
- e) Therefore the audit notebook forms an important evidence of work done and points considered in the course of an audit.
- f) The audit note book is also a very useful document to design the next audit programme so as to concrete on debatable issues.

Specimen of entries in an Audit Note Book to indicate the manner in which entries in those books ought to be made:

Queries - Cash Book Payment

Vou. No.	A/c Debited	Rs.	Query	How disposed off
38	Advertisement	1,600	Managing directors sanction required.	Sanction obtained.
107	Rent	1,500	Rent receipt required.	Produced.

Queries - Purchase Journal

Vou. No.	A/c Debited	Rs.	Query	How disposed off
42	Machinery	1,49,160	Board's sanction required.	Sanction obtained Minutes dated 10-1-03.
123	Raw Material	13,457	Rates for items (i) and (ii) are different.	Items of the quality ordered not being available; a better quality was accepted under purchase officer's approval.

Q.No.3. What do You mean by “Working Papers”? (A)
(N 90, 03, 07, 08, M 96, 98, 08, N 15, M 15, PM)

Meaning of Working Papers (SA 230): Audit working papers comprise all documents prepared or obtained by the auditor and retained by him in connection with the performance of his audit.

Functions / Importance / Advantages /Utility of working papers:

(N 90, 13, M 07, M15, PM, M15 RTP, N14 RTP, N14 MTP1 - 4M)

- a) To help in the planning and performance of the audit.
- b) To help in the supervision and review of the audit work.
- c) Provide evidence of the audit work performed to support the auditor's opinion.
- d) Record and demonstrate the audit work performed to support the Auditor's opinion.
- e) Plan the timing and extent of audit procedures to be performed.
- f) Draw conclusions from the evidence obtained.
- g) Standardise the working papers and audit procedures to improve the efficiency of the audit.
- h) Facilitate the delegation of work as a means to control quality of work performed.
- i) Provide guidance to the audit staff with regard to the manner of checking the schedules,
- j) Fix responsibility on the staff member who signs each schedule checked by him, and
- k) Act as evidence in a Court of law when a chance of negligence is brought against the Auditor.

Principles governing the Form & Contents of Working papers (or) Audit:

(M 13, N15 – 5M, RTP, M15 MTP1 - 5M)

The form and contents of the working papers is a matter of professional judgment. However, the basic principles governing the form and contents of working papers are discussed below:

- a) The size and complexity of the entity.
- b) The nature of the audit procedures to be performed.
- c) The identified risks of material misstatement.
- d) The significance of the audit evidence obtained.
- e) The nature and extent of exceptions identified.

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

The audit methodology and tools used.

Contents of permanent Audit file:

- a) Information concerning the legal organizational structure of the entity, such as memorandum and articles of association in case of a company, and relevant regulations in the case of a statutory corporation.
- b) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- c) A record of the study and evaluation of internal controls related to the accounting system.
- d) Copies of audited financial statements of previous years.
- e) Analysis of significant ratios and trends.
- f) Copies of management letter, issued by auditor, if any.
- g) Record of communication with the retiring auditor, if any, before the acceptance of the appointment as auditor.
- h) Notes regarding significant accounting policies.
- i) Significant audit observations of earlier years.
- j) List of officers, their financial powers and authorities.
- k) List of offices, factories, godowns, depots etc.

Contents of current audit file:

(N 12 - 8M)

- a) Correspondence relating to acceptance of annual reappointment.
- b) Extracts of important matters in the minutes of Board meetings and general meetings, as are relevant to audit.
- c) Evidence of the planning process of the audit and audit programme.
- d) Analysis of transactions and balances.
- e) A record of nature, timing and extent of auditing procedures performed, and the results of such procedures.
- f) Evidence that the work performed by assistants was supervised and reviewed.
- g) Copies of communication with other auditors, experts and other third parties.
- h) Letters or representation or confirmation received from the client.
- i) Copies of letters or notes concerning audit matters communicated to or discussed with the client. Including the terms of the engagement and material weakness in relevant internal controls.
- j) Conclusions reached by the auditor concerning significant aspects of the audit.
- k) Copies of the financial information being reported on, and the related audit reports.
- l) Reports of branch auditors, internal auditors and stock auditors etc.

Whose property are the Audit Working Papers?

- a) As per SA-230 Working papers are the property of the auditor.
- b) The auditor may, at his discretion, make portions of or extracts from his working papers available to the client.

- c) SQC-1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is not shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report (emphasis added).

Note: Relevant standard on auditing is SA 230.

Similar questions:

Q.No.1. What are the main functions of working papers? (N 03 – 5M)

Ans: write only advantages or functions.

Q.No.2. Discuss the principles which govern the form and content of working papers?

Ans: Write only principles governing form and content. (N 07 – 6M)

Q.No.3. What are the contents of permanent and current audit file? (M 10 – 5M)

Ans: Write only contents of permanent and current audit files.

Q.No.4. Whose property are the working papers?

Ans: Write only relating to property of working papers.

Q.No.5. "The auditor should document the matters which are important in providing evidence that the audit was conducted in accordance with the standards on auditing"-Discuss. (N 11 – 4M)

Q.No.6. What does SA 230 says about utility, ownership, custody and retention of working papers? (PM)

REFER PRACTICAL QUESTIONS – 1 & 2

Q.No.4. What is 'test check'? State the circumstances under which it can be applied. (B) (M 99, M 08 – 4M)

Meaning:

- a) The term "test check" stands for the method of auditing where instead of a complete examination of all the transactions only some of the transactions are selected and verified.
- b) It is common that the volume of transactions of a business is enormous now a days and within the time and cost constraints, it is impossible to check each and every transaction of a business (save only a small business).
- c) Checking of each and every transaction which is mostly repetitive in nature is also not required provided the internal control system is satisfactory.

Procedure: This approach begins by evaluating the accounting system and internal control and then to ascertain their reliability. If the system is found good, the detailed checking is curtailed and if the system is weak, more detailed checking would be undertaken. However, checking cannot be completely eliminated, it can only be scaled down.

Circumstances under which test checks can be adopted:

- a) In case of big concerns where number of transactions is quite large.
- b) Auditor has very little time left for audit.
- c) Number of transactions are quite repetitive or homogeneous in nature.
- d) Existence of satisfactory internal control system

Q.No.5. What are the precautions to be taken before applying test check? (or) How should the test check be made scientifically and effective? (B) (N 91, 07, M 97, 08, 14 – 6M, M 16 – 4M, PM, M15 RTP)

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

- b) Authorisations, documentations, recording of the transactions should be studied right from the beginning to end.
- c) Evaluating the system of internal control for its efficiency, soundness and capability to produce reliable accounting and financial data.
- d) Preparation of test check plan with clear audit objective understood by the audit staff.
- e) Un-biased selection of the transactions with reference to the random number tables or other statistical methods.
- f) Identification of the areas where test check may not be done.
- g) Based on degree of reliance and the confidence level required in the audit, the number of transactions to be selected for each test plan should be pre-determined.
- h) Setting up criteria to judge what constitute material or immaterial errors. Further investigation of only material errors be carried out and all immaterial errors may be avoided.

Similar question:

Q.No.1. How should the test check be made scientifically and effective? (N 08 – 6M)

Ans: Same as above.

Q.No.6. Name some transactions not suitable for test checking? (B)	(M 97 - 4M)

- a) Opening and closing balances.
- b) Matters involving estimation and computation. Example, depreciation, taxation etc.
- c) Presentation and disclosure of information in the financial statements.
- d) Items which are material.
- e) Transactions which the auditor is expected to check as required by law, e.g., transactions as referred to in Sec.143 (1) and Sec.143 (3) or computation of managerial remuneration.
- f) Transactions of non-recurring nature (like export sales) or exceptional transactions.

Q.No.7. What are the advantages of test check? (C)	(M 08 - 4M)

- a) It helps auditor in completing the audit work in a short period with lesser strain.
- b) Auditor is able to complete the audit of accounts of many concerns within stipulated time.
- c) It saves time and energy of auditor from the detailed audit of a large & repetitive data and thus it enables him to devote more time and energy on important matters.
- d) It keeps the client's staff alert, as they know that any entry recorded by them may be taken for checking by the auditor.

Q.No.8. What are the limitations of test check / risks involved their in? (C)	(N 89 - 4M)

- a) All errors or frauds may not be detected.
- b) Difficulty in determining the sample size.
- c) Unsuitable for small businesses.
- d) There is a possibility that the auditor may not be able to get the correct position of financial affairs of the concern, if he applies test checking. With the result, his report may not be correct and duly reliable.
- e) It also increases the responsibility of an auditor to a great extent, as he may be held liable for negligence in the case of subsequent detection of frauds etc.

Q.No.9. What are the factors considered while determining the sample size? (B) (N13- 5M)

Determination of Sample size: Auditor considers the following in deciding the sample size:

- a) **Nature of the item:** If the items are similar, the auditor can draw conclusions regarding the same on the basis of a sample. On the other hand, if the items are of a different nature, the auditor cannot rely upon test checking.
- b) **Effectiveness of Internal Controls** If, in relation to a class of transactions, the auditor finds that the internal controls are effective, he may reduce the extent of checking. For example, the auditor may limit extent of test checking of inventory if he is satisfied that internal control in relation to it is strong.
- c) **Materiality of the Item:** In case of material items the auditor generally does not prefer to go for test check.
- d) **Previous experience of the auditor:** For example, suppose an auditor knows from his past experience that the purchases of the concern do not contain any material errors & On the other hand there were frauds with regard to cash operations. It is obvious that with this knowledge, the auditor would proceed to check the purchases through a smaller sample, whereas in the case of cash operations, he would like to carry out an extensive checking.

Alternative answer.

As per SA 530, Requirements relating to Sample design, sample size and selection of items for testing are explained below- (PM)

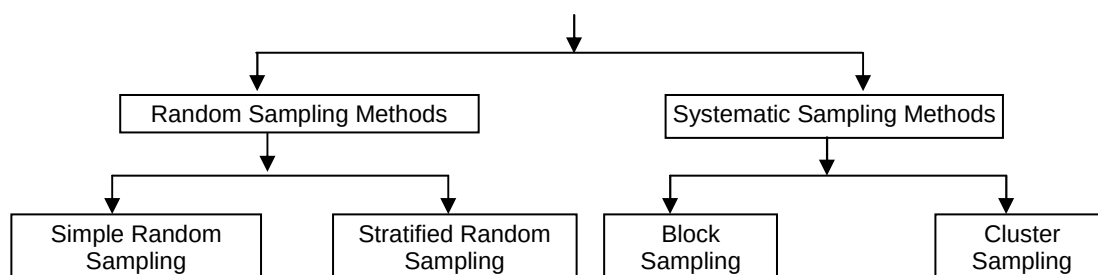
Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

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

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

Q.No.10. Write about the Sampling Techniques? (A) (M 16 – 2M)

1. **Judgmental sampling techniques:** Under this method the size of the sample are determined by the auditor on the basis of his past experience and knowledge. This has been the method followed for so many years. The main defect of this technique is that it is not scientific in nature. There are possibilities of the personal bias of the auditor in selecting the sample.
2. **Statistical sampling technique:** This method is more scientific as compared to the previous method. It involves the use of Statistical sampling methods in determining the appropriate sample size. It is not necessary for an auditor to gain in-depth knowledge of statistics, because the statistical tables are available for the use by the auditor. The following are the methods. **(N15 MTP1 - 4M)**



3. **Simple Random Sampling:** The procedure used under this method is use of random number tables for selection of sample. By using random number tables the element of bias is removed. **(M15 – 4M, PM, N14 MTP1 - 4M)**

4. **Stratified Random Sampling:** This method involves dividing the whole population in a few separate groups and then taking sample from each of the group. The group thus, formed shall be called strata. Each strata is considered as a separate Population and proportionate items are selected from each of the strata. The auditor uses his judgement in selecting the number of groups or strata. (PM, N 00 - 4M, M 11,15 - 4M)

E.g. While verifying the debtors balances the following strata may be formed: 0 to 25,000, 25,000 to 75,000, 75,000 to 1,00,000 & Over 1,00,000. In the above auditor may select all the items over 1,00,000 and reduce his % of checking gradually for other areas.

5. **Block sampling:** This method involves selection of a defined block of consecutive items, e.g. first 200 invoices from the sales day book of September or any 4 blocks of 50 sales invoices. Similarly, all items in an alphabetical or numerical sequence may be selected e.g. all debtors with their names beginning with letter 'C'.
6. **Cluster sampling:** This method involves dividing the population into groups of items which are known as clusters. A number of clusters are randomly selected from all the cluster rather than individual items of the population. The items of the selected cluster can be either checked completely or a randomly selected proportion can be examined.

Similar question: What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling". (PM, M15RTP)

Q.NO.11. Write about the advantage of statistical sampling in auditing. (A)

(N 08, M14 - 4M, PM)

1. The sample size does not increase in proportion to the increase in the size of population.
2. The selection is more objective and is based on mathematical law of probability.
3. This method gives a minimum sample size associated with a specified risk and precision level.
4. It also provides a means for taking a calculated risk and corresponding precision i.e., the probable difference in the result due to checking of transaction on sample basis in lieu of checking the entire universe.
5. It may provide a better description of large mass of data than a complete examination of all the data.

Note: Relevant standard on auditing is SA 530 (audit sampling).

Q.No.12. Write short note on Knowledge of Client's business. (C)

(PM)

Knowledge of client's business - as per SA315, the auditor "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment" Auditor can obtain this information from:

- i) Clients annual report to shareholders
- ii) Minutes of shareholders/board of directors
- iii) Internal financial management reports of current & previous year
- iv) Previous year audit working papers
- v) Discussion with client
- vi) Clients policy and procedure manual
- vii) Publications like trade journals, magazines, newspapers and
- viii) Visit to client's premises

Similar question: Matters that the auditor may consider when obtaining understanding of the nature of the entity. (N15 RTP)

PRACTICAL QUESTIONS

Q.NO.1. M/S. HEALTH ZONE, A PARTNERSHIP FIRM, RUNNING A NURSING HOME HAVE DECIDED TO DISCONTINUE YOU AS AN AUDITOR FOR THE NEXT YEAR AND REQUESTS YOU TO HANDOVER ALL THE RELEVANT WORKING PAPERS OF THE PREVIOUS YEAR. (OR)

R.K. & COMPANY ARE THE AUDITORS OF PQR COMPANY LTD. THE MANAGING DIRECTOR OF THE COMPANY DEMANDS COPIES OF THE WORKING PAPERS FROM THE AUDITORS. ARE THE AUDITORS BOUND TO OBLIGE THE MANAGING DIRECTOR?

Facts of the Case: A partnership firm discontinued an auditor for next year and requested him to submit the working papers of the previous year.

Provisions of Law: SA 230 – Audit Documentation
Relevant case Law – Chantry Mautime and Co. Vs Mattoon

Analysis: According to SA 230, the audit working papers refer to the documents proposed or obtained by the auditor and retained by him in connection with the performance of his audit.

According to SA 230, working papers should provide for:

1. Means of controlling current audit work.
2. Supervision and review of the audit work.
3. Evidence to support the auditors opinion.
4. Information about the business being audited including the recent history.

Ownership and Custody of Working Papers:

1. Working papers are the property of the auditor.
2. He may, at his discretion, make portions of it, available to its client.

Conclusion: The auditor is entitled to retain the audit working papers.

Q.NO.2. SHOULD BRANCH AUDITOR OF A COMPANY COMPLY WITH THE REQUEST OF THE PRINCIPAL AUDITOR OF THE COMPANY TO GIVE PHOTOCOPY OF THE WORKING PAPERS PERTAINING TO THE BRANCH AUDIT? EXPLAIN.

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

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

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

THE END

5. CAPITAL & REVENUE EXP., DEP. & RESERVES

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	-	-	-	-	-	-	-	-	2	-	8	-	-	5	-	-	-	4	-	-	-
2.	B	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-
3.	B	-	-	-	-	-	8	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	A	-	-	5	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-
8.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-
9.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What is meant by depreciation? What are the purposes of providing it? (B)
(M 10 – 2M, M 11 - 8M, N 12 -5M)

It refers to decrease in the value of assets due to wear and tear, obsolescence, exhaustion and effluxion of time. Depreciation is related to fixed assets. It is non-cash expenditure.

Reasons for depreciation:

- a) **Wear and tear:** By the use of fixed assets, their value is decreased day by day. This reduction is known as depreciation.
- b) **Exhaustion:** Certain assets get exhausted by their use. Oil fields, mines, etc. are such assets from which oil, minerals etc. are extracted. Such assets are known as wasting assets & the depreciation on such assets is called depletion.
- c) **Effluxion of time:** Depreciation also arises due to passage of time and it is irrelevant whether the assets are being put to use or not. There are certain assets which have a fixed period of legal life. Patents and copyrights are some of such assets.
- d) **Obsolescence:** Sometimes depreciation also arises due to the advancement in technology. For example when a new model of P&M with very high working capabilities is released the old P&M becomes obsolete.

Purposes of Depreciation:

(N 12 - 5M, PM, N14 MTP1 - 8M)

- a) **Effect's profits:** If capital expenditure is wrongly charged as revenue expenditure or vice versa it either decrease or increase the profits. In either case, the Balance Sheet and the Profit and Loss Account would show an incorrect state of affairs.
- b) **Matching concept:** The earnings of the entity shall be properly matched by the cost incurred. For example the purchase of plant & machinery results into production & sales over a period of 10 years then the cost of the asset shall also be write off over a period of 10 years in the name of depreciation.
- c) **To arrive at cost accurately:** The correct cost of production shall include depreciation.
- d) **Legal necessity:** As per the companies act dividend can be declared only if the depreciation is provided for that year i.e. No depreciation No dividend.
- e) **To provide money for purchase:** By providing for depreciation some part of the profits are retained in the business which are useful for purchasing a new asset when needed.

Q.No.2. Impairment of assets. (B)

(M 13 – 5M, PM, M15 MTP1 - 4M)

- a) Besides charging annual depreciation by the reason of wear and tear etc., to re-instate the correct value of the assets, impairment loss needs to be provided.
- b) The difference between the carrying amount of an asset and recoverable amount is termed as Impairment Loss.
- c) The treatment of impairment loss is similar to depreciation except that impairment loss can be re-instated in future if the recoverable amount of the asset exceeds the carrying amount.
- d) Various external and internal sources of information can be taken as the basis of determining the impairment for Assets.
- e) The auditor must ensure that provisions of AS 28 are followed.

Q.No.3. What are the types of reserves? What are the objects of creating? (B)

Reserves: A reserve generally means any part of the profits that is set aside for any unknown needs. In general it is not intended to meet any specific need. A company may earn higher profits in some years and may suffer losses in other years. Hence a wise company will not distribute all its profits as dividends but set aside a portion of its profits to some reserves so that such reserves can be utilised in the case of loss years.

TYPES OF RESERVES

A. GENERAL RESERVE (REVENUE RESERVE):

- a) A reserve which is created out of revenue profits i.e. it is a reserve created out of the profits which are revenue in nature by setting aside from its current profits.
- b) It is an appropriation of profits. Therefore no transfer is made to this in the year of loss.

Reserve Fund: The word “Fund” in relation to ‘reserve’ should be used only when such reserve is specifically represented by specific investments. Normally, the amounts represented by reserves are invested in the business itself, but the amount represented by reserve fund is invested separately outside the business. E.g.: Sinking fund for debenture redemption.

Duties of auditors regarding reserve fund:

- a) Check that the reserve fund is represented by outside investments.
- b) Physically verify the investments.
- c) Check that the interest received or receivable on such investments are transferred to the fund account and not to Profit and loss account.

B. CAPITAL RESERVE: A reserve which is created out of Capital Profits is a capital reserve. Capital reserve is not created by transferring the profit through profit and loss appropriation account. It is created out of profits of capital nature. **(PM, M15 MTP2 - 4M)**

Creation of capital reserve: Following are the circumstances under which it is created.

- a) Premium received on issue of shares and debentures.
- b) Profit on redemption of debentures at a discount.
- c) When the purchase consideration paid is less than the net worth of the company purchased.
- d) Profits prior to incorporation.
- e) Sale of fixed assets above the cost & Revaluation of fixed assets.

How to use Capital Profits?

- a) To Write off intangible assets like preliminary expenses, goodwill etc.

- b) Securities premium account can be utilised in the manner prescribed as per Sec.52.
- c) For declaring dividend in certain cases.

When dividend can be declared out of capital reserve: Capital profits can be distributed as dividends, if the following 3 conditions are satisfied:

- a) They are realised capital profits.
- b) The capital profits shall remain even after the revaluation of all the assets.
- c) The distribution of dividend out of capital profits is permitted by the AOA.

C. SECRET RESERVE: Secret reserves are those which are not disclosed on the face of the balance sheet. There is no account as secret reserve in the books. It is defined as the amount by which the net worth has been intentionally understated by omitting/undervaluing the assets or overstating the liabilities. Actually, because of secret reserves the position of the company is much better than what is disclosed in its balance sheet.

Objectives of creating secret reserves:

- a) *A growing company would always like to withhold some information from its competitors. For e.g. a company would not like to show its earning capacity because of the fear of the competitors.*
- b) *In case of losses, the company may lose its prestige. In every prosperous year, a part of the profits may be hidden by means of the secret reserves. Such secret reserves can be used in the years of losses.*
- c) *In order to maintain the same dividend rates over a period of time so as to preserve the prestige of the co. secret reserves are created which can be used during years of losses.*
- d) *Sometimes, the management may create secret reserves with bad motives also. The profits which are hidden may be used for personnel purposes.*

How secret reserve is created?

- a) *Over valuing the liabilities.*
- b) *Under valuation of assets.*
- c) *Provision of excess amount for doubtful debts.*
- d) *Treatment of capital expenditure as revenue expenditure.*
- e) *By creating excessive provisions.*
- f) *Showing contingent liabilities as real liabilities.*

Objections against the secret reserve: It is always a human tendency of misuse a good thing. Hence, there are objections against the creation of the secret reserve:

- a) *The management may misuse the amount represented by the secret reserve.*
- b) *The utilisation of the secret reserve in the years of losses would help the management to cover their inefficiency.*
- c) *According to the Companies Act, the balance sheet must show a true and fair view of the state of affairs of the company. As a result of the creation of the secret reserve the financial statement does not show a true and fair view. This is against to the Companies Act.*
- d) *The real worth of the company is not disclosed in the balance sheet of the company. The book value of the shares will be at low.*
- e) *If certain assets are omitted from the accounts to create secret reserves, there would not be any records for such assets. In case of loss by fire where such assets are destroyed, the company would not get a proper insurance claim.*
- f) *If certain assets are omitted from the accounts to create secret reserves, they will not be verified by the auditors also.*

Q.No.4. What is meant by window dressing and what are its objectives? (B)

Meaning: The term 'window-dressing' means manipulation of accounts with an intention to show better picture of profits and financial position. The detection of such manipulation is a difficult work because the persons in higher management are associated with this.

Objects of Window dressing:

- a) To show more profits and to get more managerial remuneration.
- b) To attract more loans from banks.
- c) To declare dividends when there are no profits.
- d) To attract potential investors for purchasing shares of the company.

How Window dressing is done? In any one of the below given ways:

- a) The sales of a subsequent period are recorded in the current year.
- b) Revenue expenditure is recorded as capital expenditure.
- c) Showing current year purchases in the subsequent year.
- d) Providing less depreciation.

Q.No.5. Write about specific reserves? (B)

- 1. A reserve created, out of profits, for meeting some specific need is called a specific reserve.
- 2. The purpose for creation may be the Article of Association, any agreement or the directors require providing for.
- 3. **E.g.'s** are Debenture redemption reserve, dividend equalisation reserve, Asset replacement reserve, Business expansion reserve etc.
- 4. These are also available for distribution as dividends on the recommendation of the directors and with the approval of shareholders.
- 5. There may be slight confusion since some of the objects for which specific reserves are created, may also appear to be covered by provisions for example, provision for bad and doubtful debts as well as reserve for bad and doubtful debts or a provision for repairs and reserve for repairs.
- 6. **The distinction between the two is based on:**
 - a) Whether it is a charge against revenue or an appropriation of profits.
 - b) To create any specific reserve existence of profit is essential.
 - c) Any amount which directors desire to retain over & above provisions is specific reserve.

Q.No.6. Capital reserve vs. reserve capital? (C)

Reserve capital: It is that part of the uncalled capital of the company which can be called up only in the event of its winding up. A limited company may, by a special resolution, determine that a portion of its uncalled capital shall be called up.

- a) In the event of winding up,
- b) For the purposes of winding up.
 - i) Reserve capital cannot be turned into uncalled capital without the leave of the Court. It is available only for the creditors on the winding up of the company. The company can neither not create charge on reserve capital nor but can cancel it in a reduction of capital [Midland Rly Carriage Co. Re].
 - ii) A company cannot borrow on the security of its reserve capital.

- iii) Reserve capital and Capital reserve are not one and the same.
- iv) Reserve capital is not required to be disclosed in the Balance sheet.
- v) It cannot be used to write off capital losses.

But the expression "Capital Reserve" does not include any amount regarded as free for distribution through the profit and loss account. Any reserve other than a capital reserve shall be "Revenue reserve".

Capital reserves comprise profits that arise in special circumstances and are connected with special circumstances.

Q.No.7. Reserves vs. provisions? (A) (N 89, M 07 - 4M, M 12 - 5M, PM)

	RESERVES	PROVISIONS
How created?	It is created by debiting the profit and loss appropriation account.	It is created by debiting the P & L account
Nature	It is an appropriation of profits.	It is a charge against profits.
Dependency on profits	The reserves to be created would depend upon profits for the year	The provisions to be created would not depend on profits for the year. Therefore even if they are losses, provisions have to be created.
Compulsory	Creation of reserves is not compulsory unless it is a statutory reserve or specific reserve.	A provision for known liabilities is compulsory.
Withdrawal	In case of necessity the amounts can be withdrawn from the revenue reserves.	Provision cannot be with drawn unless they are no longer required.
Disclosure	Reserves are shown under Reserves and surplus in the liability side of B/S.	Provisions are either shown under current liabilities / non-current liabilities or shown by way of deduction from the assets in certain cases (E.g. depreciation).
Power to decide the transfer	The amount to be transferred to the reserves will be determined by the directors. Auditors cannot interfere unless it is to be transferred compulsory.	It is the duty of the auditor to see that provisions are not less or not in excess of the necessity. In case the provision is not made or is inadequate, it is the duty of the auditor to report to the shareholders.

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.8. What is revenue expenditure? (C) (M14 – 4M)

- a) It is the expenditure incurred for day to day running of the business and in maintaining the capital assets in same level of efficiency.
- b) The benefit of such expenditure is exhausted normally within one year.
- c) **E.g.** Goods purchased for resale, salaries and wages, repairs and maintenance etc.
- d) The expenses though basically revenue in nature, if incurred for creating an asset or adding to its value or achieving higher productivity etc., are regarded as capital expenditure.
- e) The distinction between Capital & Revenue expenditure is important since wrongly charging capital expenditure to revenue or vice versa will either decrease or increase the profits.

Q.No.9. Distinguish capital & revenue expenditure. (c)

(M 93, 96, N 97 - 4M)

Refer to previous question.

Q.No.10. Why the distinction between capital & revenue exp. required? (C)

1. **Effect's profits:** The distinction between these two forms of expenditure is of very important since wrongly charging capital expenditure to revenue or vice versa will either decrease or increase the profits. In that case, the B/S and P& L A/c would show an incorrect state of affairs.
2. **Matching concept:**
 - a) The earnings of the entity shall be properly matched by the cost incurred i.e. if an expenditure results into benefits for more than a year then it should be written off over the period for which the benefits will accrue. For example the purchase of plant & machinery results into production & sales over a period of 10 years then the cost of the asset shall also be written off over a period of 10 years in the name of depreciation.
 - b) On the other hand the benefit of salaries paid will be there for a particular year only and there fore the entire salaries paid shall be write off in that particular year only which is called revenue expenditure.
 - c) Both the above two examples are based on matching concept.

Q.No.11. Write about dividend equalisation reserve? (C)

1. *A portion of the profits may be set aside so that it may be used in the years when there are inadequate profits or no profits for distribution of dividend. Such an amount may be transferred to the Dividend Equalisation Reserve.*
2. *This reserve is shown separately under the head "Reserves & Surplus" in the balance sheet.*
3. *The amount transferred to such a reserve may not be the same every year as it would depend up on the profits for the year.*
4. *Under the following circumstances, the company may be advised to maintain this:*
 - a) *Where the company is expected to incur heavy expenditure at irregular intervals.*
 - b) *Where the company's activities deal in: Agricultural activities or Production of fashions goods or Products the market prices of which fluctuate frequently.*

PRACTICAL QUESTIONS

Q.No.1. As an auditor, what would you do in the following situations?

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

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

- i) The adoption of the new method is required by statute (or)
- ii) For compliance with an accounting standard (or)

- iii) It is considered that the change would result in a more appropriate presentation of financial statements of the enterprise.

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

Q.No.2. As an auditor, comment on the MNR Co. Ltd. did not provide for depreciation during the financial year 2013-14 due to inadequacy of profits. The company declared dividend during the financial year 2014-15 without providing for the previous year's depreciation. **(PM)**

Payment of Dividend without Providing for Arrears of Depreciation: Section 123(1) of the Companies Act, 2013, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring / paying dividend:

- i) Either out of the profits of that financial year, or
- ii) Out of the profits of any other previous years.

In the present case, it would be necessary to make provisions for depreciation in respect of 2013-14 and 2014-15 in the first instance and the balance of profit after providing depreciation including the previous year, could be used for distribution as dividend. Since the company has contravened the provisions of Section 123(1), the auditor should qualify his audit report.

THE END

6. COMPANY AUDITOR

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	-	-	-	-	-	-	2	3	4	-	-	-	-	-	2	-	-	2	2	-
2.	A	4	-	-	-	-	2	-	2	3	4	-	-	-	-	-	2	-	-	2	4	-
3.	A	4	-	-	-	-	-	-	2	3	2	-	-	-	-	-	2	-	-	-	-	2
4.	A	-	4	2	4	2	2	-	-	-	9	-	-	-	-	-	2	2	-	2	2	2
5.	A																					
6.	A	-	-	-	-	-	-	-	2	-	-	-	-	-	5	-	-	-	-	-	-	-
7.	A	NEWLY INTRODUCED IN COMPANIES ACT 2013																		4	2	-
8.	A	-	-	-	-	-	5	-	5	-	-	-	-	-	-	-	6	-	-	-	-	-
9.	C	NEWLY INTRODUCED IN COMPANIES ACT 2013																		-	-	-
10.	B	NEWLY INTRODUCED IN COMPANIES ACT 2013																		-	-	-
11.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	A	-	4	-	-	-	-	-	6	-	-	-	-	-	-	-	-	-	-	-	6	-
13.	A	-	-	-	-	-	-	6	-	-	-	-	5	-	-	-	-	-	-	-	-	-
14.	A	-	-	-	2	-	-	-	-	-	-	-	-	-	5	-	2	-	-	-	-	-
15.	B	-	-	2	-	-	-	-	-	2	-	-	-	-	4	-	-	-	-	-	2	-
16.	A	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	2	6	-	-	-
17.	A	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	2	6	-	-	-
18.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
19.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-
20.	A	-	8	7	-	-	-	-	-	-	-	-	-	-	6	-	-	9	-	-	-	-
21.	A	-	-	4	2	4	-	16	10	5	4	-	-	-	-	8	-	5	-	-	4	-
22.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
23.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What are the Qualifications of a company auditor? (A)

(M, N15 – 2M)

Qualifications:

As per **Sec 141(1)** following persons are qualified to act as an auditor of a company...

- An **Individual** who is a Chartered Accountant with Certificate of Practice as per the Indian Chartered Accountants act 1949.
- A **Partnership Firm** having majority of the partners as Chartered Accounts practicing in India.
- A **Limited Liability Partnership Firm** constituted under Limited Liability Partnership Act, 2008 having majority of partners as Chartered Accounts Practicing in India.

Sec 141(2): If firm of auditors i.e. Partnership Firm or LLP is appointed as an auditor of a company, the appointment should be in the name of the firm and the report shall be signed by only those partners who are **Chartered Accountants** and entitled to sign the report.

REFER PRACTICAL QUESTION – 7

Q.No.2. What are the Disqualifications of a Company's Auditor? (A)

(N08– 2M, M15 – 2M, N15 – 4M)

As per Sec 141 (3), the following persons shall not be eligible for appointment as an auditor of a company, namely:

- a) A **Body Corporate** other than a LLP incorporated as per Limited Liability Partnership Act, 2008;
- b) An **Officer or Employee** of the company;
- c) A person who is a **Partner** or an **Employee** of an officer or employee of the company;
- d) A person who, or his relative or partner—
 - i) Is holding **any security or interest** in the company
Exception: the relatives may hold security or interest in the company of **face value not exceeding Rs 1 Lakh**.
 - ii) Is **indebted** to the company in excess of such amount as may be prescribed (**Rs 5 Lakh**); (or)
 - iii) Has given a **guarantee or provided any security** in connection with the indebtedness of any third person to the company for such amount as may be prescribed (**Rs 1 Lakh**);
- e) A person or a firm (including LLP) having **Business Relationship** (whether directly or indirectly) with the company of such nature as may be prescribed;
- f) A person whose **relative** is a director or is in the employment of the company as a director or key managerial personnel;
- g) A person who is in **full time employment** elsewhere or a person or a firm holding appointment as an auditor of **more than twenty companies** at the time of appointment or reappointment in the company;
- h) A person who has been **convicted** (imprisoned) by a court of an **offence involving fraud** and a period of **ten years** has not elapsed from the date of such verdict;
- i) Any person whose subsidiary or associate company or any other form of entity, is engaged in services as provided in **section 144**.

As per Sec 141(4) where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he **shall vacate** his office and such vacation shall be deemed to be a **casual vacancy** in the office of the auditor.

Note 1: It is to be noted that the Company includes its subsidiary, or its holding or associate company or subsidiary of such holding company for the purpose of disqualifications contained in (d) above and in case of (e) above subsidiary of such associate company will also include.

Note 2: Following transactions are to be excluded within the meaning of 'Business Relationship' contained in (e) above...

- i) Commercial transactions which are in the nature of **professional services** permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949;
- ii) Commercial transactions which are **in the ordinary course of business** of the company at **arm's length price** – like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of **telecommunications, airlines, hospitals, hotels** and such other similar businesses.

Note 3: Relative;

[The term “relative”, as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step- sister).]

REFER PRACTICAL QUESTION – 1 to 12 (Except 7)

Q.No.3. State the services which an auditor of a company is prohibited to render to the client being audited as per Sec 144 of the Companies Act 2013? (A)

An auditor appointed under this Act shall provide to the company only such services as are approved by the Board or the audit committee, as the case may be, but shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company) namely...

- a) Accounting and book keeping services;
- b) Internal audit;
- c) Design and implementation of any financial information system;
- d) Actuarial services;
- e) Investment advisory services;
- f) Investment banking services;
- g) Rendering of outsourced financial services;
- h) Management services; and
- i) Any other kind of services as may be prescribed:

Q.No.4. What is the procedure for appointment of the first auditor of a company? (A)
(M, N15 – 2M, M15 RTP)

Appointment of First Auditors in the case of a company, other than a Government Company:

As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting

Appointment of First Auditors in the case of Government Company:

As per Section 139 (7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India do not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Similar Question: Explain the following:

- (a) Appointment of First Auditor of a Non-Government Company. (PM)
(b) Appointment of First Auditor of a Government Company. (PM)

REFER PRACTICAL QUESTION – 13 to 15

Q.No.5. What is the procedure for appointment of the Subsequent Auditor of a company? (A)

Appointment of subsequent auditors in case of Non-Government Companies:

Section 139(1) provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

- a) The company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting. A retiring auditor may be re-appointed at an annual general meeting, if-
- i) He is not disqualified for re-appointment;
 - ii) He has not given the company a notice in writing of his unwillingness to be reappointed; and
 - iii) A special resolution has not been passed at that meeting appointing some other Auditor or providing expressly that he shall not be re-appointed.
- b) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- c) The certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.
- d) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.
- e) It is hereby clarified that, if the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors.

Note: An Engagement Letter may need to be entered into for each year of the period covered by the Eligibility Letter issued by the auditor under section 139 of the Companies Act, 2013 and the Appointment Letter received from the Company, to supplement / update for any subsequent changes. This may be required because the appointment would need to be ratified at each AGM under section 139 of the said Act.

Appointment of subsequent auditors in case of Government Companies: As per Section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Similar Question:

- (a) Appointment of Subsequent Auditor of a Non-Government Company. (PM)
(b) Appointment of Subsequent Auditor of a Government Company. (PM)

REFER PRACTICAL QUESTION – 16

Q.No.6. What is the procedure for filling of a casual vacancy? (A)

(PM)

- a) In the case of a company other than a Government company, Casual vacancy is filled by the Board of Directors within 30 days.
- b) If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.
- c) In the case of a Government company casual vacancy in Auditor's Office is filled by the Comptroller and Auditor-General of India within thirty days. In case C&AG fail to do so the Board of Directors shall fill the vacancy within next 30 days.
- d) As per section 140 (2) the auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form with the company and the Registrar, and in case of Government companies the auditor shall also file such statement with the Comptroller and Auditor General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140 (3).

Similar Question: Filling of a casual vacancy of auditor in respect of a company audit. **(PM)**

REFER PRACTICAL QUESTION – 17 TO 18

Q.No.7. Explain the provisions relating to Rotation of Auditor? (A)

(M15 – 4M, N15 – 2M, M15 – 4M)

Applicability: As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, Rotation of Auditor is applicable for the following companies except one person companies and small companies:-

- a) All listed companies
- b) All unlisted public companies having paid up share capital of rupees 10 crore or more; (or) having borrowings from financial institutions, banks or public deposits of rupees 50 crores or more.
- c) All private limited companies having paid up share capital of rupees 20 crore or more; (or) having borrowings from financial institutions, banks or public deposits of rupees 50 crores or more.

Period and Term of Auditor's Office:

1. As per Section 139(2) the companies as mentioned above, shall not appoint or re-appoint
 - a) an individual as auditor for more than one term of 5 consecutive years; and
 - b) an audit firm as auditor for more than two terms of 5 consecutive years.
2. An individual auditor (or) firm who (or) which has completed term as above shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term.

Additional Conditions:

1. As on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years:
2. Every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within three years from the date of commencement of this Act:

3. It has also been provided that right of the company to remove an auditor or the right of the auditor to resign from such office of the company shall not be prejudiced.
4. Subject to the provisions of this Act, members of a company may resolve to provide that-
 - a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
 - b) The audit shall be conducted by more than one auditor.
5. The incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms. *For the purposes of these rules the term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.*
6. A break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation.
7. If a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.
8. Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

Similar Question: "Provisions regarding rotation of auditors affect only specific class of companies". Discuss. (PM, M15 RTP)

Q.No.8. Under what circumstances the retiring Auditor cannot be reappointed? (A)
(N13 – 6M, PM, N14 RTP)

In the following circumstances, the retiring auditor cannot be reappointed:

- a) A specific resolution has not been passed to reappoint the retiring auditor
- b) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.
- c) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.
- d) He has given to the company notice in writing of his unwillingness to be reappointed.
- e) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
- f) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, 2013.

Q.No.9. Explain the applicability of Constitution of Audit Committee? (C)

1. **The Board of Directors of following companies shall constitute an Audit Committee:**
 - a) All **Listed** companies (and)
 - b) All unlisted **public** companies which satisfies any one of the following 3 conditions
 - i) Having **paid-up** capital of 10 crore rupees or more (or)

ii) Having **turnover** of 100 crore rupees or more (or)

iii) Having outstanding **loans or borrowings or debentures or deposits** in aggregate of 50 crore rupees or more.

(Note: for the purpose of above, date of last audited financial statements shall be consideration)

2. The Audit Committee shall consist of a minimum of **three directors** with independent directors forming a majority Provided that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statements (literate persons only).
3. Every Audit Committee of a company existing before the commencement of this Act shall, **within one year**, be reconstituted in accordance with sub-section (2) above.
4. The auditors of a company and the key managerial personnel shall have a **right to be heard** in the meetings of the Audit Committee when it considers the auditor's report but **shall not have** the right to **vote**.

Q.No.10. Explain the manner and procedure of selection and appointment of Auditors? (B)

- a) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.
- b) The Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.
- c) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- d) The Audit committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases; the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- e) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- f) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- g) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

Q.No.11. Briefly explain the provisions relating to Audit Remuneration. (C)

As per section 142 of the act the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it. Further, the remuneration, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.

REFER PRACTICAL QUESTION – 19

Q.No.12. Briefly explain the concept of Removal of Auditor before Expiry of Term. (A)
(N15 – 6M, N15 MTP1 - 4M)

According to Section 140 (1) the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014:

- a) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- b) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.
- c) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution. It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Q.No.13. Explain the process of Appointment of Auditor other than retiring Auditor. (or) Explain the procedure to remove the auditor after expiry of his term. (A)

Section 140 lays down procedure to appoint an auditor other than retiring auditor who was removed:

- a) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under subsection (2) of section 139.
- b) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- c) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-
 - i) In any notice of the resolution given to members of the company, state the fact of the representation having been made; and
 - ii) Send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.
 - iii) If a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar.

Q.No.14. Write about ceiling on Number of Audit. (A)

(PM, N15 MTP1 - 5M)

- a) A chartered accountant in practice cannot hold appointments as auditor for more than 20 companies at any time.
- b) In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.
- c) Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.
- d) For the purpose of computation of ceiling limits following companies are **excluded**-
 - i) One person companies,
 - ii) Dormant companies,
 - iii) Small companies, and
 - iv) Private limited companies having a paid capital less than Rs.100 crores.

ICAI notification: As per ICAI notification, a CA in practice will be guilty of professional misconduct, if he holds at any time, the appointment of more than **30** audit assignments, **including audit of private companies.**

Similar Question: Discuss about the Ceiling on number of audits in a company to be accepted by an auditor. **(PM)**

REFER PRACTICAL QUESTION – 20, 21

Q.No.15. Write about Powers / Rights of an Auditor. (B)

(N15 – 2M)

Following are the rights of the companies' auditor

1. Right of Access to Books, Documents, Vouchers etc.:

- a) Every auditor of a company shall have a right of access to the books of account and vouchers of the company **at all times** (Which implies during Working Days and working Hours)
- b) This right can be exercised even without any prior notice to the company.
- c) This right can be exercised in respect of books, documents etc. whether kept at the registered office of the company or at any other place
- d) This right is also applicable in respect of the books and documents maintained at branch office (irrespective of branch audit).
- e) The auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries.
- f) Books and documents includes any books and documents which the auditor may consider necessary for his purpose including statistical records, Inventory reports, minutes day books etc. and need not always to be the financial books.

2. Right to Receive Information:

- a) Every auditor of a company shall be entitled to require from the **officers or employees** of the company **such information and explanation** as he may consider necessary for the performance of his duties.
- b) Without this, it is not possible for an auditor to get the information on which to base his opinion.
- c) If the auditor is unable to get the required information, then can mention the same in his report as an observation.

3. Right to Receive Notice of General Meetings:

- a) All notices and other communications relating to any **general meeting** shall be forwarded to the auditor of the company.
- b) The auditor shall attend the GM either by himself or through his authorized representative, who shall also be qualified to be an auditor (unless otherwise exempted by the company).
- c) He shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.
- d) This right is not specific to the meetings in which audited statements are discussed and therefore the auditor shall be given the notice of GMs whether the financial statements are discussed or not in that GM.
- e) This is to be noted that this right is in respect of **General Meetings only** and not in respect of any Board meetings.

4. Right of Lien:

(PM)

- a) Lien refers to **lawful possession** of some others property.
- b) Auditor can exercise lien right on the **client books & documents** subject to the following conditions...
 - i) Books & Documents should pertain to the client **who owes money** in respect of services rendered
 - ii) Books & Documents must not have been received through irregular or illegal means.
 - iii) Books & Documents must have come into auditors possession on the authority of the Client
 - iv) Books & Documents must pertain to the year in respect of which the fees are due

Note: However the above right can't be enforced by the auditor, since it leads to violation of **Sec 128** (i.e. as per sec 128 Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company)

In '**RD Saxena Vs Balram Prasad Sharma**' case, the Supreme Court had held that "no professional can be given the right to withhold the returnable records relating to the work done by him with his clients matter on the strength of any claim for unpaid remuneration"

5. Right of representation: At the time of retirement, the retiring auditor has ...

- i) a right of making representation (not exceeding reasonable length) and
- ii) a right to ask the company to circulate the same to every member of the company along with special notice of the GMs (unless it is sent by him too late).
- iii) If a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting

REFER PRACTICAL QUESTION – 22 TO 27

Q.No.16. What are the Duties of Companies auditor as per Sec 143(1) of the Companies Act 2013 (or) State the matters to be enquired by a company's auditor as per Sec 143(1) of the Companies Act 2013? (A) (PM, N15 MTP2 - 4M)

As per Sec 143(1) of the Company's Act 2013, the company's auditor shall make **enquiries** on the following matters and required to report on those matters on which he is having **negative remarks**.

- a) Whether **loans and advances** made by the company on the **basis of security** have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- b) Whether transactions of the company which are represented **merely by book entries** are prejudicial to the interests of the company;
- c) Whether any assets of the company consisting of **shares, debentures and other securities** have been sold at a price less than its purchase price by the company.

Note: this provision is not applicable in respect of Banking and Investment Companies

- d) Whether **loans and advances** made by the company have been **shown as deposits**;
- e) Whether **personal expenses** have been charged to revenue account;
- f) Where it is stated that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Similar Question: Write a short note on Audit enquiry under Section 143(1) of the Companies Act, 2013. (PM)

REFER PRACTICAL QUESTION – 28

Q.No.17. What are the Duties of Companies Auditor as per Sec 143(3) of the Companies Act 2013 (or) what are the matters to be stated or reported in the Company's auditors report as per Sec 143(3) of the Companies Act 2013? (A) (PM, N15 RTP)

As per sec 143(3), the company's auditors report shall include a statement on the following matters:

- a) Whether he has obtained all the **information and explanations** which to the best of his knowledge and belief were necessary for the purpose of his audit and **if not**, the details thereof and the effect of such information on the financial statements;
- b) Whether, in his opinion, **proper books of account** as required by law have been kept by the company and **proper returns** adequate for the purposes of his audit have been received from branches not visited by him;
- c) Whether the **report** on the accounts of any branch office of the company audited by a person other than the company's auditor **has been sent to him** and **how he has dealt with** it in preparing his report;
- d) Whether the company's balance sheet and profit and loss account are in **agreement with the books** of account and returns;
- e) Whether, in his opinion, the financial statements comply with the **accounting standards**;
- f) The **observations or comments** of the auditors on financial transactions or matters which have any adverse effect on the **functioning** of the company;
- g) Whether any **director is disqualified** from being appointed as a director under section 164 (2);
- h) Any **qualification, reservation or adverse remark** relating to the maintenance of accounts and other matters connected therewith;
- i) Whether the company has **adequate internal financial controls system** in place and the operating effectiveness of such controls;
- j) Such **other matters** as may be prescribed.

Similar Question: State the matters to be specified in Auditor's Report in terms of provisions of Section 143(3) of the Companies Act, 2013. (PM)

REFER PRACTICAL QUESTION – 29, 30

Q.No.18. What are the other Duties of Companies Auditor as per Sec 143 of the Companies Act 2013? (C)

Duty to Sign the Audit Report (sec 143 (2)): The person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of sub-section (2) of section 141 and the qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

Duty to state the reason for qualification or negative report: As per Section 143(4), where any of the matters required to be included in the audit report is answered in the negative or with a qualification, the report shall state the reasons there for.

Duty to comply with Auditing Standards: As per Section 143(9), every auditor shall comply with the auditing standards. CG may prescribe the standards of auditing or any addendum thereto, as recommended by the ICAI in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Duty to report on any other matter specified by Central Government: The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

Q.No.19. Write about the Duties of Companies Auditor to Report on Fraud as per Sec 143(12) of the Companies Act 2013? (B) (N15 – 2M)

Reporting to the Central Government- As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ` 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
- d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

- e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- f) the report shall be in the form of a statement as specified in Form ADT-4.

Reporting to the Audit Committee or Board - Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ` 1 crore], the auditor shall report the matter to the audit

committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed. In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub-rule (1) [i.e. less than ` 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

- a) Nature of Fraud with description;
- b) Approximate amount involved; and
- c) Parties involved.

Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed. In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that the auditor is also required to disclose in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year:

- a) Nature of Fraud with description;
- b) Approximate Amount involved;
- c) Parties involved, if remedial action not taken; and
- d) Remedial actions taken.

Similar Question: Discuss the procedure to be followed by the auditor in case he has sufficient reason to believe that an offence involving fraud has been committed against the company by its officers. (N15 RTP)

Q.No.20. What are the basic elements of Audit Report? (A)	(PM, N14 RTP)

The Auditor's report includes the following basic elements, ordinarily, in the following layout:

1. Title.
2. Addressee, as required by the circumstances of the engagement.
3. **Opening or introductory paragraph:** (M14 – 4M)
 - a) Identify the entity whose financial statements have been audited;
 - b) State that the financial statements have been audited;
 - c) Identify the title of each statement that comprises the financial statements;
 - d) Refer to the summary of significant accounting policies and other explanatory information; and
 - e) Specify the date or period covered by each financial statement comprising the financial statements

4. Management's Responsibilities for the Financial Statements:

- a) That gives true and fair view of financial position, financial performance and cash flows in accordance with the accounting standards as per Sec 129 (specified in Sec 133).
- b) Designing, implementation and maintenance of internal control.

5. Auditor responsibility:

- a) An expression of opinion on the financial statements and scope of audit.
- b) Reference to SAs issued by ICAI and law or regulation.

6. Auditor's opinion:

- a) Expression of opinion
- b) Reference to applicable financial reporting framework

7. Other reporting responsibilities

8. Signature of the auditor

9. Date of the auditor's report.

10. Place of signature.

Q.NO.21. Write about different types of opinions. (A) (M15 – 2M, M15 MTP1 - 8M)

CLEAN OR UNQUALIFIED OPINION

(PM, N14RTP)

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view.

2. An unqualified opinion also indicates that:

- a) The financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied ;
- b) The financial statements comply with relevant statutory requirements and regulations; and
- c) There is adequate disclosure of all material matters.

MODIFIED OPINION

(M14 – 5M, M15 – 5M, PM)

1. Qualified Opinion:

(N15 – 4M)

- a) A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with the management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not material and pervasive as to require a disclaimer of opinion.
- b) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- c) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

2. Adverse Opinion:

- a) An adverse opinion should be expressed when the disagreement with management is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is inadequate to disclose the misleading or incomplete nature of the financial statements.
- b) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

3. Disclaimer of Opinion:

(PM, N14 MTP1 - 4M)

- a) A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor is unable to obtain sufficient appropriate audit evidence and is thus unable to express an opinion on the financial statements.
- b) The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence and concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Similar Question: When does an auditor issue unqualified opinion and what does it indicate?
(PM)

Ans: Refer Para 1.

REFER PRACTICAL QUESTION – 31

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.22. Distinguish between audit report and audit certificate. (C)

(PM)

Particulars	Audit Report	Audit Certificate
Meaning	An Audit Report is an expression of opinion, on the "true and fair view" presented by Financial Statements.	"Certificate" is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion.
Utility	The term Audit Report is used when the Auditor expresses his opinion on the Financial Statements.	The term Certificate is used when the Auditor verifies certain exact facts, e.g. Royalty Payment made to Foreign Collaborators, Value of imports or exports of a Company during a Financial Year.
Implication	Audit report implies that the Auditor– - Has examined relevant records in accordance with generally accepted auditing standards, & - Is expressing an opinion whether or not the Financial Statements represent a true and fair view of the state of affairs and of the working results of an enterprise.	An Auditor's Certificate implies that the Auditor – - Has verified certain precise figures, and - Is in a position to vouchsafe their accuracy as per the examination of documents and books of accounts produced before him
Responsibility	When a Audit Report is issued, the Auditor is responsible for ensuring that the report is based on factual data, and his opinion is in accordance with facts, and that it is arrived at by the application of due care and skill.	When a certificate is issued, the Auditor is responsible for the factual accuracy of what is stated therein.

Q.No.23. In what way does the co. law safeguard the independence of an auditor? (C)

The Companies Act, 2013, has therefore enacted specific provisions to give concrete shape to this vital concept:

- i) The provisions disqualifying certain types of persons from undertaking audit of limited companies.
- ii) Provisions relating to ceiling on the number of audits that can be undertaken by a chartered accountant.

- iii) Provisions requiring special resolution for appointing auditors in certain cases.
- iv) Other provisions on appointment, re-appointment and removal of auditors, are designed with sufficient independence to carry out the audit in the larger interest of shareholders and other users.
- v) Power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence.
- vi) Provisions relating rotation of auditor/audit firm.

PRACTICAL QUESTIONS

Q.NO.1 "MR. V", A PRACTICING CHARTERED ACCOUNTANT, IS HOLDING SECURITIES OF "XYZ LTD." HAVING FACE VALUE OF Rs 900/-. WHETHER MR. VINOD IS QUALIFIED FOR APPOINTMENT AS AN AUDITOR OF "XYZ LTD."?

Provisions of Law: As per section 141 (3)(d) (i) an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

Conclusion: In the present case, Mr. V. is holding security of Rs 900 in the XYZ Ltd, therefore he is not eligible for appointment as an Auditor of "XYZ Ltd".

Q.NO.2 "MR. S" IS A PRACTICING CHARTERED ACCOUNTANT AND "MRS. S", IS HOLDING SECURITIES OF "ABC LTD." HAVING FACE VALUE OF Rs 90,000/-. WHETHER "MR. S" IS QUALIFIED FROM BEING APPOINTED AS AN AUDITOR OF "ABC LTD."?

Provisions of Law: As per section 141 (3)(d)(i) an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further as per proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of Rs 1,00,000.

Conclusion: In the present case, Mrs S. (relative of Mr. S, an auditor), is having securities of Rs 90,000 face Value in the ABC Pvt. Ltd., which is as per requirement of proviso to section 141 (3)(d)(i), Therefore, Mr. S will not be disqualified to be appointed as an auditor of ABC Ltd.

Q.No.3 "BC & CO." IS AN AUDIT FIRM HAVING PARTNERS "MR. B" AND "MR. C", AND "MR.A" THE RELATIVE OF "MR. C", IS HOLDING SECURITIES OF "MWF LTD." HAVING FACE VALUE OF Rs 1,01,000/-. WHETHER "BC & CO." IS QUALIFIED FROM BEING APPOINTED AS AN AUDITOR OF "MWF LTD."?

Provisions of Law: As per section 141 (3)(d) (i) an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company: Further as per proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of Rs 1,00,000.

Conclusion: In the instant case BC & Co, will be disqualified for appointment as an auditor of MWF Ltd as the relative of Mr. C i.e. partner of BC & Co., is holding the securities in MWF Ltd which is exceeding the limit mentioned in proviso to section 141(3)(d)(i)

Q.NO.4. A, A CHARTERED ACCOUNTANT HAS BEEN APPOINTED AS AUDITOR OF LAXMAN LTD. IN THE ANNUAL GENERAL MEETING OF THE COMPANY HELD IN SEPTEMBER, 2013, WHICH ASSIGNMENT HE ACCEPTED. SUBSEQUENTLY IN JANUARY, 2014 HE JOINED B, ANOTHER CHARTERED ACCOUNTANT, WHO IS THE MANAGER FINANCE OF LAXMAN LTD., AS PARTNER.

Provisions of Law: As per section 141(3) (c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted clause (3) (c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of M/s Laxman Limited.

Q.NO.5. AN AUDITOR PURCHASED GOODS WORTH Rs 501,500 ON CREDIT FROM A COMPANY BEING AUDITED BY HIM. THE COMPANY ALLOWED HIM ONE MONTH'S CREDIT, WHICH IT NORMALLY ALLOWED TO ALL KNOWN CUSTOMERS.

Purchase of goods on credit by the auditor: Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company.

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office.

Q.NO.6. B&M ASSOCIATES, CHARTERED ACCOUNTANTS IN PRACTICE HAVE BEEN APPOINTED AS STATUTORY AUDITOR OF ANDHRA LTD. FOR THE ACCOUNTING YEAR 2013-2014. MR. M HOLDS 100 EQUITY SHARES OF GUJARAT LTD., A SUBSIDIARY COMPANY OF ANDHRA LTD.

As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. M, Chartered Accountant, a partner of B&M Associates, holds 100 equity shares of Gujarat Ltd. which is a subsidiary of Andhra Ltd. Therefore, the firm, would be disqualified to be appointed as statutory auditor of Andhra Ltd., which is the holding company of Gujarat Ltd., because one of the partner Mr. M is holding equity shares of its subsidiary.

Q.NO.7. DEVI, A MEMBER OF THE ICAI, DOES NOT HOLD A CERTIFICATE OF PRACTICE. IS HER APPOINTMENT AS AN AUDITOR VALID?

A person shall be qualified for appointment as an auditor of a company, only if one is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Under the Chartered Accountants Act, 1949, only a Chartered Accountant holding the certificate of practice can engage in public practice. Devi does not hold a certificate of practice and hence cannot be appointed as an auditor of a company.

Q.NO.8. 'B' OWES Rs 5,01,000 TO 'C' LTD., OF WHICH HE IS AN AUDITOR. IS HIS APPOINTMENT VALID? WILL IT MAKE ANY DIFFERENCE, IF THE ADVANCE IS TAKEN FOR MEETING-OUT TRAVELLING EXPENSES?

As per Section 141(3)(d)(ii) of the Companies Act, 2013, a person who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company, or a subsidiary of its holding company, for an amount exceeding Rs 5,00,000/- then he is not qualified for appointment as an auditor of a company. Accordingly, B's appointment is not valid and he is disqualified as the amount of debt exceeds Rs 5,00,000. Even if the advance was taken for meeting out travelling expenses particularly before commencement of audit work, his appointment is not valid because in such a case also the auditor shall be indebted to the company. The auditor is entitled to recover fees on a progressive basis only.

Q.NO.9. MR. AMAR, A CHARTERED ACCOUNTANT, BOUGHT A CAR FINANCED AT Rs 7,00,000 BY CHANDRA FINANCE LTD., WHICH IS A HOLDING COMPANY OF CHARAN LTD. AND DAS LTD. HE HAS BEEN THE STATUTORY AUDITOR OF DAS LTD. AND CONTINUES TO BE TO EVEN AFTER TAKING THE LOAN.

According to section 141 (3)(d) (ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of any company, If he is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh.

In the given case Mr. Amar is disqualified to act as an auditor under section 141 (3)(d) (ii) as he is indebted to M/s Chandra Finance Ltd. for more than Rs 5,00,000 Also according to Section 141 (3)(d) (ii) he cannot act as an auditor of any subsidiary of Chandra Finance Ltd. i.e. he is also disqualified to work in Charan Ltd. & Das Ltd. Therefore he has to vacate his office in Das Ltd. Even though it is a subsidiary of Chandra Finance Ltd.

Hence audit work performed by Mr. Amar as an auditor is invalid, he should vacate his office immediately and Das Ltd must have to appoint any other CA as an auditor of the company.

Q.NO.10. CAN A DIRECTOR OF THE COMPANY BE APPOINTED AS AN AUDITOR?

There is no express prohibition that a director cannot be appointed as an auditor. But the below given two provisions of the companies Act prohibits a director to be appointed as an auditor:

- a) Sec.141 enumerates that an officer of the company cannot be appointed as an auditor.
- b) Sec.2 (59) of companies Act, which defines the officer to include the director.

Q.NO.11. WHETHER THE FOLLOWING PERSONS CAN BE APPOINTED AS THE AUDITOR OF A COMPANY?

A). PRASAD, A PERSON WHO IS A CHARTERED ACCOUNTANT OF THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS BUT IS NOT A MEMBER OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA.

- B).** MRS. P IS A MEMBER OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA. THE DIRECTORS OF A LIMITED COMPANY SAY THAT SHE BEING A LADY CAN NOT BE APPOINTED AS AN AUDITOR OF THE COMPANY.
- C).** MR. KRISHNA OWES Rs. 10,00,000 TO A LTD. TO WHICH HE IS AN AUDITOR.
- D).** MR. RAMU, A MEMBER OF THE ICAI, DOES NOT HOLD A CERTIFICATE OF PRACTICE.
- E).** MR. NANI, WHO WAS A MEMBER OF THE ICAI, IS OF UNSOUND MIND.
- F).** MR. HRITHIK, WHO WAS A MEMBER OF THE ICAI, IS OF INSOLVENT/BANKRUPT.
- G).** ABI CONSULTANTS LTD IS A REGISTERED COMPANY WITH A, K AND V AS ITS DIRECTORS. ALL THE THREE DIRECTORS ARE CHARTERED ACCOUNTANTS. CAN THE CO. BE APPOINTED AS AUDITOR OF ANOTHER COMPANY?
- H).** A, A PARTNER IN THE FIRM OF M/S BALAJI & CO., CHARTERED ACCOUNTANTS, IS THE SECRETARY OF C LTD. CAN A OR BALAJI & CO., BE APPOINTED AS THE COMPANY AUDITOR?
- I).** B, CHARTERED ACCOUNTANT, IS THE PARTNER OF N, WHO IS A DIRECTOR IN P LTD. CAN B BE APPOINTED AS STATUTORY AUDITOR?

- a) He cannot be appointed an auditor of a limited company in India. He must be a chartered accountant within the meaning of the Chartered Accountants Act, 1949.
- b) Mrs. P can be appointed as an auditor of the company. There is no bar on a lady.
- c) Mr. Krishna is disqualified. He will be disqualified if he owes an amount in excess of Rs.5,00,000
- d) Ramu does not hold a COP and hence cannot be appointed as an auditor of a company.
- e) Mr. Nani, being of unsound mind, cannot continue himself to be a member of this Institute. Therefore, he cannot be appointed as the auditor of any company.
- f) Mr. Hrithik, being insolvent, cannot continue himself to be a member of this Institute. Therefore, he cannot be appointed as the auditor of any company.
- g) A Body Corporate cannot be appointed as Statutory Auditor of a Company. In the above case, the Company cannot be appointed as Statutory Auditor of another Company.
- h) A, being an Officer of the Company is disqualified. Also, M/s Balaji & Co., is not qualified to be appointed as auditor as one of its partners is an employee of the Company.
- i) B is not qualified to be appointed as auditor, as u/s 141, a person who is a partner of an officer of a Company cannot be appointed as its auditor.

Q.NO.12. B IS APPOINTED AS AN AUDITOR OF PQR LTD., AT A TOTAL REMUNERATION OF RS.10,00, 000, CLASSIFIED AS UNDER: (I) FOR UNIT X OF THE COMPANY RS.6,00,000; (II) FOR UNIT Y OF THE COMPANY RS.2,00,000 AND (III) FOR HEAD OFFICE RS. 2,00,000. AS PER TERMS OF APPOINTMENT, B CAN COLLECT HIS FEES ON PROGRESSIVE BASIS, ON COMPLETION OF AUDITS OF UNIT X AND /OR Y. B COMPLETED THE AUDIT OF UNIT Y AND RECOVERED RS.6,00,000 ON ACCOUNT OF THE AUDIT FEES THOUGH THE ENTIRE AUDIT IS NOT COMPLETED. EXPLAIN WHETHER B IS INDEBTED TO THE COMPANY FOR AN AMOUNT EXCEEDING RS. 5,00,000 AND THEREFORE DISQUALIFIED. (OR) WILL AN AUDITOR WHO RECEIVED THE AUDIT FEES FROM THE CO. ON PROGRESSIVE BASIS, IS CALLED INDEBTED.

Auditor cannot be said to be indebted to the Company at any stage if he recovers his fees on a progressive basis. As and when a part of the work is done, he can recover his fees in accordance with the terms of his engagement with the client, without waiting for the completion of the whole job. Hence, B is not indebted to the Company and is qualified to act as its Statutory Audit

Q.NO.13. MANAGING DIRECTOR OF PQR LTD. HIMSELF WANTS TO APPOINT SHRI GANPATI, A PRACTICING CHARTERED ACCOUNTANT, AS FIRST AUDITOR OF THE COMPANY. COMMENT ON THE PROPOSED ACTION OF THE MANAGING DIRECTOR.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 (the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company”. In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

Conclusion: In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

Q.NO.14. THE FIRST AUDITOR OF M/S HEALTHY WEALTHY LTD., A GOVERNMENT COMPANY, WAS APPOINTED BY THE BOARD OF DIRECTORS.

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 (the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company”. Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013. Hence in the case of M/s Healthy Wealthy Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditors made by the Board of Directors of M/s Healthy Wealthy Ltd is null and void.

Q.NO.15. NICKSON LTD. IS A SUBSIDIARY OF AJANTA LTD., WHOSE 20% SHARES HAVE BEEN HELD BY CENTRAL GOVERNMENT, 25% BY UTTAR PRADESH GOVERNMENT AND 10% BY MADHYA PRADESH GOVERNMENT. NICKSON LTD. APPOINTED MR. P AS STATUTORY AUDITOR FOR THE YEAR.

According to Section 139 (7) of the Companies Act, 2013, a Government company is defined “as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company as thus defined”. The auditors of a government company shall be appointed or reappointed by the Comptroller and Auditor General of India. In the given case Ajanta Ltd is a government company as its 20% shares have been held by Central Govt, 25% by U.P. State Government and 10% by M.P. State Govt. Total 55% shares have been held by Central and State governments. Therefore, it is a Government company.

Nickson Ltd. is a subsidiary company of Ajanta Ltd. Hence Nickson Ltd. covers in the definition of a government company. Hence the Auditor of Nicksons Ltd. can be appointed only by C & AG.

Therefore, appointment of ‘P’ is invalid and ‘P’ should not give acceptance to the Directors of Nicksons Ltd.

Q.NO.16. NO ANNUAL GENERAL MEETING (AGM) WAS HELD FOR THE YEAR ENDED 31ST MARCH, 2014, IN XYZ LTD., NINU IS THE AUDITOR FOR THE PREVIOUS 3 YEARS, WHETHER SHE IS CONTINUING TO HOLD OFFICE FOR CURRENT YEAR OR NOT.

Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting. But in this regard it is to be noted that the company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

In case the annual general meeting is not held within the period prescribed, the auditor will continue in office till the annual general meeting is actually held and concluded. Therefore, Ninu shall continue to hold office till the conclusion of the annual general meeting.

Q.NO.17. AT THE AGM OF ICI LTD., MR. X WAS APPOINTED AS THE STATUTORY AUDITOR. HE, HOWEVER, RESIGNED AFTER 3 MONTHS SINCE HE WANTED TO GIVE UP PRACTICE AND JOIN INDUSTRY. STATE, HOW THE NEW AUDITOR WILL BE APPOINTED BY ICI LTD AND THE CONDITIONS TO BE COMPLIED FOR. (OR)
MR. A WAS APPOINTED AUDITOR OF AAS LTD. BY BOARD TO FILL THE CASUAL VACANCY THAT AROSE DUE TO DEATH OF THE AUDITOR ORIGINALLY APPOINTED IN AGM. SUBSEQUENTLY, MR. A ALSO RESIGNED ON HEALTH GROUNDS DURING THE TENURE OF APPOINTMENT. THE BOARD FILLED THIS VACANCY BY APPOINTING YOU THROUGH DULY PASSED BOARD RESOLUTION. COMMENT.

Appointment of New Auditor in case of Resignation: Section 139(8) of the Companies Act, 2013 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr. X has been validly appointed and thereafter he had resigned.

The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the Board cannot fill in that vacancy itself, such appointment shall also be approved by the company at general meeting convened within three months of the recommendation of the board and then he shall hold office till the conclusion of the next annual general meeting.

In this case the casual vacancy has been created on account of resignation. Therefore, Board of Directors will have to fill the vacancy within thirty days and such appointment shall be approved by the company at the general meeting within three months of the recommendations of the board. . The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

Q.NO.18. M/S YOUNG & CO., A CHARTERED ACCOUNTANT FIRM, AND STATUTORY AUDITORS OF OLD LTD, IS DISSOLVED ON 1.4.2014 DUE TO DIFFERENCES OF OPINION AMONG THE PARTNERS. THE BOARD OF DIRECTORS OF OLD LTD. IN ITS MEETING ON 6.4.2014 APPOINTED ANOTHER FIRM M/S SHARP & CO. AS THEIR NEW AUDITORS FOR ONE YEAR.

Section 139(8) of the Companies Act, 2013 lays down that the Board of Directors may fill any casual vacancy in the office of an auditor provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall be filled in general meeting.

The expression “casual vacancy” has not been defined in that Act. Talking its natural meaning it may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firm etc. Furthermore Section 139(8) stipulates that any auditor appointed in a casual vacancy shall hold office until the conclusion of the next AGM.

In the instant case the action of the board of directors in appointing M/s Sharp & Co. to fill up the casual vacancy due to dissolution of M/s Young & Co., is correct. However, the board of directors are not correct in giving them appointment for one year. M/s Sharp & Co. can hold office until the conclusion of next AGM only.

Q.NO.19. NO RESOLUTION WAS PASSED BY A COMPANY FOR REMUNERATION OF THE RETIRING AUDITOR AT THE TIME OF HIS RE-APPOINTMENT.

If no resolution is passed for remuneration of the retiring auditor at the time of his re-appointment, the existing remuneration will continue.

Q.NO.20. "ABC & CO." IS AN AUDIT FIRM HAVING PARTNERS "MR. A", "MR. B" AND "MR. C", CHARTERED ACCOUNTANTS. "MR. A", "MR. B" AND "MR. C" ARE HOLDING APPOINTMENT AS AN AUDITOR IN 4, 6 AND 10 COMPANIES RESPECTIVELY.

1. PROVIDE THE MAXIMUM NUMBER OF AUDITS REMAINING IN THE NAME OF "ABC & CO."
2. PROVIDE THE MAXIMUM NUMBER OF AUDITS REMAINING IN THE NAME OF INDIVIDUAL PARTNER I.E. MR. A, MR. B AND MR. C.

Provisions and Explanations: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

As per section 141 (3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion: Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Mr. A can hold: $20 - 4 = 16$ more audits

Mr. B can hold $20 - 6 = 14$ more audits and

Mr. C can hold $20 - 10 = 10$ more audits.

Q.NO.21. KBC & CO. A FIRM OF CHARTERED ACCOUNTANTS HAS THREE PARTNERS, K, B & C; K IS ALSO IN WHOLE TIME EMPLOYMENT ELSEWHERE. THE FIRM IS OFFERED THE AUDIT OF ABC LTD. AND IS ALREADY HOLDING AUDIT OF 40 COMPANIES.

Ceiling on Number of Company Audits: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies. In the firm of KBC & Co., K is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. If B and C do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by KBC & Co., is forty, and in the given case company is already holding forty audits, therefore, KBC & Co. can't accept the offer for audit of ABC Ltd.

Q.NO.22. WHILE CONDUCTING THE AUDIT OF A LIMITED COMPANY FOR THE YEAR ENDED 31ST MARCH, 2014, THE AUDITOR WANTED TO REFER TO THE MINUTE BOOKS. THE BOARD OF DIRECTORS REFUSED TO SHOW THE MINUTE BOOKS TO THE AUDITOR.

Provisions and Explanation: Section 143 of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

Conclusion: In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

Q.NO.23. MR. B, STATUTORY AUDITORS OF SECRET LTD. WAS NOT PERMITTED BY THE BOARD OF DIRECTORS TO GIVE NOTICE OF ATTEND GENERAL MEETING OF THE COMPANY ON THE GROUND THAT HIS RIGHT TO RECEIVE NOTICE OF GENERAL MEETINGS IS RESTRICTED ONLY TO THOSE MEETINGS AT WHICH THE ACCOUNTS AUDITED BY HIM ARE TO BE PRESENTED AND DISCUSSED.

According to Section 146 of the Companies Act, 2013 the auditors of a company are under an obligation to attend any general meeting of the company and not only those meetings at which the accounts audited by them are to be presented and discussed.

In the instant case, the board of directors of Secret Ltd., have no right to restrict Mr. B from attending the general meeting and Mr. B has every right to attend such meeting as conferred by Section 146. Thus, the action of the board of directors is contrary to the provisions of law and curtails the right of the auditor.

Q.NO.24. A IS APPOINTED AS THE AUDITOR OF X LTD. ON 26TH JULY, 2014. HE INFORMS THE COMPANY THAT HE WILL VISIT ITS HEAD OFFICE ON AUGUST 15, 2014 (A HOLIDAY FOR THE COMPANY) AND EXAMINE THE CASH BOOK. THE ACCOUNTANT ARGUES THAT A SHOULD COME AFTER MARCH 31, 2015 WHEN THE ACCOUNTS ARE CLOSED. MOREOVER, HE SHOULD NOT COME ON A SUNDAY AS THE OFFICE IS CLOSED ON THAT DAY. IS THE POSITION TAKEN BY THE ACCOUNTANT LEGALLY CORRECT?

Facts of the case: A, auditor of X Ltd. want to visit head office on 15th Aug, Sunday. The accountant argues that A should come only after closure of accounts.

Provisions of law: Sec 143 – Right of an auditor.

Analysis: According to Sec 143 of the Companies Act, 2013, The auditor enjoys the right of accessibility to books of accounts and vouchers at all times because he has to mention in his report whether proper books of accounts and records are maintained.

The right can be exercised by the auditor at all times mean that Normal business hours on a working day and during the period of his office.

Thus, the auditor has access to books, etc, at all times. This implies that he can examine them at any time after assuming his office as the auditor and he need not to wait for the closing of the accounts i.e. March 31st, 2015.

However, the expression “at all times” refers to only the normal business hours on any working day.

Conclusion: A cannot examine the books on a holiday.

Q.NO.25. YOU HAVE NOT BEEN PAID THE FEES FOR AUDIT OF A COMPANY. YOU ARE ASKED BY THE MANAGING DIRECTOR OF THE COMPANY TO SEND HIM THE PAPERS RELATING TO THE TAX COMPUTATIONS OF HIS OWN PROPRIETORSHIP BUSINESS, THE TAXATION WORK OF WHICH IS LOOKED AFTER BY YOU. THE AUDITOR WANTS TO EXERCISE HIS LIEN.

Facts of the case: The auditor of a company exercised lien on papers of the taxation work done by him to the Managing Director for the non – receipt of fees for audit of the company.

Provisions of law & Analysis: The 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 guidelines to be followed while exercising this right are:

- a) Documents retained must belong to the client who owes the money.
- b) Documents must have come into possession of the auditor on the authority of the client.
- c) The auditor can retain the documents only if he has done work on the documents assigned to him.
- d) Such of the documents can be retained which are connected with the work on which fees have not been paid.

In the given case, the auditor of a company exercised lien on paper relating to tax computations of Managing Director's own proprietorship business for the non receipt of fees for audit of the company. The fees for which lien is exercised is in respect of some unrelated work.

Conclusion: The lien exercised by the auditor is not valid.

Q.NO.26. THE COMPANY HAD ALSO APPOINTED A COST AUDITOR AND THEREFORE, THE MANAGEMENT HAD REQUESTED YOU NOT TO REVIEW THE COST RECORDS. COMMENT.

As per Sec.128 of the companies Act the term books of accounts included the cost records and the auditor has the duty to state in the audit report u/s 143 whether proper books of accounts as required by law have been kept by the company.

Accordingly, the auditors cannot be requested not to review the cost records as a cost auditor has been appointed by the company. The statutory auditor's duties cannot be limited in any way either by the Articles or by the Directors or members. This is confirmed by the judgement given in Newton vs. Birmingham small arms co. case

Q.NO.27. AT THE ANNUAL GENERAL MEETING OF THE COMPANY, A RESOLUTION WAS PASSED BY THE ENTIRE BODY OF SHAREHOLDERS RESTRICTING SOME OF THE POWERS OF THE STATUTORY AUDITORS. WHETHER POWERS OF THE STATUTORY AUDITORS CAN BE RESTRICTED?

Restrictions on Powers of Statutory Auditors: Section 143 of the Companies Act, 2013 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner.

Hence, any such resolution even if passed by entire body of shareholders is ultra vires and therefore void.

Q.NO.28. THE AUDITOR OF TRILOK LTD. DID NOT REPORT ON THE MATTERS SPECIFIED IN SUB-SECTION (1) OF SECTION 143 OF THE COMPANIES ACT, 2013, AS HE WAS SATISFIED THAT NO COMMENT IS REQUIRED.

Section 143(1) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in non-reporting on the matters specified in Section 143(1).

Q.NO.29. M/S XYZ & CO., AUDITORS OF GOODWILL EDUCATION FOUNDATION, A RECOGNISED NONPROFIT ORGANISATION FEELS THAT THE STANDARDS ON AUDITING NEED NOT TO BE APPLIED AS GOODWILL EDUCATION FOUNDATION IS A NON-PROFIT MAKING CONCERN.

As per sub section 9 of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further as per sub section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:

Provided that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards. Further, the Preface to Standards on Auditing gives the scope of the Standards on Auditing. As per the Preface, the SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial statements/information of any entity; whether profit oriented or not and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.

Also while discharging their attest function; it is the duty of the Chartered Accountant to ensure that SAs are followed in the audit of financial information covered by their audit reports.

In the given case, even though the client is a non-profit oriented entity the SAs shall apply and the auditor shall be guilty of professional misconduct for failing to discharge his duty in case of non-compliance with SAs.

Q.NO.30. ONE OF THE DIRECTORS OF HITECH LTD. IS ATTRACTED BY THE DISQUALIFICATION UNDER SECTION 164(2) OF THE COMPANIES ACT, 2013.

Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under section 164(2) of the Companies Act, 2013. The auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by Section 164(2).

Since in this case, one of the director is attracted by disqualification under section 164(2) of the Act, the auditor shall state in his report as per section 143 about the disqualification of the particular director.

Q.NO.31. THE AUDITOR DOES NOT AGREE WITH AFFIRMATIONS MADE IN THE FINANCIAL STATEMENTS.

- a) The financial information contained in the financial statements represents affirmations made by the management in respect of various assets and liabilities included therein as to their valuation, existence, completeness, proper presentation and disclosure by the management to arrive at the final amounts being included in the financial statements.
- b) When the auditor does not agree with affirmations made in the financial statements he either issues a qualified or negative opinion, based on the seriousness of disagreement.
- c) It may be noted that in actual practice it is quite common to come across qualified reports while adverse reports are quite rare.

Q.NO.32. THE MEMBERS OF C. LTD. PREFERRED A COMPLAINT AGAINST THE AUDITOR STATING THAT HE HAS FAILED TO SEND THE AUDITORS REPORT TO THEM.

Dispatch of Auditor's Report to Shareholders: Section 143 of the Companies Act, 2013 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. In *Re Allen Graig and Company (London) Ltd.*, 1934 it was held that duty of the auditor after having signed the report to be annexed to a balance sheet is confirmed only to forwarding his report to the secretary of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

Q.NO.33. THE AUDITOR OF A LIMITED COMPANY HAS GIVEN A CLEAN REPORT ON THE FINANCIAL STATEMENT ON THE BASIS OF XEROX COPIES OF THE BOOKS OF ACCOUNTS, VOUCHERS AND OTHER RECORDS WHICH WERE TAKEN AWAY BY THE INCOME-TAX DEPARTMENT IN SEARCH UNDER SECTION 132 OF THE I.T. ACT, 1961.
(N15RTP)

The degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly. Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

Q.NO.34. URANUS LTD. HAS PURCHASED AND INSTALLED NEW MACHINERY DURING THE YEAR IN EXPECTATION OF INCREASED SALES. HOWEVER, NO PRODUCTION WAS MADE BY USING THE NEW MACHINE. THE DIRECTORS CONTEND THAT AS THE MACHINERY WAS NOT USED, NO DEPRECIATION NEEDS TO BE PROVIDED.

As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising out of use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the machinery was installed and made ready for production, it means it was intended to be used for the purpose of business. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for depreciation. Thus, depreciation in respect of this machinery ought to have provided in the accounts for the year under audit.

Thus, the auditor may suitably qualify the report stating that depreciation has not been provided.

Q.NO.35. M.N.P. COMPANY LTD. PURCHASED A MACHINERY FOR Rs 1 CRORE. THE STATE GOVERNMENT GRANTED THE COMPANY A SUBSIDY OF Rs 40 LAKHS TO MEET PARTIAL COST OF MACHINERY. THE COMPANY CREDITED THE SUBSIDY RECEIVED FROM THE STATE GOVERNMENT TO ITS PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED MARCH 31, 2014. COMMENT.

As per AS 12 “Accounting for Government Grants”, accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.

Following are two methods of presentation of grants related to specific fixed assets in financial statements as acceptable alternatives;

- a) Under the first alternative the grant is shown in the balance sheet as a deduction from the gross value of the assets concerned. The grant is recognized in profit and loss accounts over the useful life of the depreciable life of asset by way of a reduced depreciation charge.
- b) Under second alternative, it is treated as a deferred income which should be recognized in profit and loss account over useful life of asset in proportion in which depreciation will be charged on the assets concerned. Deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description i.e. Deferred Government Grant.

In the instant case, MNP Company Ltd received a subsidy from government worth Rs 40 lakhs towards meeting partial cost of machinery. The company credited the same to its profit & loss account. Accounting treatment of grant received towards partial cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report bringing out the quantification impact clearly.

Q.NO.36. MR. RAJENDRA, A FELLOW MEMBER OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA, WORKING AS MANAGER OF SHRIVASTAV AND CO., A CHARTERED ACCOUNTANT FIRM, SIGNED THE AUDIT REPORT OF OM LTD. ON BEHALF OF SHRIVASTAV & CO.

Facts of the case: Mr. Rajendra, a manager of Shrivastav and Co. signed the audit report on behalf of the firm.

Provisions of law: Sec 145 – Signature of audit report etc.

Analysis: Sec 145 of the Companies Act, 2013, requires that only a person appointed as the auditor of the company or where a firm is so appointed, a partner in the firm practicing in India, may sign the auditor’s report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

If any auditor’s report or any document of the company is signed or authenticated otherwise than in conformity with the requirements of Sec 145. The auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the documents shall, if the default is willful, be punishable with a fine.

In the given case, Rajendra signed the audit report on behalf of Shrivastav & Co, Where he is a manager. But according to the Sec 145, only any of the partners in the firm practicing in India can sign the audit report on behalf of the firm, when the firm is appointed.

Conclusion: The act of Rajendra is not valid.

Q.NO.37. Y, IS THE AUDITOR OF X PVT. LTD. IN WHICH THERE ARE FOUR SHAREHOLDERS ONLY, WHO ARE ALSO THE DIRECTORS OF THE COMPANY. ON ACCOUNT OF BAD TRADE AND FOR REDUCING THE EXPENSES IN ALL DIRECTIONS, THE DIRECTORS ASKED Y TO ACCEPT A REDUCED FEE AND FOR THAT HE HAS BEEN OFFERED NOT TO CARRY OUT SUCH FULL AUDIT AS HE HAS DONE IN THE PAST. Y ACCEPTED THE SUGGESTIONS OF THE DIRECTORS.

Restricting Scope of Audit: Y may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders.

There is no concept of full or part audit under Section 143 of the Companies Act, 2013. Further, remuneration is a matter of arrangement between the auditor and the shareholders. Section 142 specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

His duties may not necessarily commensurate with his remuneration. Y, therefore, should not accept the suggestions of the directors regarding the scope of the work to be done. Even if Y accepts the suggestions of the directors regarding the scope of work to be done, it would not reduce his responsibility as an auditor under the law. Under the circumstances, Y is violating the provisions of the Companies Act, 2013.

Q.NO.38. MR. A & MR.B HAVE BEEN CARRYING ON THE PROFESSION OF CHARTERED ACCOUNTANTS UNDER THE NAME OF M/S EXPERT STUDY & CO., SINCE 2013 UNDER A DEED OF PARTNERSHIP DATED 1.5.2012. C WAS INTRODUCED AS A PARTNER IN M/S EXPERT STUDY & CO., ON 09.09.14 AND THE NAME WAS CHANGED TO M/S NEW EXPERT STUDY & CO. DUE TO CHANGE IN NAME, IT IS CONTENDED BY A COMPANY "X LTD" (FOR WHICH EXPERT STUDY IS THE AUDITOR) THAT THE OLD FIRM CEASES TO BE THE AUDITORS OF THE COMPANY & NEW AUDITORS SHALL BE APPOINTED AT AN EGM. STATE YOUR OPINIONS WHETHER SUCH CONTENTION IS CORRECT.

Admission of a partner amounts to Reconstitution of the Firm. After reconstitution, it continues to carry on its profession and the firm is not dissolved as such. The audit Firm should communicate the change in its name to the Company under audit. The question of appointment of new auditors in an EGM does not arise.

Q.No.39. WHITE STAR LTD. WAS INCORPORATED ON 01.08.2014 AND MR. T, WHO IS A RELATIVE TO THE CHAIRMAN & MANAGING DIRECTOR (CMD) OF THE COMPANY, APPOINTED AS AUDITOR BY THE BOARD OF DIRECTORS IN THEIR MEETING ON 04.09.2014. COMMENT.

Appointment of First Auditors by the Board: Apparently, there are two issues arising out of this situation, viz., first one relates to appointment of first auditor by the Board of Directors; and second, pertains to relation of such an auditor with the Chairman of the company. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditors, it may be noted as per the provisions of Section 139(6) of the Companies Act, 2013, the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

As per the facts given in the case, the Board has failed to appoint the first auditor within 30 days from the registration of company because the date of incorporation of White Star Ltd. is 01-08-2014 and the date of appointment of auditors by the Board of Directors is 04-09-2014.

Accordingly if the Board fails to appoint the first auditor, it shall inform the members of the company, who shall within 90 days at an extraordinary general meeting has to make the appointment.

Thus the appointment of Mr. T is not valid. Under the circumstances, the second issue relating to relationship of auditor with the Chairman & Managing Director (CMD) becomes redundant.

Q.No.40. MR. Y WAS APPOINTED AS AN AUDITOR OF PQR LTD. FOR THE YEAR ENDED 31.3.2015 AT THE ANNUAL GENERAL MEETING HELD ON 16.08.2014. MR. Y HAS BEEN INDEBTED TO THE COMPANY FOR SUM OF RS 5,10,000 AS ON 01.04.2014, THE OPENING DATE OF ACCOUNTING YEAR WHICH HAS BEEN SUBJECT TO HIS AUDIT. HOWEVER, MR. Y HAVING COME TO KNOW THAT HE MIGHT BE APPOINTED AS AUDITOR, HE REPAID THE AMOUNT ON 10.8.2014. ONE OF THE SHAREHOLDERS, COMPLAINS THAT THE APPOINTMENT OF MR. Y AS AN AUDITOR WAS INVALID BECAUSE HE INCURRED DISQUALIFICATION U/S 141 OF THE COMPANIES ACT, 2013. COMMENT.

Indebtness to the Company: According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding Rs 5,00,000 shall be disqualified to act as an auditor of such company and he should vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, Mr. Y was appointment as an auditor of PQR Ltd. for the year ended 31.03.2015 at the Annual General Meeting held on 16.08.2014. He repaid the loan amount fully to the company on 10.8.2014 i.e. before the date of his appointment.

Hence, the appointment of Mr. Y as an auditor is valid and the shareholder's complaint is not acceptable.

Q.No.41. COMMENT ON THE FOLLOWING SITUATION.
ABC COMPANY LTD. REMOVED ITS FIRST AUDITOR BEFORE THE EXPIRY OF HIS TERM WITHOUT OBTAINING APPROVAL OF THE CENTRAL GOVERNMENT.

Removal of Auditor Before Expiry: As per sub-section (1) of Section 140 of the Companies Act, 2013, an auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the prior approval of the Central Government in that behalf as per Rule 7 prescribed under Companies (Audit & Auditors) Rules, 2014:

- i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
- ii) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- iii) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

In the instant case, the first auditor was removed by the company before the expiry of his term without obtaining approval of the Central Government.

Therefore, it may be concluded that the action of the company for removal of the auditor before expiry of term is not justified and auditor may be removed from his office only by following the above mentioned procedure.

QNo.42. The Board Of Directors Of A Company Have Filed A Complaint With The Institute Of Chartered Accountants Of India Against Their Statutory Auditors For Their Failing To Attend The Annual General Meeting Of The Shareholders In Which Audited Accounts Were Considered.

Fact: Statutory auditor failing to attend the annual general meeting of the shareholders.

Provision: Auditors to attend general meeting All notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.

Analysis: As per above provision it is the duty of the statutory Auditors to attend general meeting.

Conclusion: Statutory auditor failing to attend general meeting so, he is guilty of misconduct.

QNo.43. MR. A WAS APPOINTED AUDITOR OF AAS LTD. BY BOARD TO FILL THE CASUAL VACANCY THAT AROSE DUE TO DEATH OF THE AUDITOR ORIGINALLY APPOINTED IN AGM. SUBSEQUENTLY, MR. A ALSO RESIGNED ON HEALTH GROUNDS DURING THE TENURE OF APPOINTMENT. THE BOARD FILLED THIS VACANCY BY APPOINTING YOU THROUGH DULY PASSED BOARD RESOLUTION. COMMENT.

Filling of a Casual Vacancy: Section 139(8) of the Companies Act, 2013 provides that any casual vacancy in the office of an auditor shall be filled by the Board of Directors within 30 days. However, if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting. In the present case, the auditor Mr. A resigned and the vacancy had been filled in by Board. But, the vacancy caused by resignation cannot be filled by Board itself, such appointment shall also be approved by the company at general meeting. The fact that the Mr A was appointed by Board originally is a matter irrelevant in this situation. If the cause of vacancy is resignation, then the power of appointment shall vest with the general meeting only. As such, the appointment made by Board is invalid.

Q.NO.44. MR. ADITYA, A PRACTISING CHARTERED ACCOUNTANT IS APPOINTED AS A "TAX CONSULTANT" OF ABC LTD., IN WHICH HIS FATHER MR. SINGHVI IS THE MANAGING DIRECTOR. **(M16 – 2M)**

A chartered accountant appointed as an auditor of a company, should ensure the independence in respect of his appointment as an auditor, else it would amount to "misconduct" under the Chartered Accountants Act, 1949 read with Guidance Note on Independence of Auditors.

In this case, Mr. Aditya is a "Tax Consultant" and not a "Statutory Auditor" or "Tax Auditor" of ABC Ltd., hence he is not subject to the above requirements.

THE END

7. MISCELLANEOUS MATTERS IN COMPANY AUDIT

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	-	-	2	2	-	-	-	5	-	8	-	5	-	-	-	-	5	-	-	-
2.	A	-	-	-	2	-	-	-	-	-	-	-	-	-	-	2	-	-	-	-	-	-
3.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	-	-	6
9.	C	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	6
10.	C	NEWLY ADDED QUESTION																		-	-	-
11.	B				-															-	-	-
12.	B				-				4			4								-	-	-
13.	B				-															-	-	-
14.	B				-															-	-	-
15.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Write about Joint Auditor. (A)

(M10, N14 - 5M, PM, N14 RTP)

Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. The advantages of joint audit are:

- 1) Sharing of expertise
- 2) Lower workload
- 3) Better quality of performance
- 4) Improved service to the client
- 5) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- 6) A sense of healthy competition towards a better performance.

The general disadvantages may be the following:

- 1) Psychological problem where firms of different standing are associated in the joint audit.
- 2) General superiority complexes of some auditors.
- 3) Problems of co-ordination of the work.
- 4) Areas of work of common concern being neglected.
- 5) Uncertainty about the liability for the work done.

REFER PRACTICAL QUESTION – 1

Q.No.2. Write about Audit of Branch Office Accounts. (A)

Where a company has a branch office, the accounts of that office shall be audited either by

1. The auditor appointed for the company or
2. By any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or
3. where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

As per **the Companies (Audit and Auditors) Rules, 2014**, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

REFER PRACTICAL QUESTION – 2&3

Q.No.3. Write about Cost Audit. (B)

As per the section 148 the Central Government may by order specify audit of items of cost in respect of certain companies.

Who can be cost auditor: The audit shall be conducted by a Cost Accountant in Practice.

Provided that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records:

Appointment of Cost Auditor: As per rule 14 of the Companies (Audit and Auditors) Rules, 2014

- a) In the case of companies which are required to constitute an audit committee the Board shall appoint an individual, who is a cost accountant in practice, or a firm of cost accountants in practice, as cost auditor on the recommendations of the Audit committee, which shall also recommend remuneration for such cost auditor.
- b) The remuneration recommended by the Audit Committee under (i) shall be considered and approved by the Board of Directors and ratified subsequently by the shareholders;
- c) In the case of other companies which are not required to constitute an audit committee, the Board shall appoint an individual who is a cost accountant in practice or a firm of cost accountants in practice as cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.
- d) *Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said rules to appoint an Auditor within 180 days of the commencement of every financial year. Every referred company shall inform the cost auditor concerned of his or its appointment as such and File a notice of such with the central Government within a period of 30 days of the Board meeting in which such appointment is made or within a period of 180 days of the commencement of the financial year. Whichever is earlier, through electronic mode, in Form CRA-2 along with the feed as specified in companies (Registration offices and Fees) Rules, 2014.*
- e) *The cost auditor appointed as such shall continue in such capacity till the expiry of 180 days from the closure of the financial year, or till he submits the cost audit report, for the financial year for which he has been appointed.*
- f) *Casual Vacancy in the office of a cost Auditor: Any casual vacancy in the office of a cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30days of such appointment of cost auditor.*

Qualification, disqualification, rights, duties and obligations of Cost Auditor: Similar to the company auditor.

Q.No.4. Write about maintenance of cost records by certain class of companies. (A) (PM)

Companies (cost records and Audit) Rules 2014: The Central Government has notified the Companies (Cost Records and Audit) Rules, 2014 (amended dated 31st December, 2014) which prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc.

Maintenance of Cost Records: Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of Rs.35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

The said rule has divided the list of companies into regulated sectors and non-regulated sectors. Some of the companies/ industry/ sector/ product/ service prescribed under the said rule are given below:

a) Regulated Sectors –

- i) Telecommunication services made available to users by means of any transmission or reception of signs, signals, images etc. (other than broadcasting service) and regulated by the telecom Regulatory Authority of India.
- ii) Generation, transmission, distribution and supply of electricity regulated by the relevant regulatory body or authority under the Electricity Act, 2003, other than for captive generation.
- iii) Petroleum products regulated by the Petroleum and Natural Gas Regulatory Board.
- iv) Drugs and Pharmaceutical.
- v) Fertilisers.
- vi) Sugar and industrial alcohol.

b) Non-Regulated Sectors-

- i) Machinery and mechanical appliances used in defence, space and atomic energy sectors excluding any ancillary item or items.
- ii) Turbo jets and turbo propellers.
- iii) Tyres and Tubes.
- iv) Steel; Cement.
- v) Production, import and supply or trading of following medical devices, such as heart valves; orthopedic implants; pacemaker (temporary and permanent), etc. The rule excludes the foreign companies having only liaison offices.

As per Rule 5 of the companies (Cost Records and Audit) Rules, 2014, every company under these rules including all units and branches thereof, shall, in respect of each of its financial year, is required to maintain cost records in Form CRA – 1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.

Additionally, as per clause (vi) to Paragraph of the CARO, 2016, where maintenance of cost records has been specified by the Government under section 148(1) of the Companies Act, 2013, the auditor has to report whether such accounts and records have been made and maintained.

Q.No.5. Write about applicability of Cost Audit. (A)

(PM)

Applicability of Cost Audit: Rule 4 of the companies (Cost Records and Audit) Rules, 2014 states the provisions related to the applicability of the cost audit depending on the turnover of the company as follows:

Classes of companies specified under item (A) "Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is Rs.50 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is Rs.25 crore or more.

Classes of companies specified under item (B) "Non-Regulated Sectors" are required to get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is Rs.100 crore or more and the aggregate turnover of the individual product(s) or service(s) for which cost records are required to be maintained under rule 3 is Rs.35 crore or more.

Cost Audit Rules Not to Apply in Certain Cases: sub-rule(3) of rule 4 provides that the requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- i) Whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or
- ii) Which is operating from a special economic zone.

Q.No.6. Write about submission of cost Audit Report. (A)

Submission of cost Audit Report:

- i) To the Board of Directors of the Company The cost auditor shall submit the cost audit report along with his his reservations or qualifications or qualification or observations or suggestions, if any, in Form CRA-3. He shall forward his report to the Board of Directors of the Company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examines such report particularly any reservation or qualification contained therein.
- ii) To the Central government. The company shall within 30 days from the dated of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein in Form CRA-4 along with fees specified in the companies (Registration offices and Fees) Rules. 2014. If after considering the cost audit report and the information and explanation furnished by the company as above, the central Government is of the opinion that any further information or explanation is necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government

Duty to Report on fraud: The provisions of section 143(12) of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules.

Q.No.7. Write about Books of Accounts as per Company Act 2013. (B)

Maintenance of books of accounts [Section 128(1)]: Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which gives a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any.

1. The company shall be in a position to explain the transactions effected both at the registered office and its branches.
2. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Place of maintenance of books of accounts [Section 128(1)]:

1. The books of account and other relevant papers are required to be kept at the registered office of the company.
2. The company may also keep all or any of the books of accounts at any other place in India as the Board of directors may decide. In such a case, the company should file with the Registrar of Companies, a notice in writing giving the full address of that place within 7 days of the Boards' decision.

Electronic form of Books of accounts: The Companies (Accounts) Rules, 2014 provides that the company may keep its books of account or other relevant papers in electronic mode.

Proper Books of Account in relation to a Branch of the Company:

1. Proper books of account relating to the transactions effected at the branch office in India or outside India shall be kept at that branch office.
2. Proper summarised returns periodically must be sent by the branch office to the company at its registered office or the other place as decided by the Board of directors.

Persons who can inspect [Section 128(3) and (4)]: The books of account and other books and papers maintained by the company within India shall be open for inspection at the registered office of the company or at such other place in India by any director during business hours.

Period of Maintenance [Section 128(5)]: The books of account of every company together with the vouchers relevant to any entry in such books of accounts shall be kept in order by the company for a minimum period of 8 financial years immediately preceding a financial year.

REFER PRACTICAL QUESTION – 4

Q.No.8. Write about Financial Statements. (C)

(N07 – 4M)

1. The financial statements shall-
 - a) Give a true and fair view of the state of affairs of the company or companies,
 - b) Comply with the accounting standards notified under section 133 and
 - c) Shall be in the form or forms as may be provided for different class or classes of companies in Schedule III.
2. The above provisions relating to nature and content of financial statement shall not apply to following companies:
 - a) Insurance Companies
 - b) Banking companies
 - c) Company engaged in the generation or supply of electricity
 - d) Any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.
3. At every annual general meeting of a company, the Board of directors of the company shall lay before the company the financial statements for the financial year.
4. If the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements the following namely:
 - a) the deviation from the accounting standards,
 - b) the reasons for such deviation and
 - c) the financial effects, if any, arising out of such deviation
5. The financial statements, including consolidated financial statement, if any, shall be approved by the board of directors before they are signed on behalf of the board as per the provisions of section: 134.

(M16 – 6M)

- a) The chairperson of the company where he is authorised by the Board; or
- b) By two directors out of which one shall be managing director and
- c) The Chief Executive Officer, if he is a director in the company,
- d) The Chief Financial Officer, wherever he is appointed; and
- e) The company secretary of the company, wherever he is appointed.

Similar Question: State the disclosure required to be made in the financial statements if these do not comply with the accounting standards. (PM, M15 RTP)

Ans: Refer Para - 4.

Q.NO.9. Write short notes on Directors Responsibility Statement (DRS)? (C)
(M16 – 6M, PM, M15 RTP)

Sec 134 (5): The Directors' Responsibility Statement shall state that—

1. In the preparation of the annual accounts, the **applicable accounting standards** had been followed along with proper explanation relating to material departures;
2. The directors had selected such **accounting policies** and applied them consistently and made **judgments and estimates** that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
3. The directors had taken proper and sufficient care for the maintenance of **adequate accounting records** in accordance with the provisions of this Act, for **safeguarding the assets** of the company and for preventing and detecting fraud and other irregularities;
4. The directors had prepared the annual accounts on a **going concern** basis, the directors, in the case of a listed company, had laid down **internal financial controls** to be followed by the company and that such internal financial controls are adequate and were operating effectively.
5. The directors had devised proper **systems to ensure compliance with the provisions** of all applicable laws and that such systems were adequate and operating effectively.

Q.NO.10.National Financial Reporting Authority: Constitution and Functions Sec 132. (C)

Establishment: As per Sec 132(1) The Central Government may by way of notification constitute a National Financial Reporting Authority to provide for matters relating to accounting and auditing standards under this Act.

Functions:

The National Financial Reporting Authority shall -

- a) Make recommendations to the Central Government on the formulation and laying down of accounting and auditing policies and standards for adoption by companies or class of companies or their auditors, as the case may be;
- b) Monitor and enforce the compliance with accounting standards and auditing standards in such manner as may be prescribed;
- c) Oversee the quality of service of the professions associated with ensuring compliance with such standards, and suggest measures required for improvement in quality of service and such other related matters as may be prescribed; and
- d) Perform such other functions relating to clauses (a), (b) and (c) as may be prescribed.

Members: The National Financial Reporting Authority shall consist of a chairperson, who shall be a person of eminence and having expertise in accountancy, auditing, finance or law to be appointed by the Central Government and such other members not exceeding fifteen consisting of part-time and full-time members as may be prescribed.

Q.No.11. What are the payments controlled by the companies Act 2013? (B)

Payments controlled by the Companies Act, 2013: Under section 180, the Board of Directors of a company with the consent of the company by a special resolution shall exercise the following powers.

1. To sell, lease or otherwise dispose of the whole or substantially the whole of the undertaking of the company or where the company owns more than one undertaking, of the whole or substantially the whole of any of such undertakings.
2. To invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation;
3. To borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed aggregate of its paid-up share capital and free reserves, apart from temporary loans obtained from the company's bankers in the ordinary course of business:
Provided that the acceptance by a banking company, in the ordinary course of its business, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise, shall not be deemed to be a borrowing of monies by the banking company within the meaning of this clause.
4. To remit, or give time for the repayment of, any debt due from a director.

Q.No.12. Write about Restrictions on Charitable Contribution by Board of Directors? (B)

Under section 181, the Board of Directors of a company can contribute to the bonafide charitable and other funds any amount in any financial year. Prior permission of the company in general meeting is required in case if the aggregate of such contribution exceeds 5% of its average net profits for the three immediately preceding financial years.

REFER PRACTICAL QUESTION – 5

Q.No.13. What is the prohibition and restriction regarding political contributions. (B)

Section 182 deals with prohibition and restriction regarding political contributions.

According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, contribution in any financial year should not exceed $7\frac{1}{2}\%$ of average net profits during the three immediately preceding financial years.

Q.No.14. Write about contributions to the National Defense Fund. (B)

Section 183 permits the Board and other person to make contributions to the National Defense Fund or any other Fund approved by the Central Government for the purpose of National Defense to any extent as it thinks fit.

Q.No.15. What are the punishments for non-compliance?

Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:

1. If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.

2. If an auditor of a company contravenes any of the provisions of section 139 section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees:

Provided that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

3. Where an auditor has been convicted under sub-section (2), he shall be liable to:-

- i) Refund the remuneration received by him to the company;
- ii) And pay for damages to the company statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

3A. The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

4. Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in an fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil criminal as provided in this Act or in any other law for the time being in force, for such act shall be the partner or partners concerned of the audit firm and of the firm jointly and severally.

PRACTICAL QUESTIONS

Q.NO.1. E AND S WERE APPOINTED AS JOINT AUDITORS OF X AND Y LTD. WHAT WILL BE THEIR PROFESSIONAL RESPONSIBILITY IN A CASE WHERE THE COMPANY HAS CLEVERLY CONCEALED CERTAIN TRANSACTIONS THAT ESCAPED THE NOTICE OF BOTH THE AUDITORS?

In conducting a joint audit, the auditor(s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit. The principles laid down in SA 200, SA 240 and SA 299 need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However, in this case, if it can be assumed that the joint auditors E and S have exercised reasonable care and skill in auditing the accounts of X & Y Ltd. and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence. However, if such concealment could have been discovered by the exercise of reasonable care and skill, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.

Q.NO.2. M/S. SEEMAN & CO. HAD BEEN THE COMPANY AUDITOR FOR AMUDHAN COMPANY LIMITED FOR THE YEAR 2013-14. THE COMPANY HAD THREE BRANCHES LOCATED AT CHENNAI, DELHI AND MUMBAI. THE AUDITS OF BRANCHES-CHENNAI, DELHI WERE LOOKED AFTER BY THE COMPANY AUDITORS THEMSELVES. THE AUDIT OF MUMBAI BRANCH HAD BEEN DONE BY ANOTHER AUDITOR M/S VASAN & CO.,

A LOCAL AUDITOR SITUATED AT MUMBAI. THE BRANCH AUDITOR HAD COMPLETED THE AUDIT AND HAD GIVEN HIS REPORT TOO. AFTER THIS, BUT BEFORE FINALIZATION, THE COMPANY AUDITOR WANTED TO VISIT THE MUMBAI BRANCH AND HAVE ACCESS TO THE INVENTORY RECORDS MAINTAINED AT THE BRANCH. THE MANAGEMENT OBJECTS TO THIS ON THE GROUNDS OF THE COMPANY AUDITOR ARE TRANSGRESSING THE SCOPE OF AUDIT AREAS AGREED. COMMENT.

1. The audit of the branch of a company is dealt with in Section 143(3) of the Companies Act, 2013. According to this section, the audits of the branches can be done by the company auditor himself or by another auditor. Even where, the branch accounts are audited, the company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor.
2. He has also right of access at all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the report of the branch auditor in framing his main report. He will disclose how he had dealt with the branch audit report.
3. In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor.
4. Applying the above provisions, to the instant case, management's objection that the company auditor is transgressing the scope of audit areas agreed, is absolutely, wrong. The right of company auditor in visiting and accessing the records of branch cannot be forfeited. Even where the branch accounts are audited by another local auditor, the company auditor has right to visit the branch and can have access to the books and vouchers of the company maintained at the branch office.

Q.NO.3. DURING THE YEAR 2013-14, IT WAS DECIDED FOR THE FIRST TIME THAT THE ACCOUNTS OF THE BRANCH OFFICE OF AAS COMPANY LIMITED BE AUDITED BY QUALIFIED CHARTERED ACCOUNTANTS OTHER THAN THE COMPANY AUDITOR. ACCORDINGLY, THE BOARD HAD APPOINTED BRANCH AUDITORS FOR THE ENSUING YEAR. ONE OF THE SHAREHOLDERS COMPLAINED TO THE CENTRAL GOVERNMENT THAT THE APPOINTMENTS WAS NOT VALID AS THE BOARD OF DIRECTORS DO NOT HAVE POWER TO APPOINT AUDITORS, BE THEY COMPANY AUDITOR OR BRANCH AUDITORS?

1. **Appointment of Branch Auditor:** The Companies Act, 2013 leaves it to the company to designate or not to designate any establishment of the company as 'branch office'. Under the Companies Act, 2013, only establishment "described as such by the company" shall be treated as a 'branch office'. Further, as per Section 143(8) of the Companies Act, 2013, where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed: Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.
2. Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

3. The shareholders in general meeting, instead of appointing branch auditor, may authorize the board of directors to appoint branch auditors.
4. In the present case, the board has appointed branch auditors without obtaining authorization from the shareholders in general meeting. The board had appointed the auditor where it did not have authority to do so. As such, the appointment is invalid. The shareholder's complaint is right.
5. The branch auditor should ascertain before accepting the audit whether his appointment is valid.

Q.NO.4. X LTD. HAS ITS REGISTERED OFFICE AT MUMBAI. DURING THE CURRENT ACCOUNTING YEAR IT SHIFTED ITS CORPORATE OFFICE TO DELHI. THE MANAGING DIRECTOR OF THE COMPANY WANTS TO SHIFT COMPANY'S BOOKS OF ACCOUNT TO DELHI BECAUSE HE HOLDS THE VIEW THAT THERE IS NO LEGAL BAR IN DOING SO.

1. As per section 128(1) of The Companies Act 2013, every company shall keep at its registered office proper books of accounts. It is permissible, however, for all or any of the books of accounts to be kept at such place in India as the Board of Directors may decide but, when a decision in this regard is taken, the company must file within seven days of such decision with the Registrar of Companies a notice in writing giving full address of the other place.
2. In view of the above provisions, X Ltd should maintain its books of account at its registered office at Mumbai. The Managing Director is not allowed to shift its books of account to Delhi unless decision in this behalf is taken by the Board of Directors and a notice is also given to the Registrar of Companies.

Q.NO.5. XYZ LTD. CO. GAVE A DONATION OF Rs 50,000 EACH TO A CHARITABLE SOCIETY RUNNING A SCHOOL AND A TRUST SET UP FOR THE SERVICE OF BLIND DURING FINANCIAL YEAR ENDING ON 31ST MARCH, 2014. THE AVERAGE NET PROFITS OF THE COMPANY FOR THE LAST THREE YEARS WERE 15 LAKHS. COMMENT. **(N14 RTP)**

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

Facts of the case: In the instant case, the company has given donation of Rs 50,000/- each to the two charitable organisations which amounts to Rs 1,00,000. Assuming that the charitable organisations are not related to the business of the company, the average profits of the last 3 years is Rs15 lakhs and the 5% of this works out to Rs 75,000. Hence the maximum of donation could be Rs 75,000 only. For excess of Rs 25,000 the company is required to take prior permission in general meeting which is not been taken.

Conclusion: By paying donations of Rs 1,00,000 which is more than Rs 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence the auditor should qualify his report accordingly.

Q.NO.6. Janta Ltd. has made a contribution of RS 7.8 lacs during the financial year ended 31.3.15 to Samaj Seva Party, a political party, for running a teaching institute situated in the rural area, where most of the workers of the company reside. It is admitted that the benefit of the institute is mostly for the children of the workers of the company. The average net profit of the company during the three immediately preceding financial years was RS 100 lakhs. Comment.

Restrictions Regarding Political Contribution: Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, aggregate contribution in any financial year should not exceed $7\frac{1}{2}$ % of average net profit during the three immediately preceding financial years.

In the given case, Janta Ltd. has made a contribution of RS 7.8 lacs to Samaj Seva Party, a political party. The average net profit of the company during the three immediately preceding financial years is RS 100 lakhs and the $7\frac{1}{2}$ % of this works out to RS 7.5 lacs.

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

Q.NO.7. Ganga-Kaveri Project Ltd. was incorporated on 1.7.2014. During the year ended 31.3.2015 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore, the Chief Accountant of the company contends that for the relevant year there was no need to prepare a Statement of Profit and Loss or any other statement except a Balance Sheet as at 31.3.2015. Comment.

Preparation of Financial Statements: Section 128 of the Companies Act, 2013 requires every company to prepare its financial statements for every financial year which gives a true and fair view of the state of the affairs of the company and such books shall be kept on accrual basis, and according to the double entry system of accounting. Further, the definition of “financial statement”, given under section 2(40) of the Companies Act, 2013, includes balance-sheet, statement of profit and loss, cash flow statement, a statement of change in equity if applicable and explanatory note as annexure. In the given case, Ganga - Kaveri Project Ltd. did not carry any manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery, etc. Though the company did not carry any manufacturing or trading activity, the company has carried on certain activities like construction of factory shed, acquisition of plant and machinery, etc. In such a case, it is necessary to provide for depreciation and other expenses.

The mere fact that there was no manufacturing or trading activity cannot be the basis for not preparing the Statement of Profit and Loss. Therefore, the contention of the Chief Accountant is not correct.

THE END

8. SPECIAL AUDIT

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	8	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	B	-	-	5	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	6
3.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	6	-	-
4.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	A	-	-	-	-	6	-	-	-	-	-	-	-	8	-	-	-	-	8	-	-	-
6.	A	-	-	-	-	-	-	-	-	-	8	-	8	-	-	-	8	-	-	-	-	-
7.	A	-	10	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-	-	-	-
8.	A	-	-	-	-	-	6	-	-	-	-	8	-	-	8	-	-	-	-	-	-	-
9.	A	-	-	-	-	-	6	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-
13.	B	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-
14.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15.	B	-	-	-	5	-	-	-	-	-	4	-	-	-	-	8	-	-	-	-	-	-
16.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
17.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	4	-	6

The answers in this chapter are very lengthy. Some questions contain 40 points. However in examination it's not required to write all the points listed here. The question will be asked for a maximum of 8 marks, it will be sufficient if we can write 12 points in our answer.

The answers given below are divided into two parts those in italics and the ones in normal font. The italics represent those points which are very common in every question. The ones in normal font represent the specific points in each question. The students should try to concentrate more on specific points and present them in the examination. The more we concentrate on the special points, the better will be our answer and thus the marks we get.

Q.No.1. "Audit of the accounts of the sole-proprietor is not compulsory. However, he may get his books audited for various reasons". Comment. (B) (N 91, M 06 - 8M, PM)

The various benefits, which may attract the sole proprietor to get his books audited:

- a) The audit helps in detecting frauds and errors.
- b) The visit by auditor acts as a moral check on the employees.
- c) Audited/reliable information is available to the proprietor and therefore he/she is able to take more accurate decisions.
- d) The sole proprietor will be very much benefited by the suggestions given by the auditor, with regard to the system of accounts, internal controls and checks over employees etc,
- e) The audited accounts may help considerably in case a tax audit is required.
- f) Banks generally rely on audited accounts even in case of proprietary concerns.
- g) Insurance companies also rely on audited accounts, in case of any insurance claims.
- h) At the time of sale of the business, audited accounts would be more useful for deciding the purchase consideration.

- i) At the time of admission of a new partner, audited accounts would be more useful for determining the value of goodwill.

Since it is a non statutory audit the sole trader has the right to decide the scope of audit.

Letter of engagement: The issuing of this letter, in case of non-statutory audit, is highly recommended, as there is no requirement of audit by any act, due to which the possibility of misunderstanding is greater.

Conclusion: The audit of the accounts of sole proprietor is not compulsory under any statute. However, various benefits would accrue to the sole proprietor if he gets his accounts audited.

Similar Questions: How the audit is advantageous to Sole Trader? (PM)

Q.No.2. Mention any eight special points which you as an auditor would look in to while auditing the books of a partnership firm? (B) (M03, 07, 13 - 8M, M16-2M PM)

Special Points in Audit of a Partnership Firm: Matters which should be specially considered in the audit of accounts of a partnership firm are as under:

- a) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- b) Examine the partnership deed signed by all partners and its registration with the registrar of firms. Also ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.
- c) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorization of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other such matters which are not of a routine nature.
- d) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
- e) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
- f) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreement.
- g) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
- h) Also see various requirements of legislations applicable to the partnership firm like Section 44(AB) of the Income-tax Act, 1961 have been complied with.

Q.No.3. You are approached by a partnership firm to list out the advantages that will accrue to them, if the accounts are audited. State five important advantages. (C) (M15 - 6M, PM, N14 RTP)

Advantages of audit of accounts of a partnership firm: Advantages are as follows (any five):

- a) Audited accounts provide a convenient and reliable means of settling accounts between the partners and thereby possibility of dispute among them is mitigated.
- b) On the retirement/death of a partner, audited accounts constitutes a reliable evidence for computing the amount due to the retiring partner or representative of deceased partner.
- c) Audited accounts are generally accepted by the Income tax authorities for computing the assessable income.

- d) Audited accounts are relied upon by banks for advancing loan.
- e) Audited accounts can be helpful in the negotiation for sale or admission of a new partner.
- f) It is an effective safeguard against any undue advantage being taken by a working partner as against the non working partners.

Similar Questions: You are approached by a partnership firm to list out the advantages that will accrue to them, if the accounts are audited. State five important advantages. (PM)

REFER PRACTICAL QUESTIONS: 1

Q.No.4. You have been appointed as an auditor of a small company. What, in your opinion, would be the auditor's duties and responsibilities towards audit problems of such a company? (B)
(N 92 - 4M)

The duties and responsibilities of Auditor and the essential features of audit remain the same, irrespective of the size of the Company under Audit. The following points may be noted for a small Company.

1. Satisfactory accomplishment of the audit work can be achieved only by skilful adaptation and application of the principles of auditing to the individual case.
2. The relationship of the Auditor, with the Directors, is generally informal. Hence, the arrangement and scope of the work should be clearly defined and recorded.
3. At the time of engagement, the Auditor should explain to the Directors, Management's responsibilities for the preparation of the accounts and establishing a system of internal control appropriate to the needs of the business. The Auditor's need to rely on the internal control system should be documented in the letter of engagement.
4. For a small company, the internal control system may not be fully operational, due to the reasons like - (a) substantial domination of accounting and financial functions by one person, and (b) lesser number of employees. Internal controls in a small company may be effective for its primary purpose as a check for management use, but they would be defective as a check on Management itself. (M 11 - 4M)
5. Due to inherent limitations of internal control, it is necessary to perform detailed audit procedures and rely more on Management Representations. Before signing the report, a letter of representation on the company's letterhead addressed to the Auditor should be obtained. The purpose of this representation is to place on record, the representations of the Management on significant matters affecting the accounts such as the ownership and basis of stating the amount of assets, liabilities and contingent liabilities.
6. The Auditors must consider whether the examination of the records of the company, the evidence available to him and the knowledge of all the circumstances affecting the company are consistent with and support the representations of management for which direct confirmatory evidence is not available.
7. If the Auditor forms an opinion that the records are adequate and have been properly maintained, he may place reliance on them as a basis for the preparation of accounts showing a true and fair view. However, if he is not able to do this, it will be necessary for him to state his reservations clearly in the Audit report.

Q.No.5. What special steps are involved in conducting the audit of a college? (or) Educational institutions (college, school or university) (A)
(N 95, 04, 14, M 00, 07 - 16M, M 12 - 8M, PM, N15 RTP, N14 MTP1 - 8M)

1. Examine the bye laws, minutes of the meetings of the Managing Committee or Governing Body of school or college etc. In the case of a university, refer to the Act under which such university was formed.

2. Check the fees received by comparing counterfoils issued to the students with the entries in the Cash Book.
3. Trace the names entered in the Students Fee Register with the respective Class Registers and test the amount of fees charged.
4. See that the fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
5. Check that the admission fee has been credited to a Capital fund.
6. See the free studentship and concession have been granted by a person authorised to do so and it is in accordance with the rules prepared by the Managing Committee.
7. Also reconcile amount of total fees receivable with the fees collected and that of outstanding.
8. If the institution has hostel facilities for students, the auditor should verify the bills raised for accommodation charges, electricity charges etc. are in accordance rules.
9. See the Register of students to ascertain the students dues, which are in arrear and enquire whether necessary steps have been taken for their recovery.
10. Verify any government or local authority grant received with the order passing the grant and see that any grants granted for a special purpose have been utilised for that purpose.
11. If some donations were meant for any specific purpose, see that the money was utilised for the same purpose.
12. Verify rental income from any property let out (Like canteens, banks etc.) with the rent agreements.
13. See whether the share income is properly received from the respective sources as per the agreement. **Ex:** Share from the cycle stand, canteen.
14. In case canteen is maintained by college itself, ascertain the system of issue of provisions, food stuff and other equipment is efficient and all bills are duly authorised and passed before payment.
15. Vouch purchase of sports items, furniture, books etc. and trace their entries into the respective stock registers.
16. Verify the inventories of furniture, stationery, books etc. These should be checked by reference to Stock Register and Values applied to various items should be test checked.
17. **Library:**
 - a) Examine the rules and regulations relating to the purchase of books, their accounting and safe custody in the library.
 - b) Examine the rules relating to recovery of costs of books issued to teachers or students in case these are lost.
 - c) Examine the inventory of the library books and see the method of disposing of discarded or outdated books.
18. Confirm that the refund of taxes deducted from the income from investment (interest on securities etc.) has been claimed and recovered since generally these institutions are exempted from the payment of income tax.
19. **Fund disclosures:** Verify that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel fund etc.

Similar Questions: Mention the special steps involved in the audit of an Educational Institution. (PM)

REFER PRACTICAL QUESTIONS: 2, 3 & 8.

Q.No.6. Audit of club. (A)

(M 91, N 97, 99 - 16M, N13 – 8M, PM, N15 MTP1 - 6M)

The special steps involved in such an audit are stated below:

1. **Legal status:** A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 2013, relating to the audit of accounts of companies, are also applicable to its audit.
2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions to see that these have been duly complied with.
3. Vouch the receipt on account of entrance fees with member's applications & see that it is capitalised.
4. See the free membership and concession have been granted by a person authorised to do so and it is in accordance with the rules prepared by the Managing Committee.
5. Vouch member's subscriptions with the counterfoils of receipt issued to them, trace the receipts for a selected period to the Register of Members.
6. Check the subscriptions received by comparing counterfoils/duplicates of receipts issued to the members with the entries in the Cash Book.
7. Also reconcile the amount of total subscriptions receivable with the subscriptions collected and subscriptions outstanding.
8. See that the subscriptions paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
9. See the Register of Members to ascertain the Member's dues, which are in arrear and enquire whether necessary steps have been taken for their recovery.
10. Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis etc.
11. **Purchases:**
 - a) **Sports items:** Vouch purchases of sports items, furniture, crockery, etc. and trace their entries into the respective stock registers.
 - b) **Food items:** Vouch purchases of foodstuffs, cigars, wines, etc. and trace their entries into the respective stock registers.
12. Check the stock of furniture, sports material, food items etc. physically with the respective stock registers.
13. Refer to property and investment registers to see that all the income that should have been recovered by way of rents from properties, dividend, and interest on securities etc. has been collected.
14. Vouching gross receipts and outgoings in respect of any special functions, E.g. concerts, dramatic performance, etc.

Similar Questions: Draft an Audit Programme to audit the accounts of a Recreation Club with facilities for indoor games and in-house eating. (PM)

Q.No.7. Audit of a cinema theatre. (A)

(M 93, N 98, 06 - 10 M, M 11 - 8M, PM)

The special steps involved in its audit are stated below:

1. Verify whether, at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
2. Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements.

3. Verify the cash collection separately for benefit shows.
4. Verify whether free passes are issued under proper authority.
5. Verify that the charges collected for advertisement slides are in line with the agreement entered with the advertisers in this regard.
6. Verify the payments made for film hire with the bills of distributors and the concerned agreements.
7. Ensure that expenses of painting, decoration, renovation of building etc. are properly checked.
8. Confirm that depreciation on machinery and furniture has been charged at a higher rate, as compared to the similar assets used in other businesses.
9. Examine whether the unadjusted balance out of advances paid to the film distributors against film hire contracts to see that they are good and recoverable. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
10. See that the share income is properly received from the respective sources as per the agreement.

Ex: Share from canteen, cycle stand.

- a) In case the cycle stand is run by the Cinema hall, its accounts should be checked.
- b) In case the canteen is run by the Cinema hall, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cool drinks, etc.

Similar Question: Draft an audit programme to audit the receipts of a cinema theatre owned by partnership firm. (PM)

Similar Questions: What special steps are involved in audit of a Cinema Hall?

(PM, N14 MTP2 - 8M)

REFER PRACTICAL QUESTIONS: 11

Q.No.8. Audit of hospital. (A)

(N 90 - 16M, M 93, 96, 98, 02, 08 - 10 M, M 11,14, N 12 - 8M, PM, N15 MTP2 - 8M)

1. **Legal Status:** See the relevant documents to ascertain whether the hospital is a Company, proprietary concern, partnership, co-operative society etc.
2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions to see that these have been duly complied with.
3. Check that the cash collections are entered in the cash book, with the receipt counterfoils and other evidences as regards amounts having been collected, e.g. copies of patient's bills.
4. Ascertain that Grants and donations received for a specific purpose have been so applied.
5. Check whether the outpatient register is maintained and trace the names of such patients in the cash book. Also check whether the rates adopted for billing are the approved management rates.
6. See that free check up or concession have been granted by a person authorised to do so and it is in accordance with the rules prepared by the Managing Committee.
7. Check the bills raised on the in-patients and see whether the rates adopted for the room rents etc are as per the management approved rates.
8. Where the operation theatre facilities are used by outside doctors and consultants check whether the theatre charges are collected.

9. Lab receipts:

- a) See that the share income is properly received from the respective sources as per the agreement.
 - b) In case this is run by the hospital, its accounts should be checked.
10. See that the share income is properly received from the respective sources as per the agreement. **Ex:** Share from canteen receipts, pharmacy receipts.
- a) In case the Canteen is run by the hospital, its accounts should be checked.
 - b) In case the pharmacy is run by the Hospital, its accounts should be checked.
11. Verify whether the internal check as regards the issue and receipts of stores, medicines, apparatus, clothing, instruments etc. and see that purchases have been made properly recorded in the stock register and issues have been made only against proper authorisation.
12. Check the stock of stores, medicines, apparatus, clothing, furniture etc. physically with the respective stock registers.
13. See that the collections on account of the sale of the old furniture & surgical equipments are duly supported by evidences such as quotations, cash receipt etc.
14. Inspect the shares and bonds in respect of investments & also ascertain that the arrangements for their safe custody are satisfactory.
15. Refer to property and investment registers to see that all the income that should have been recovered by way of rents from properties, dividend, & interest on shares & securities etc. has been collected.
16. Verify the agreements, registration with regard to affiliation to colleges with the hospital.
17. Verify the cash collections and relevant expenses on the occasions of seminars conducted by the hospital.

Similar Questions: What steps would you take in to consideration in Auditing the receipts from patients of a Hospital? (PM)

Ans: write only receipts points.

REFER PRACTICAL QUESTIONS: 10

Q.No.9. Audit of hotels. (A)	(N 89, 09, M 91, 94, 05 - 10M, PM, N14 MTP1 - 8M)

1. **Legal status:** A big hotel is usually constituted as a company. Therefore, various provisions of the Companies Act, 2013 relating to the audit of accounts of companies are also applicable to its audit.
2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions to see that these have been duly complied with.
3. Pilfering is one of the greatest problems in any hotel and the implementation of good internal control is very much needed. Therefore, auditor should evaluate the implementation of internal control system in the following areas:
 - a) Collection of cash from different collection points.
 - b) Procedures regarding billing the customer.
 - c) Procedures for purchase of various stocks.
 - d) Procedures for recording & physical custody of edibles, wines, cigars, cigarettes, crockery, cutlery, linen, furniture, carpets etc.
4. **Verification of Stocks:**
 - a) The stocks in a hotel are both portable and easily saleable particularly the food and beverages

- b) Therefore it is important that all movements and transfers of such stocks should be properly documented.
 - c) The areas where stocks are kept should be locked under the supervision of the departmental manager.
 - d) The auditor should see that the movement of goods takes place only after proper authorisation and recording.
5. It is in general that many hotels operate largely with the help of casual Labour & the auditor should see whether adequate records have been maintained in this respect or not. The auditor should see that manipulation on this account did not take place.
6. **Compliance with Statutory Provisions & Conditions:**
- a) All big hotels are governed by various rules and regulations by different authorities. The Department of Tourism also prescribes various conditions to be complied.
 - b) Since it is very common in big hotels to have the facility of exchanging foreign currency into Indian Rupees, the auditor should see that the various applicable provisions of Foreign Exchange Management act, 1999 have been complied with.
 - c) Compliance with conditions of license for running the hotel should also be seen.
7. In general the hotels get their bookings through travel agents. The auditor should see that:
- a) Money is recovered from travel agents as per the terms of credit allowed &
 - b) Commission, if any, paid to travel agents should be checked by reference to the agreement on that behalf.
8. Compare the occupancy rate of the hotel with the same for the previous year and also with the same for similar hotels in the city.
9. Verify the restaurant bills with reference to KOT (Kitchen Order Ticket).
10. Check the billing's made to customer's which should be based on approved tariffs & see that billing is correct according to the dates of arrival and departure recorded in the Guest Register.
11. Check the billing's made to customer's on sampling basis to see that the consumption shown in the various physical stock accounts have been billed for.
12. Vouching gross receipts and outgoings in respect of any special functions, E.g. concerts, dramatic performance, etc.

Similar Questions: What special steps will you take into consideration in auditing the accounts of a hotel? (PM)

Q.No.10. Audit of charitable institution. (A)	(M 92, 07 - 16M, PM)

1. **Legal Status:** It is usually constituted either as a company limited by guarantee or as a society. Therefore, various provisions of the Companies Act, 2013 or Societies registration act, 1860 relating to the audit of accounts are also applicable to its audit.
2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions to see that these have been duly complied with.
3. **Subscriptions:**
 - a) See that receipts are issued on receipt of subscriptions.
 - b) See whether the subscriptions collected is as per the rules designed by the managing committee or governing body.
 - c) Examining the system of internal check regarding moneys received from box collections, flag days, etc.
 - d) See whether adequate control is imposed over unused receipt books.

4. Verify any government or local authority grant received with the order passing the grant and see that any grants granted for a special purpose have been utilised for that purpose.
5. If some donations were meant for any specific purpose, see that the money was utilised for the same purpose.
6. Refer to investment registers to see that all the income that should have been recovered by way of dividend & interest on shares & securities etc. has been collected.
7. See that the rental income from the properties let out is properly collected as per the tenancy agreements and report any deviations to the management committee. Also check whether such income is properly accounted for from the counterfoils of receipt books and the entries in the cashbook.
8. If the institution also provides the accommodation facilities to the public (Like old age people), see whether rent from such occupants is collected as per the rates fixed by the managing committee.
9. Vouch the receipts and expenses in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity.
10. See that the funds of the trust/institution have been spend only for those purposes for which the charitable institution has been set up and that no member of the Managing Committee has been benefited there from that either directly or indirectly.
11. Some societies need to send some reports by the auditor for those persons / government / institutions, who/which has given the grants to it certifying whether conditions attached to the issue of grants have been met or not. Therefore the auditor has to prepare such special audit reports in addition to the ordinary audit report.
12. Some societies publish some general books for spreading the activities/objects for which such society was formed. Vouch the income and expenses relating to any such publications.
13. Vouch all capital expenditure in the usual way and verify whether the sanction of the Committee exists.
14. Ensure that expenses of painting, decoration, renovation of building etc. are properly checked.
15. Confirm that depreciation on machinery and furniture has been charged at a higher rate, as compared to the similar assets used in other businesses.
16. Verify whether fixed assets register is updated or not. Obtain the schedule of fixed assets and ensure that they are properly valued and disclosed.
17. Verify that all the assets are properly insured and adjustment is done with regard to prepaid insurance.
18. **Establishment expenses:**
 - a) Vouch, in the usual manner, all establishment expenses and enquire for if there is any unreasonable heavy expenditure.
 - b) If any annual budget was prepared, see that any excess under any head over the amount budgeted or increase in the salaries was duly sanctioned by the Managing Committee.
 - c) If not, bring it to the Committee's notice in your report.
 - d) Computation and payment of salaries and wages vis-à-vis no. of employees must be checked.
 - e) Verify whether proper adjustment done with regard to service tax, TDS.
19. Where income tax has been deducted from the Investment income/rental income, it should be seen that a refund of tax has been obtained since charitable institutions are exempt from payment of Income tax U/s 11 of the I.T. Act.

20. See that the society has complied with all the requirements of the Income tax law for claiming the exemption U/s 11.

Similar Questions: Mention any ten special points to be examined by you in the audit of Income and Expenditure of a Charitable institution running a hospital. (PM, M15RTP)

REFER PRACTICAL QUESTIONS: 4, 5

Q.No.11. Audit of hire purchase company. (A)

(N94, 96- 16M, N13 - 8M)

Features:

1. **Legal Status:** It is usually constituted as a company (NBFC). Therefore, various provisions of the Companies Act, 2013 relating to the audit of accounts are applicable to its audit.
2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions to see that these have been duly complied with.
3. See the object clause of the hire purchase company to see that the company can undertake such activities.
4. See whether the institution is being managed as per the law under which it formed.
5. See that Hire purchase agreements are in writing and is signed by all the parties.
6. Examine the hire purchase agreements to verify that they are legally valid or not?
7. Verify the contents of the Hire Purchase agreement to confirm that whether it contains clearly:
 - a) The hire-purchase price of the goods.
 - b) The cash price of the goods.
 - c) The date on which the agreement is commenced.
 - d) Name of the purchaser.
 - e) Description of the goods to which the agreement relates.
 - f) The number of installments by which the hire-purchase price is to paid, the amount of each of those installments, and the date, the person to whom and the place where it is payable.
 - g) The stipulation that the equipment/asset shall not be removed from the described location except for repairs.
 - h) For the sake of identification, the vendor may also require plates or marking to be attached to the equipment/asset.
8. Whether there exists a procedure to ascertain the credit analysis of buyer like buyer's ability to meet the commitment under hire purchase, credit record, capital strength, availability of collateral security, etc.
9. See that the copies of the insurance policies have been obtained by the vendor for his records.
10. See that payments are being received regularly as per the agreement.
11. Examine the accounts of debtors to identify the overdue accounts. Review the steps taken for recovery of installments not paid.
12. Steps taken for re-possession of goods (for non payment of rent).
13. Examine the adequacy of provision for doubtful debts against outstanding debtors.
14. Check the correctness of Interest calculations.
15. See that depreciation is not provided for the assets so sold in the books of the vendor (Seller), though he is the legal owner.

16. Establishment expenses:

- a) Vouch, in the usual manner, all establishment expenses and enquire for if there is any unreasonable heavy expenditure.
- b) If any annual budget was prepared, see that any excess under any head over the amount budgeted was duly sanctioned by the Management.
- c) If not, bring it to the management's notice in your report.

Q.No.12. Audit of leasing company. (B)

(N 94, 96 - 16M, N13 – 8M, PM, N15 RTP, N15 MTP2 - 8M)

The special steps involved in its audit are stated below:

1. **Legal Status:** It is usually constituted as a company (NBFC). Therefore, various provisions of the Companies Act, 2013 relating to the audit of accounts are applicable to its audit.
2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions to see that, these have been duly complied with.
3. Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, credit record, capital strength, availability of collateral security, etc.
4. See whether the company is being managed as per the law under which it formed.
5. See that Lease agreements are in writing and is signed by all the parties.
6. Examine the Lease agreements to verify that they are legally valid or not?
7. Verify the contents of the Lease agreement to confirm that whether it contains clearly:
 - a) The description of the lessor, the lessee, the equipment and the location where the equipment is to be installed.
 - b) The date on which the agreement is commenced.
 - c) The number of rental installments, the amount of each of such installments, and the date, the person to whom and the place where it is payable.
 - d) Who has to bear the cost when the equipment is returned to the lessor on termination of the agreement?
 - e) Rights of the lessee relating to the subletting of the equipment.
 - f) The stipulation that the equipment shall not be removed from the described location except for repairs.
 - g) For the sake of identification, the lessor may also require plates or marking to be attached to the equipment.
8. Examine the lease proposal form, submitted by the lessee requesting the lessor to provide him on lease the equipment.
9. Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
10. See the invoices for the purchase of assets given on lease to ensure that they are in the name of the lease company.
11. See that the copies of the insurance policies have been obtained by the lessor for his records.
12. Check the correctness of rent calculations.
13. Ensure that payments are being received regularly as per the agreement.
14. Examine the accounts of debtors to identify the overdue accounts. Review the steps taken for recovery of rent not paid.

15. Steps taken for re-possession of goods (for non payment of rent).
16. Examine the adequacy of provision for doubtful debts against outstanding debtors.
17. See that depreciation is provided on the assets sold in the books of the Lessor. (Operating Lease)

Similar Questions: What procedure may be adopted by an auditor while auditing leasing transactions entered into by the leasing company? **(PM)**

Q.No.13. Write about audit of incomplete records? (B) (M 98, 01, 08, N 02, 03 - 12M, PM)

Circumstances leading to incomplete records:

- a) The accounting records kept are on Single Entry System (E.g. - Proprietary concern's).
- b) The accounting records though kept on Double Entry System are not available because these may have seized by the court or some other authority in connection with some violation.
- c) The accounting records, though maintained on Double Entry System but either partially or fully destroyed by fire, flood or some other natural calamity like earthquake etc.

Audit approach in above circumstances:

1. **1st case:** The auditor should ask the management of the entity to write up the books to the extent possible to conform to double entry system.
2. **2nd case:** The auditor should ask the management to complete or reconstruct the non-available records from available related documents, such as:
 - a) When vouchers are available and then cash book/journal, etc., are not available, then these may be written from vouchers.
 - b) Obtain the latest available Balance Sheet from an external source such as the Registrar of companies or from Income-tax office with whom the balance sheet, etc. were filed.
 - c) Arrange to obtain bank statements from the bankers.
 - d) Arrange to have statements of account from suppliers as well as from customers.
 - e) Personal knowledge of the proprietors, directors, and the dealing staff, as case may be.
 - f) Even though such books which are prepared may not be complete, but may still contain useful information for the auditor.
3. **3rd case:** Same as above.

Further steps which may be followed in this regard are as under:

- a) Vouch transactions recorded in books with reference to appropriate audit evidence.
- b) Confirm that all entries appearing in bank account are posted in the ledger.
- c) Similarly, it would be necessary to analyse the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonoured, etc., to relevant accounts.
- d) Verify fixed assets by observing physical verification.
- e) Obtain indirect evidence to verify the existence of fixed assets e.g. payment of local taxes to municipal authorities, electrical bills, etc. in case of building.
- f) Apply analytical review procedures in depth and notice deviations to investigate in detail.
- g) From an auditor's view point, the supervisory controls exercise by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination / observation, management representation and perform analytical procedures.

- h) Give an appropriate audit opinion based on above findings. A disclaimer of opinion may be appropriate in case there is any restriction on the scope of an audit.

Similar Questions: Mention the special points in the case of an audit of the entity from Incomplete Records. (PM)

Q.No.14. Describe the salient features of financial administration of local bodies. (A)

(N 04 - 8M, PM)

1. The objective of local body's budgetary procedure is financial Accountability, control of expenditure, and to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and with in the limits of sanction and authorization by the legislature or Council. Different aspects covered in budgeting are - determining the level of taxation, fees, rates, and laying down the ceiling on expenditure, under revenue and capital heads.
2. At the State and Central level, there is a clear demarcation between the legislature and executive. In local body, legislative powers are vested in the council where as executive powers are delegated to the officers, e.g. Commissioners. All matters of regular Revenue and expenditures are generally delegated to the executive wing. For special situations like, reduction in property taxes, refund of security deposits, etc. sanction from the legislative wing is necessary.
3. Municipal Accounting System has been conventionally prepared under the Cash System. In the recent past however, it is being changed to the accrual system of accounting. The accounting system is characterised by:
 - a) Subsidiary and statistical registers for taxes, assets, cheques etc.,
 - b) Separate vouchers for each type of transaction,
 - c) Compulsory monthly bank reconciliation,
 - d) Submission of summary reports on periodical basis to different authorities at regional state level.

Q.No.15. Write about audit of non-Governmental organisations (NGO)? (B)

(N10 – 4M, N07 – 5M, M13 – 8M, PM, M15 MTP - 8M)

1. NGO's can be defined as non-profit making organizations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.
2. Non-Governmental Organizations are generally incorporated as societies under the societies Registration, Act, 1860 or as a trust under the India Trust Act, 1882. NGO's can also be incorporated as a company under section 8 of the Companies Act, 2013.
3. Examples of NGO's in India are child relief and you (CRY) UNICEF / Godhali, Vidya, Concern India foundation etc.
4. While planning the audit, the auditor may concentrate on the following:
 - a) Knowledge of the NGO's work, its mission and vision, area of operations and environment in which it operates.
 - b) Reviewing the legal form of the organization and its Memorandum of Association, Articles of Association, rules and Regulations.
 - c) Reviewing the NGO's organization chart, Financial and Administrative Manuals, Project and Program guidelines, Funding Agencies Requirements and Formats, budgetary policies, if any.

- d) Examination of minutes of the Board / Managing Committee / Governing Body to ascertain the impact of any decisions on the financial records.
- e) Study of the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

5. Audit programme:

- a) **Corpus Fund:** The contributions / grants received towards corpus are vouched with reference to the letters from the donor(s). The interest income is checked with investment Register and physical investments in hand.
- b) **Reserves:** Vouch transfers from projects/ programmes with donor's letters and board resolutions of NGO.
- c) Check requirements of donor's institutions, board resolutions of NGO, rules and regulations of the schemes of the ear-marked funds.
- d) Vouch disbursements and Expenditures as per agreements with donors for each of the project/agency balances.
- e) Vouch loans with loan agreements and receipts/repayments with counter-foil issued.
- f) Vouch all acquisitions/ sale or disposal of fixed assets including depreciation and the authorisations for the same. For immovable property, check title deeds, etc.
- g) Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis-investments are made after approval by the appropriate authority.
- h) Physically verify the cash in hand and imprest balance, at the close of the year and whether it tallies with the books of accounts.
- i) Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.
- j) Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.
- k) Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/ project.
- l) Vouch, in the usual manner, all establishment expenses and enquire for if there is any unreasonable heavy expenditure. If any annual budget was prepared, see that any excess under any head over the amount budgeted was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice.

REFER PRACTICAL QUESTIONS: 6 & 9

Q.No.16. Write about local bodies? (B)

(M14 – 8M, PM, N15 MTP1 - 6M)

1. Purpose of Local Bodies:

- a) Administration of a locality, i.e. village/town/city/cantonment etc.
- b) By a body representing the local inhabitants.
- c) Possessing fairly large autonomy.
- d) Raising at least a part of its revenue through local taxation e.g. Property taxes, professional taxes, fees & Licences, non taxes income (Rent of land, houses, incomes from commercial undertaking, govt. grants etc).
- e) Spending its income on local services, distinct from state and central services, e.g. Education, Public Health, Sanitation, medical relief, roads & public works.

2. Types:

- a) Municipal Corporations.
- b) Municipal Councils.
- c) Notified area Committees.
- d) Cantonment Committees.

3. **Functions:** Local areas covering Regulatory & Maintenance.
4. **Funds:**
 - a) General or Reserve Fund.
 - b) Water supply and Drainage Fund.
 - c) Elementary Education Fund.
5. **Expenditure:**
 - a) General Administration and revenue collection.
 - b) Public Health & Public Safety.
 - c) Education.
 - d) Public Works.
 - e) Interest Payments.
6. **Incomes:**
 - a) Taxes on Property, Octroi, Advertisement taxes etc.
 - b) Non tax incomes - licence fees, Sale of bonds, rents, interests, Grants etc.
7. **The revenue grants are of three categories:**
 - a) **General Purpose Grants:** These are primary intended to substantially bridge the gap between the needs resources of the local bodies.
 - b) **Specific purpose Grants:** These grants, which are tied to the provision of certain services or performance of certain tasks.
 - c) **Statutory & Compensatory Grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

Q.No.17. Write a short note on audit of local bodies? (B)
(M10 – 5M, M14 – 8M, M15 – 4M, M16 – 6M) (FOR STUDENTS SELF STUDY)

1. The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Bombay and a few others have powers to appoint their own auditors for regular external audit.
2. The important objectives of audit are:
 - a) Reporting on the fairness of the content & presentation of financial statements;
 - b) Reporting upon the strengths and weaknesses of systems of financial controls;
 - c) Reporting on the adherence to legal and/ or administrative requirements;
 - d) Reporting upon whether value is being fully received on money spent; and
 - e) Detection and prevention of error, fraud and misuse of resources.
3. Increasing attention is being given, to what is described as 'Value for money' audit. This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (known as 'the three Es').

PRACTICAL QUESTIONS

Q.NO.1. M/S.XYZ, A PARTNERSHIP FIRM, APPROACHES YOU AND ENQUIRES, WHETHER IT IS NECESSARY FOR THEM, UNDER ANY STATUTE OR OTHERWISE, TO GET THEIR ACCOUNTS AUDITED. YOU ARE REQUIRED TO ADVISE THEM, EXPLAINING BRIEFLY THE OBJECTIVES AND ADVANTAGES OF AUDIT OF A PARTNERSHIP FIRM

Refer: Theory question no.2

Q.NO.2. STATE ANY SIX IMPORTANT POINTS TO BE EXAMINED BY YOU, AS AN AUDITOR, IN VERIFYING THE CORRECTNESS OF BANK BALANCE OF AN EDUCATIONAL INSTITUTION WHICH DEPOSITS ALL ITS COLLECTION / RECEIPT IN SEPARATE COLLECTION ACCOUNT OF A BANK. (M 08) (OR)

MENTION ANY SIX POINTS TO BE CONSIDERED FOR GOOD INTERNAL CONTROL FOR COLLECTION OF TUITION FEES FROM STUDENTS OF COLLEGE.

1. **Cash Collection Register:** Vouch the entries in the Daily Cash collection Register, based on the carbon copies / counterfoils of receipts issued to students. Check the totals thereof. In case of Columnar Register, cross-check whether the totals of individual columns and total columns are tallied properly.
2. **Denomination:** Verify the denominations written in the cash collection register, towards Total cash collected and cheques collected.
3. **Pay-in-Slip:** Examine the Pay-in-slip for cash and cheques deposited on the following day, noting particularly whether the denominations for cash deposit are the same as per the cash collection register of the previous day.
4. **Cheque Register:** Examine whether there is a system for monitoring whether all cheques deposited are duly collected. Whether cheques dishonoured are properly following-up, etc. Test check a few entries in the cheque register, along with, the date of credit in the Bank Statement.
5. **Direct Deposits:** Where the Educational institution gives pre-printed challans to the students for direct deposit in the Collection Bank Account, see whether there is a system of proper recording of receipts against the appropriate student's Name and Head of Account (Term Fees, Lab Fees, etc.)
6. **Funds Transfer:** Where a separate collection account is maintained, payment for expenses is not made directly from such collection bank account. The funds are transferred to another account maintained separately for meeting expenditure. See whether the funds transferred between these Bank Accounts is properly authorised and recorded.
7. **Reconciliation:** Pursue the Bank Reconciliation Statement and see whether there are any abnormal items requiring specific attention. Scrutinise the subsequent period's bank statement to ensure that items entered in the Reconciliation Statement have been duly entered by the Bank on clearance of cheque deposits / presentation of cheques issued.
8. **Certificate:** Ensure the correctness of bank balance as on the Balance Sheet date, based on the certificate given by the bank.

Q.NO.3. THE VIDHWAT COLLEGE, AN INSTITUTION MANAGED BY DAYAL TRUST, HAS RECEIVED A GRANT OF RS.1.35 CRORE FROM GOVERNMENT NODAL AGENCIES FOR FUNDING A PROJECT OF RESEARCH ON RURAL HEALTH SYSTEMS IN INDIA. DRAFT AN AUDIT PROGRAMME FOR AUDITING THESE FUNDS IN THE ACCOUNTS OF THE COLLEGE. (M 08 - 12M)

Audit of grant fund of a college:

1. The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.
2. The government policy on grant should be checked with the relevant application, brochure, and sanction advices.
3. The conditions stipulated in award of grant should be studied.
4. The receipt of grant should be vouched with bank statement.

5. The budgeted heads of expenses for the project and actual utilization of the fund should be checked.
6. The purchases of capital items covered within the project should be correctly capitalised. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.
7. The expenses of revenue nature incurred from and out of grant in the form of salaries to filed staff, materials purchased, traveling, survey and field work expenses and analysis and preparation of reports etc should be vouched with the relevant vouchers.
8. The expenses should be accounted as withdrawal of amounts from the fund. It is to be checked that these expenses are not accounted in income and expenditure of the college.
9. In balance sheet, the fund account should be shown as a liability with a separate schedule indicating the receipts, payments and balance as on the date of closing of accounts.
10. The funds balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.
11. The physical verification of assets pertaining to the project should be done by the management of the college.
12. The progress of the project may be ascertained from the minutes, committee meeting extracts and reports. This must be done to ensure that the project fund is genuinely utilised for the purpose it intended for.

Q.NO.4. MENTION THE SPECIAL POINTS TO BE EXAMINED BY THE AUDITOR IN THE AUDIT OF A CHARITABLE INSTITUTION RUNNING HOSTEL FOR STUDENTS PURSUING THE CHARTERED ACCOUNTANCY COURSE AND WHICH CHARGES ONLY RS.500 PER MONTH FROM A STUDENTS FOR HIS LODGING / BOARDING. **(N 00 - 16 M)**

1. General:

- a) Study the constitution under which the charitable institution has been set up whether under the Society Registration Act, as a trust or as a company limited by guarantee. Verify whether it is managed as contemplated by the law and rules and regulations made there under.
- b) Examine the internal control structure particularly with reference to admission to hostel, expenses incurred on different kinds of activities.
- c) Verify the broad nature of expenses likely to be incurred with reference to the previous years annual Audited accounts.

2. Verification of the receipts:

- a) Check the amounts received on account of, monthly rentals, etc., and receipts issued for the same.
- b) Ascertain that there is adequate internal control over the issue of official receipts, custody of unused receipt books, printing of receipt books, etc.
- c) Cross-tally the rent received along with the number of students (from the student register) staying in the hostel during the year.
- d) Check the amounts received from additional services rendered like guest fees, receipts for breakage, fines, penalties, etc.

3. Verification of Expenses:

- a) Check the day-to-day administration expense incurred along with the necessary vouchers, supporting for the same like salary registers, repairs register, etc.;
- b) Verify whether the expenses incurred are in conformity with the budgets prepared internally or filed with the relevant authorities.

- c) Check the amount spent on provisions of hostel facilities with reference to bills, etc.
- d) See that whenever heavy expenditure has been incurred on renovation of the hostel, computer centre, etc. the same is accounted for properly. (if such facilities are being provided by the hostel)
- 4. Verify investments made from surplus funds as well as existing investments by physically verifying the same and that they are in the name of the institution and that there is no charge / pledge against the same.
- 5. Verify all capital expenditure and expenditure on repairs, etc., incurred with the vouchers and also whether proper tenders, etc., were invited for the same. See that all furniture, glass, cutlery, kitchen utensils, liner, etc. are adequately depreciated.
- 6. **Library Facilities:** See that proper library register are maintained. The system regarding issue and receipt of books is in order. Late fee fines and money received on account of lost book is accounted for properly. Obsolete books are written off only after proper authorisation. Expenses incurred on newspapers and weekly magazines as compared to journals and periodicals have been accounted for properly.
- 7. Check the provision of other additional facilities like computer facilities, etc. Ensure that proper registers are maintained for charging fees, based on monthly or hourly basis. In case such facility is extended to each room, whether the charges are payable on lumpsum basis or on actual usage basis. Also ensure that amounts spent has been allocated properly.
- 8. Verify whether the institution is eligible for income tax exemption and if not, whether provision for taxation has been made.

Q.NO.5. MEDICAL COUNCIL OF INDIA ORGANISED A THREE-DAY INTERNATIONAL CONFERENCE OF DOCTORS IN DELHI. YOU ARE ASKED TO AUDIT THE ACCOUNTS OF THE CONFERENCE. DRAFT THE AUDIT PROGRAMME FOR AUDIT OF RECEIPT OF PARTICIPATION FEES FROM DELEGATES TO THE CONFERENCE. MENTION ANY SIX POINTS, PERCULIAR TO THE SITUATION, WHICH YOU WILL LIKE TO INCLUDE IN YOUR AUDIT PROGRAMME. **(M 05 - 6M)**

Audit of Receipts of Participation Fees:

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

1. Internal control system:

- a) Examine the organisation structure of special cell created for the international conference, if any, and division of responsibilities among persons and control / custody over receipt books.
- b) Verify the internal control system for restricting the participation of unregistered delegates.

2. Rate of Participation Fees:

- a) Verify with reference to resolution passed by the Organising Committee / Medical Council of India.
- b) Also Verify the rate from the literature / registration form circulated for promotion of conference.

3. Receipts of participation fees:

- a) Obtain the list of Members / Delegates who are entitled to attend the conference.
- b) Verify counter foil of the receipts issued for individual registration.

- c) Ensure that receipts are issued for all the registration received in cash.
- d) Trace the receipts in Bank Statement or Cash Book-as the case may be.
- e) Verify Bank Reconciliation Statement and list out dishonoured cheques.
- f) Verify subsequent recovery in respect of dishonoured cheques.

4. Overall Checking:

- a) Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.
- b) Cross check the total number of delegates with reference to the following:
 - i) Kits distributed to participants
 - ii) Bill of catered for providing meals during conference.
 - iii) Capacity of the Hall
 - iv) Participation Certificate if any issued.
- c) **Stock Register:** Where stock Register is maintained in respect of Conference / Seminar Material / Books / Kits distributed to Delegates, cross verify the quantity distributed to Members / Delegates.

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

6. Special issues:

- a) Take out list of absentees and in case of nil absentees, probe the issue further with proper authorisation in this regard.
- b) If certain participants are exempted from payments for obtain the list along with proper authorization.

Q.NO.6. AN NGO OPERATING IN DELHI HAD COLLECTED LARGE SCALE DONATIONS FOR TSUNAMI VICTIMS. THE DONATIONS SO COLLECTED WERE SENT TO DIFFERENT NGO'S OPERATING IN TAMILNADU FOR RELIEF OPERATIONS. (OR)

THIS NGO OPERATING IN DELHI HAS APPOINTED YOU TO AUDIT ITS ACCOUNTS FOR THE YEAR IN WHICH IT COLLECTED AND REMITTED DONATIONS FOR TSUNAMI VICTIMS. DRAFT AUDIT PROGRAMME FOR AUDIT OF RECEIPTS OF DONATIONS AND REMITTANCE OF THE COLLECTED AMOUNT TO DIFFERENT NGO'S. (OR)

MENTION SIX POINTS EACH, PECULIAR TO THE SITUATION, WHICH YOU WILL LIKE TO INCORPORATE IN YOUR AUDIT PROGRAMME FOR AUDIT OF SAID RECEIPTS AND REMITTANCES OF DONATIONS. (N14 RTP, N14 MTP2 - 8M)

Receipt of Donations:

- 1. **Internal control system:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorized collection of donations, custody of receipt books and safe custody of money.
- 2. **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- 3. **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.
- 4. **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

5. **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
6. Foreign contributions, if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of donations to different NGOs:

- a) **Mode of Sending Remittance:** All remittances are through account payee cheques, Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- b) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- c) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration number, etc.
- d) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
- e) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- f) **System of NGO's Selection:** Check the system for selecting NGO to whom donations have been sent.

Q.NO.7. WHAT SPECIAL STEPS WITH YOU TAKE INTO CONSIDERATION IN AUDITING THE RECEIPTS FROM ENTRY FEES OF AN AMUSEMENT PARK? MENTION ANY FOUR POINTS SPECIFIC TO THE ISSUE?
(N 05 - 4M, PM)

Audit of Receipts from Entry Fees of an Amusement Park

1. Evaluate the internal control system regarding entry and collection for entry tickets including rotation of staff.
2. Ensure that tickets are pre numbered.
3. Ensure that the deposit of cash collected into the bank account very same next day.
4. Compute analytical ratios in respect of the receipts pattern i.e. on week ends, holidays, etc. and make comparisons to draw conclusions.

Q.NO.8. MENTION ANY SIX POINTS TO BE CONSIDERED FOR GOOD INTERNAL CONTROL FOR COLLECTION OF TUITION FEES FROM STUDENTS OF COLLEGE.

Internal control points for collection of tuition fees:

1. There must be a clear cut tuition fee structure approved by the college council.
2. The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.
3. The paying in slip when filled by the students, should be checked for its correctness as to applicable amount etc by one clerk and the amount should be entered in a scroll. He must initial the slip which authorises the cashier to accept the fees as per slip.
4. The cashier scroll and the authorising officer/s scroll should be checked by an officer daily.
5. All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.
6. Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinised by college officers.

7. Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.
8. Delayed remittance should carry fines or compensating charges for delay.
9. When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.

Q.No.9. STATE ANY FIVE SPECIAL POINTS WHICH YOU, AS AN AUDITOR, WOULD LOOK INTO WHILE EXAMINING THE INCOME AND COLLECTION OF FUND BY AN NGO ENGAGED IN PROVIDING RELIEF WORK FOR FLOOD VICTIMS.

Examination of Income and Collection of Fund by an NGO: Five special points to be looked into are-

- a) Grant donations and contributions received from various Government, other NGO, industry and public should be checked with reference to the grant letter, bank statements and ensured that they are properly accounted and banked.
- b) Foreign contribution received should be checked with reference to the correspondence receipt issued, bank statement, conversion into local currency. It should be ensured that all such contributions are as per RBI guidelines and be kept in separate bank account.
- c) In the case of any fund raising cultural or sports program, verify the internal control system, mode of receipt and the authority accountable. Ensure that all collections are duly receipted and deposited in the bank promptly.
- d) Check the fee received from members with the register of members.
- e) Check interest and dividend received from investments with investment held.

Q.No.10. WHAT STEPS WOULD YOU TAKE IN TO CONSIDERATION IN AUDITING THE RECEIPTS FROM PATIENTS OF A HOSPITAL? **(PM)**

Auditing the Receipts from Patients of a Hospital: Following are the steps to be considered-

- a) Examine the internal check system as regards the receipts of bills from the patients.
- b) Vouch the register of patients with copy of bills issued to them.
- c) Verify bills for a selected period with the patient's attendance record to see that the bills have been correctly repaired.
- d) See that bills have been issued to all the patients according to the rules of the hospital.
- e) Check cash collections as entered in the cash book with the receipts, counterfoils and other evidence.
- f) Compare the total income with the amount budgeted for the same and report to the management for significant variations which have been taken place.

Q.No.11. DRAFT AN AUDIT PROGRAMME TO AUDIT THE RECEIPTS OF A CINEMA THEATRE OWNED BY A PARTNERSHIP FIRM.

Programme for Receipts of Cinema Theatre of a Firm: Audit programme for checking the receipts of a cinema theatre of a partnership firm-

- 1) The partnership deed should be first scrutinized.
- 2) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.
- 3) The internal control for collections from sale of tickets should be checked.
- 4) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.

- 5) Check the rough cash book and reconcile from the inventory of ticket books issued, the cash to be collected each day.
- 6) Check that the cash balance and ticket sales from inventory is daily checked by the manager.
- 7) Check that the collections are banked daily, the very next day.
- 8) See rates for each class and the ticket rates are as per current prices.
- 9) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.
- 10) Check the relation between the amounts of tax collected and sales.
- 11) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.
- 12) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.
- 13) The cash collections should not be used for meeting petty cash expenses. There should be separate impressed system.
- 14) Do surprise checking of cash balances.
- 15) See that cash collections are insured and the policy is in force.

THE END

9. GOVERNMENT AUDIT

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	8	6	5	-	-	-	-	-	-	-	4	8	-	-	-	4	-	-	-	-	-
2.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
3.	A	-	-	-	5	5	-	-	7	-	-	-	-	-	10	-	-	-	4	-	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	-
6.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Write about Audit of Government Expenditure? (A)
 (M 96, 00, 07, N 96, 01, 03, 06, 08, 13 - 8M, M 11 - 4M, PM, N14RTP, M15 MTP2 - 8M, N14 MTP1- 4M)

It is one of the major components of the government audit. The components of this are:

Audit against rules and orders: In this auditor looks for whether the expenditure incurred complies with the relevant provisions of the act and in accordance with the financial rules and regulations. (M 08 - 4M)

These rules and orders mainly fall under the following categories:

1. Rules and orders dealing with the making of the claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund.
2. Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State and the Contingency Fund of India or of a state.
3. Rules and orders regulating the conditions of service, pay and allowances and pensions of government servants.

Duty of auditor in this regard:

1. *It is the function of the government executives/employees to frame rules and orders, which are to be observed by its subordinate authorities.*
2. *The auditor is to see that these rules and orders are complied with by the subordinates.*
3. *It is, however, not the function of auditor to prescribe what such rules & orders shall be.*
4. *In this the auditor will see that:*
 - a) *They are not inconsistent with any provisions of the Constitution or laws.*
 - b) *They do not come in conflict with the orders or rules made by any higher authority.*

Audit of Sanctions: The government auditor has to ensure that the expenditure is subject to proper sanction by competent authority. It is a two-fold aspect to be covered namely.

1. Existence of sanction &
2. Sanction should be by appropriate authority.

Audit against Provision of Funds: In this the auditor looks for that the expenditure incurred has been for the purpose for which the grant has been provided and the amount of expenditure does not exceed the amount provided for.

Propriety Audit: The term propriety refers to reasonableness or appropriateness. The Government auditor tries to bring about instances of improper, avoidable, useless expenditure.
(M 06 - 8M, N 07 - 4M, PM)

Government auditor should not only see the regularity aspect, but also match with the various standards of propriety. (i.e. Instead of too much dependence on documents, vouchers, etc. it shifts the emphasis to the substance of transactions and looks into financial prudence, public interest and the need of expenditure.)

Government audit is basically performed by combining both the angles of regularity and propriety. It is seen whether every officer has exercised the same care in respect of expenditure as a person of ordinary prudence (carefulness) would exercise in expenditure of his own money.

There cannot be any precise rules in regard of propriety. However some general rules can be framed which are given below:

1. *The expenditure should not be prima facie more than the occasion demands.*
2. *No authority should sanction the expenditure so that it will be a direct or indirect benefit to him.*
3. *Public money should not be utilised for the benefit of a particular person or section of the community unless:*
 - a) *The amount of expenditure is insignificant.*
 - b) *The expenditure incurred is to comply with a recognised policy or custom.*
 - c) *The claim for the expenditure can be enforced even in the court of law.*
4. *The amount of allowances, such as traveling expenses should be so controlled that the allowances are not the sources of profit to the recipients.*

Note: Under the Companies Act also propriety element has been introduced - U/s 143 of the Companies Act.

Performance Audit: Performance Audit involves preliminary study, planning & execution of audit and reporting. It aims to ascertain that government programmes have achieved the desired objectives at the lowest cost and given the intended benefits. It includes: **(M 00, 08 - 4M, PM)**

- a) **Efficiency audit:** The efficiency audit finds out whether the various projects are executed and operations conducted efficiently. In other words a constant comparison is made between the input and output. The object of efficiency audit is to find out the extent to which operations are carried out in an efficient manner.
- b) **Economy audit:** It finds out whether the government has acquired the financial, human and physical resources in the most economic manner and whether the sanctioning and spending authorities have observed economy.
- c) **Effectiveness audit:** It is aimed at carrying out an appraisal of the performance of programmes, schemes and projects with reference to over all objectives as well as efficiency of the means adopted for the attainment of the objectives.

Similar Question:

An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:

i) Audit against Rules and Orders	iv) Propriety Audit
ii) Audit of Sanctions	v) Performance Audit (PM)
iii) Audit against Provision of Funds	

Ans: Refer above answer.

Similar Question: What are the focus points in doing propriety audits by C&AG as regards government expenditure? **(PM)**

Ans: Refer above propriety audit.

REFER PRACTICAL QUESTIONS: 1

Q.No.2. Audit of Government Receipts. (B)

It aims to ensure that there is no leakage of revenue which should legally come to the government. The emphasis is on examining the procedure regarding - assessments, collection, accounting, refunds. Such an audit provides for checking:

- a) **Generation of revenue:** Whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the authorities.
- b) **Rules & Procedures:** Whether adequate rules and procedures have been designed, by the concerned department to ensure an effective check on assessment, collection and proper allocation of cases.
- c) **Controls:** Whether adequate controls are imposed for prompt detection of irregularities regarding double refunds, fraudulent or forged refund vouchers or other loss of revenue.
- d) **Implemented:** Whether such regulations and procedures are actually being carried out.
- e) **Judicial decisions:** A review of the judicial decisions, taken by tax authorities, is done to judge the effectiveness of the assessment procedure.

Q.No.3. What are the Powers & Duties of C & AG? (A)

(M 95, 03 – 8M, N 12-10M, M15 – 2M, N15 RTP)

Duties of C & AG: The C & AG Act 1971 defines the functions/duties of the C & AG as: **(PM)**

1. **Compilation of Accounts:** He is responsible for the compilation/preparation of accounts of the union and State and each union Territory.
2. **Receipts and payments:** He shall also prepare the annual receipts and payments of the union, each state and each union Territory.
3. **Submission of Accounts:** The accounts prepared should be submitted to:
 - a) In the case of central government/ Union, to the president of the country.
 - b) In the case of state, to the Governor of each State.
 - c) In the case of Union Territory, to the Chief Administrator
4. **Submission of information:** He is also responsible to provide such information as may be required by the Union Government, State Government or the Governments of the Union Territories which will enable them to compile the accounts.
5. **General provisions regarding Audit:**
 - a) It is the duty of the C & AG to audit and report on all expenditure from the consolidated Fund of union and the consolidated fund of each State and Union Territory.
 - b) It is the duty of the C & AG to audit and report on all expenditure from the contingency Fund of union and the State's.
 - c) Finally he is also responsible for auditing and reporting on all manufacturing, trading, profit and loss A/c Or income and expenditure account and balance sheet and other subsidiary accounts kept in any department of the Union or State.
6. **Audit of Receipts and Expenditure:** Where any entity is substantially financed by grants or loans from the consolidated/contingency fund of India/state, the C&AG shall audit all receipts and expenditure of that body and report the same.
7. **Audit of grants and loans:** Where any grant or loan is given for any specific purpose from the consolidated Fund or Contingency fund of India/state, the C&AG shall see the procedures which will be used by the sanctioning authority for getting himself satisfied of the fulfillment of the conditions subject to which such grants or loans have been given.

8. **Audit of Receipts of Union or States:** It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.
9. **Duty to audit the stores and stocks:** It is his duty to audit and report on the accounts of stores and stocks kept in any office or department of the Union or state government.
10. **Audit of accounts of Government companies and corporations:** Finally, the C & AG is responsible for carrying out the audit of accounts of government companies in accordance with provisions of Companies Act, 2013.

POWERS OF C& AG:

(N 09 - 5M, PM)

1. The following are the powers given by C & AG Act 1971:

- a) Inspection of the accounts maintained by any office under the control of the Union & State
- b) He has the power to direct the offices responsible to send the accounts, books, papers and other documents which are relevant to the transactions under audit.
- c) He has a right to question persons responsible for maintaining the accounts.
- d) He may also ask for such additional information, which he considers relevant.

Q.No.4. Write a short note on audit of stores and stocks in the context of government auditing. (A) (N 97 - 6M, PM)

1. Audit of stores and stocks by C&AG assumes lot of importance since:

- a) It forms significant part of the government expenditure and
- b) Further the stores include all types of purchases made by the government such as plant, machinery, office equipments, etc.

2. Audit of stores & Stocks has been developed as a part of expenditure audit.

3. The following procedure is adopted for the audit of store's:

- a) Regulations governing purchases, receipts, issue, custody, sales, write-off and stocktaking etc. are reviewed.
- b) Purchases are audited according to the rules prescribed for audit of expenditure.
- c) It is to be seen that when purchases are made from contractors, the system of open competitive tenders is adopted.
- d) The auditor has to ensure that the prices paid are reasonable and is in agreement with those shown in the contract for the supply of stores.
- e) See that the certificate of quality and quantity are furnished by the receiving units before accepting the purchases.
- f) Cases of uneconomical purchases of stores and losses attributable to defective or inferior quality of stores are brought to the notices of concerned authority.
- g) Ensure that the balance of stocks and stores in hand is within reasonable & prescribed limits.
- h) The valuation of the stocks should be seen carefully so that book value of stores tallies with the physical value of the stores.
- i) The sanction for write-offs is to be checked.

Similar Question: "Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG."

(PM, M15 RTP)

Q.No.5. With reference to Government Audit what do you understand by 'Audit of Commercial Accounts'. (A)
(M 05 - 8M, PM)

Public enterprises are required to maintain commercial accounts and are generally classified under three categories:

- a) Departmental enterprises engaged in commercial and trading operations.
- b) Statutory corporations created by specific statutes.
- c) Government companies set up under the Companies Act, 2013.

Departmental concerns: The audit of departmental concerns is undertaken in the same manner as any department of government where commercial accounts are kept.

Statutory corporations: Audit of statutory corporations depends on the nature and type of the statute governing the corporation.

Government companies: In the case of a Government company, the auditor of a Government company shall be appointed by Comptroller and Auditor General of India.

The performance of the above entities are reviewed and reported in the audit reports to the government/legislatures.

The C & AG shall have powers under Sec. 139:

- a) To direct the manner in which the company's accounts shall be audited or/and to give instructions in regard to any matter relating to the performance of audit.
- b) To conduct a supplementary or test audit of the company's accounts by such person as he may authorise in this behalf.
- c) For the purpose of audit given in b above, to get the required information on such matters as the Comptroller and Auditor General may by order direct.
- d) The directions covers the system of book keeping and accounts, internal control etc.
- e) **Submit report:** The auditor aforesaid shall submit a copy of his audit report to the C & AG who shall have the right to comment upon or supplement the audit report.

Duty to reply the qualifications: In the absence of provisions requiring the board of directors to give reply on the qualifications made by the C & AG, the board of directors of such a company is not bound to give explanation in respect of such comments.

Q.No.6. Write about Powers / Rights of Comptroller and Auditor-General of India? (A)
(N14 - 4M)

Powers / Rights of Comptroller and Auditor-General of India: In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (7) or sub-section (5) of section 139 i.e. appointment of First Auditor or Subsequent Auditor (discuss in the beginning of the chapter) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to,

- a) Conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

- b) **Comment upon or supplement such audit report:** Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.
- c) **Test Audit :** Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under subsection (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit. '

Similar Question: What role is played by Comptroller and Auditor General of India in the audit of a Government company? **(PM, M15 RTP)**

REFER PRACTICAL QUESTIONS: 2

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.7. What are the basic differences in the method of auditing as followed in the case of statutory audit under the companies act and propriety audit as carried on by the C&AG? (C)

In case of statutory audit:

1. Objectives:

- a) **The main objective:** Reporting whether the financial statements are showing true and fair view is the main objective of auditing.
- b) **Secondary objective:** Detection and prevention of frauds and errors.

2. Aspects to be covered in a statutory audit: Refer to 1st lesson.

In case of propriety audit: Refer to the previous question.

Guided by: Another point to be noted in this connection is that the statutory auditor is guided by specific responsibilities imposed on him by Sec.143 of the Companies Act. On the other hand the propriety audit by C & AG is guided not only by Sec.143 of the Companies Act but also by the guidelines by C & AG in this regard.

PRACTICAL QUESTIONS

Q.NO.1. AS AN AUDITOR, HOW WILL YOU REACT TO AN EXPENDITURE INCURRED BY A GOVERNMENT DEPARTMENT WHICH WAS SANCTIONED BY A FELLOW OFFICER OF THE COMPETENT AUTHORITY AS THE CONCERNED OFFICER WAS ON LEAVE.

The auditor has to ensure that each item of government expenditure is covered by a sanction of the competent authority. The audit of sanction is directed both in respect of ensuring that the expenditure is properly covered by a sanction and the authority sanctioning is competent for the purpose. Accordingly, if the fellow officer has not been delegated the financial power by the competent authority, the sanction of expenditure should be treated as improper.

Q.NO.2. THE DIRECTORS REPORT OF A GOVERNMENT COMPANY IS SILENT ON THE COMMENTS MADE BY THE COMPTROLLER AND AUDITOR GENERAL OF INDIA IN HIS SUPPLEMENTARY AUDIT REPORT.

In the absence of provisions requiring the board of directors to give reply on the qualifications made by the C & AG, the board of directors of such a company is not bound to give explanation in respect of such comments. However the board of directors are still have to reply to the qualifications made by the statutory auditor.

Q.NO.3. GOVERNMENT COMPANIES ARE ALSO TO BE CONSIDERED FOR THE CEILING OF NUMBER OF AUDITS.

True: As per Sec. 139 Government companies are also to be considered for ceiling of number of audits.

THE END

10. EDP AUDIT**QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS**

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	-	5	-	-	-	-	-	-	6	-	-	-	-	-	-	4	-	-	-	-
2.	A	-	-	-	-	-	4	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-
3.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	A	10	-	-	6	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-	-	4
5.	B	-	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	B	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-
10.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	B	-	-	-	-	6	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-
12.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5

Q.No.1. Write about different approaches to auditing in a computerised environment.
(A) **(M 05 - 8M, PM)**

There are basically 2 approaches for auditing Information Systems in a computerised environment:

Audit around Computer - The Black Box Approach: In early days of data processing applications, computers could be considered as another type of book keeping machine. Computer functions used to replicate manual processes in a straightforward way. Thus, the auditor completely ignores what is happening inside the computer.

Since this approach completely relies on non - EDP segment of a system, it is commonly known as auditing around the computer. Under this approach auditing is done in usual traditional way. No attempt is made to test the client's EDP system and to use the computer for auditing purpose.

In this approach the auditor does not verify the processing part of the computer application programs.

Audit around the computer can be followed when:

- Source documents are available in a non machine language.
- The documents are maintained in such a way that it is possible to read manually.
- It is possible to trace individual transactions from source documents to output and vice versa.
- Auditing around the computer is acceptable approach when the information needs of client's organisation require it to maintain the necessary source documents, detailed outputs and the system is batch oriented and simple.

The advantages of this approach are:

- This method is fast, easy and inexpensive,
- It requires less knowledge of computers,
- Since the source documents are available in non-machine language, audit trails are easy to trace,
- There is no possible risk of tampering with client's data.

Audit through computer: This approach involves running the auditor's program on a controlled basis in order to verify the client's data recorded in the computer. The auditor can perform different kinds of tests and other functions with such computer program. These include: **(N 03, M 07 - 5M, PM)**

- a) Examining records for quality, completeness, consistency and correctness,
- b) Comparing data on separate files,
- c) Summarizing or re - sequencing data and performing analysis,
- d) Selecting audit samples and
- e) Checking the logic and controls existing within the system.

There are several circumstances where it is compulsory to use auditing through computer:

- a) The application system processes large volumes of input and produces large volumes of output,
- b) Significant parts of the internal control system are embodied in the computer system,
- c) The logic of the system is complex and
- d) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test a computer system. Thus the auditor acquires great confidence that data processing is correct.

The primary disadvantage of this approach is that it is very costly and it requires expert technical knowledge. The most serious problem in this approach is to obtain a suitable program at a reasonable cost. Three options are available:

- a) Use the client's program.
- b) Write a program specifically for the audit.
- c) Use computer assisted audit techniques (CAATs)

In first 2 options the auditor should have expert knowledge in the area of computers. However, Computer Assisted Audit Softwares are readily available which do not need expert knowledge.

Similar Question: State the circumstances where the auditing through the computer must be used. **(PM)**

Ans: Refer above circumstances.

Q.No.2. Write about the design and special characteristics / procedural aspects of EDP system. (A) (N 01, 08 - 4M, PM)

The EDP systems have certain design and procedural characteristics which are different from those found in manual systems. They are:

- a) **Consistency of Performance:** EDP systems perform functions exactly as they are programmed. This is particularly important from an auditor's viewpoint since it implies that if a computer program is correct, the information will be consistently processed correctly (except in the event of malfunctioning of the hardware). On the other hand, if the computer is not correctly programmed, it will consistently process the data erroneously. Thus, in auditing EDP-generated information, it is not wise to test large sample of similar transactions but it is sufficient to test the programs, changes in programs and unusual transactions.
- b) **Programmed Control Procedures:** In an EDP system, some of the internal control procedures may be incorporated into the computer program itself. *For example, password controls. In such environment there is little visible evidence of their execution. But in non EDP environment, evidence of execution can be reviewed through manual procedures.*

- c) **System - generated transactions:** In an EDP system, certain transactions may be initiated by the system itself without the need for an input document. *For example, interest may be calculated and charged to customer accounts automatically by the computer program. The authorisation of such transactions may not be visible. Similarly, EDP system may be programmed in such a way that an order for purchase of inventory is automatically placed when some pre-determined ordering level is reached. In these instances, authorisation is not made for each transaction but is implicit in the design of the computer system.*
- d) **Vulnerability of Programs and Data:** In an EDP environment, huge volume of data and programs are stored centrally. When such data or programs are stored on portable storage media such as floppy disks, magnetic tapes, etc. they are vulnerable to theft, loss, etc. These, as well as other media like hard disks are also susceptible to intentional or accidental destruction.

The above characteristics of an EDP environment affect the nature, timing and extent of audit procedures. For example, an auditor may use special audit procedures, which use computer itself, while carrying out the audit. Similarly, the timing of certain procedures may also undergo change.

E.g., where the transaction trail is available only for a limited period of time, the auditor may decide to conduct the relevant audit procedures at that time. Finally, the auditor may decide the extent of audit procedures based on the special features of EDP systems.

Similar Questions: In a CIS environment, what are the different design and procedural aspects which are different from those found in manual systems?

Ans: Same as above

Q.No.3. Write about nature of processing in an EDP environment? (B)

The nature of processing in an EDP environment has certain distinguishing features. They are:

1. **Likely Absence of Input Documents:** In a manual system, each transaction is recognised in the books of account on the basis of a source document. However, in many EDP systems, number of transactions is fed into the computer without any source document.
2. **Lack of Visible Transaction Trail:** The transaction trail (or the 'audit trail') refers to the successive stages in the recording of a transaction in the books of accounts through which one can trace accounting entries in the books back to their initiation and vice versa.
In a manual system, it is normally possible to follow a transaction by examining the relevant source documents, books of accounts records, etc.
In an EDP environment, source documents for many transactions may not exist. Moreover, the updating of multiple files may be done by a single transaction. For example, the sale of a unit may be processed by a computer to update inventory records, sale records and debtor records. Because of these, it may be difficult to trace.
3. **Lack of Visible Output:** In a manual system, it is normally possible to examine the detailed results of processing. However, in some EDP systems, certain transactions or results of processing may not be printed or only summary data may be printed. Due to this the auditor should access the required data in computer only.
4. **Difference in nature of output:** In a manual system, visual examination of records enables an auditor to identify cuttings, insertions, overwritings, etc. The auditor examines these things thoroughly because presence of these things indicates an attempt to manipulate the records. In an EDP environment, on the other hand, the alteration of records cannot be identified through their visual examination. The auditor, therefore, has to apply other appropriate procedures to satisfy himself that the records are not altered in an unauthorised manner.
5. **Easy to Access Data and Computer Programs:** The data and computer programs may be accessible through computer terminals at remote locations. Thus, there are more chances for unauthorised access, alteration of programs and data by unauthorised persons unless there are adequate controls.

Q.No.4. Why are CAAT required in EDP Audit? What are the advantages of CAAT? (A)
(M16 - 4M, M 06 - 10M, PM, N14 RTP)

The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. CAATs are such techniques applied through the computer which are used in verifying the data being processed by it. System characteristics resulting from the nature of EDP processing that demand the use of Computer Aided Audit Techniques (CAAT) are:

- a) The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- b) The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- c) The lack of visible output may necessitate access to data retained on files readable only by the computer.

Advantages of CAAT:

1. **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will be improved through the use of CAAT in obtaining and evaluating audit evidence, for example.
 - a) Some transactions may be tested more effectively for a similar level of cost by using the computer.
 - b) In applying analytical review procedures, transactions or balance details of unusual items may be reviewed and reports got printed more efficiently by using the computer.
2. **Savings in time:** The auditor can save time by reviewing the EDP controls using CAAT than using other audit procedures.

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

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

Q.No.5. State your opinion / Comment on “the overall objective and scope of an audit does not change in an EDP Environment.” (B)
(M 00 - 6M, PM)

1. The overall objective and scope of an audit does not change in an EDP environment. However; the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control.
2. Accordingly, the auditor should possess adequate skill and competence to discharge his duties and responsibilities in an EDP environment.
3. Therefore, the auditor should be familiar with the following to understand the computer system used by the client:
 - a) Knowledge of EDP vocabulary and terminology is absolutely essential to decipher system.
 - b) Understanding of computer hardware and software.
 - c) Computer hardware being physical part of computer system, he should understand input devices, output devices storage devices and processing devices.
 - d) With the development of application softwares the auditor need not be familiar with the detailed knowledge of programming. However knowledge of system softwares is essential.

- e) Type of computers in use would have to be studied essentially to know how transactions are processed. Today, PC – ATs are quite popular but in case of large organisations mini and main – frame computers are in operation.
- f) Understanding of different type of system in operations such as micro – computer system , stand alone systems, on – line systems etc;
- g) Knowledge of flow – charts and various symbols.
- h) Ability to read various types of documentation, etc.

Similar Questions: Is there any change in audit approach in the audit of computerised accounts as compared to audit of manual accounts?

Ans: Same as above

Q.No.6. Write about controls in an EDP Environment? (A) (N 02 - 16M, M 03 - 8M, PM)

To achieve the overall objectives of internal control, some internal controls shall be placed in EDP environment also. Some of such controls are designed to be implemented manually and some are inserted in the application program itself. Some controls are designed to check the overall EDP environment (called general EDP controls) and some other are designed to check the specific accounting application (called Application controls).

General EDP Controls: The purpose of general EDP controls is to establish a framework of controls over the activities of EDP department. It also provides assurance that overall objectives of internal control are achieved. General EDP controls may include:

1. **Organization and management controls:** Designed to establish an organizational framework over EDP activities, including:
 - a) Establishing Policies and procedures relating to control functions.
 - b) Appropriate segregation of functions (e.g. preparation of input transactions, programming and computer operations).
2. **Application systems development and maintenance controls:** designed to provide reasonable assurance that systems are developed and maintained in an authorized in efficient manner. They are also designed to establish control over:
 - a) Testing, conversion, implementation and documentation of new or revised systems,
 - b) Changes to application systems,
 - c) Access to systems documentation,
 - d) Acquisition of application systems from third parties.
3. **Computer operation controls:** designed to control the operation of the systems and to provide reasonable assurance that:
 - a) The systems are used for authorized purposes only,
 - b) Access to computer operations is restricted to authorized personnel,
 - c) Only authorized programs are used,
 - d) Processing errors are detected and corrected
4. **Systems software controls:** Designed to provide reasonable assurance that system software is acquired or developed in an authorized and efficient manner, including:
 - a) Authorization, approval, testing, implementation and documentation of new systems software and systems software modifications.
 - b) Restriction of access to systems software and documentation to authorized personnel.
5. **Data entry and program controls:** Designed to provide reasonable assurance that:
 - a) An authorization structure is established over transactions being entered into the system.

- b) Access to data and programs is restricted to authorized personnel.
- c) There are other EDP safeguards that contribute to continuity of EDP processing. These are:
 - i) Offsite back-up of data and computer programs.
 - ii) Recovery procedures for use in the event of theft, loss or intentional or accidental destruction.
 - iii) Provision for offsite processing in the event of disaster.

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

1. **Controls over input:** designed to provide reasonable assurance that: **(M 07 - 4M, PM)**
 - a) Transactions are properly authorized before being processed by the computer.
 - b) Transactions are accurately converted into machine readable form and recorded in the computer data files.
 - c) Transactions are not lost, added, duplicated or improperly changed.
 - d) Incorrect transactions are rejected, corrected and, if necessary, resubmitted on a timely basis.
2. **Controls over processing and computer data files:** designed to provide reasonable assurance that:
 - a) Transactions, including system generated transactions, are properly processed by the computer.
 - b) Transactions are not lost, added, duplicated or improperly changed.
 - c) Processing errors are identified and corrected on a timely basis.
3. **Controls over output:** designed to provide reasonable assurance that:
 - a) Results of processing are accurate.
 - b) Access to output is restricted to authorized personnel.
 - c) Output is provided to appropriate authorized personnel on a timely basis.

Q.No.7. Write a short note on 'Audit trail in a computerised accounting environment'. (A) (N 00, 04 - 4M, PM, M15 MTP2- 4M)

1. 'Audit Trail' refers to a situation where it is possible to relate, on a "one-to-one" basis, the original input with the final output.
2. In a manual accounting system, it is possible to relate the recording of a transaction of each successive stage enabling an auditor to locate and identify all documents from beginning to end for the purpose of examining documents, totaling and cross-referencing.
3. In first and early second generation computer systems, a complete audit trail was generally available.
4. However, with the advent of modern machines, the EDP environment has become more complex.
5. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output.
6. The lack of visible evidence may occur at different stages in the accounting process, for example:
 - a) Input documents may be non-existent, where sales orders are entered online.
 - b) Accounting transactions such as discounts and interest calculations may be generated by computer programmers with no visible authorisation of individual transactions.

- c) The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers invoices may be matched by a computer programme.
- d) Programmed control procedures, such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.
- e) Output reports may not be produced by system or a printed report may only contain summary totals while supporting details are retained in computer files.

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

The auditor can use the computer to test-

- 1) The logic and controls existing within the system, and
- 2) The records produced by the system.

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

Similar Question: What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool. (PM)

Q.No.8. Write a short note on 'problems faced while shifting from manual to computer based accounting records.' (B)

The problems which are encountered while shifting from manual based accounting records to computer based accounting records are as under:

1. **Visual Observation:** Visual observation is more difficult because of the speed with which the equipment operates. Even slowing down the system may be of no value to the auditor because of his inability to understand the electronic pulses of information stored in an electronic media.
2. **Internal Storage:** Internal storage is a representation of the information in electronic form inside the computer. As a result of this, the auditor is unable to observe the processing of data to determine whether procedures are being followed.
3. **Changes in Programmes:** Changes in the Programmes used for procedures the data can be brought about without the auditor's knowledge. The procedures that the auditor believes are being performed to process data may not be used at all.
4. **Disappearance of Audit Trail:** Audit trail can be explained as those documents, records, journals, ledgers, master files etc enable an auditor to trace the transactions from the source document to the summarized totals in accounting reports or vice – versa. In a computerised environment where data are being entered directly into the system the auditor faces the problem of partial elimination or disappearance of audit trail.
5. **High level languages:** A major problem faced by the auditors is the fact that source code listing provided to the auditor may not agree with the object code used by the computer for processing. Further, high level languages with multiple versions of some of them place extra – ordinary burdens on the auditor who has to understand and work with them.

Q.No.9. 'Doing an audit in an EDP environment is simple since the Trial Balance always tallies' analyse critically? (B) (N 00 - 4M, PM)

1. Though it is true that in an EDP environment the trial balance tallies, the same cannot imply that the job of an auditor becomes simpler.
2. There can still be some errors of omissions like omission of certain entries, compensating errors, duplication of entries, etc. in the books of account even when the trial balance tallied.
3. In today's complex business environment, the importance of trial balance in an audit has to be gauged not from the view point of arithmetical accuracy but the nature of transaction to be recorded which in fact have become very complex.
4. In an audit besides the tallying of a trial balance, there are also other issues like estimation of depreciation, valuation of inventories, etc. which still require judgement to be exercised by the auditor.
5. The total time taken in an audit may still be considerably higher even though the trial balance has tallied than an audit where the trial balance has not tallied. The responsibility will still remain even in an EDP environment.
6. Therefore, simply because of EDP environment and the trial balance has tallied, do not make the audit simpler.

Q.No.10. To prepare an audit plan in CIS environment an auditor should gather information. Mention such important information which he has to collect. (B) (PM)

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

1. How the CIS function is organized and the extent of concentration or distribution of computer processing throughout the entity.
2. The computer hardware and software used by the entity.
3. Each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies.
4. Planned implementation of new applications or revisions to existing applications.
5. When considering his overall plan the auditor should consider matters, such as:
 - a) Determining the degree of reliance, if any, he expects to be able to place on the CIS controls in his overall evaluation of internal control.
 - b) Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.
 - c) Planning auditing procedures using computer-assisted audit techniques.

Q.No.11. How would you assess the reliability of internal control system in computerised information system? (B) (M 08 - 6M)

The following administrative controls ensure an acceptable standard of discipline and efficiency in a computer based accounting system:

1. **Division of responsibilities:** The principal division of responsibilities should be that between the functions of the computer department and the user department. The following safeguards in connection with the proper segregation of duties are desirable, whenever practicable;
 - a) Only the control and data preparation sections should have access to the documents containing the original data to be processed by the computer;

- b) Computer department staff should not have access to any of the company's clerically maintained financial records;
 - c) Only computer operators should have access to the computer during production runs;
 - d) Only the user department staff and control section should be allowed to amend input data;
 - e) Access to the computer room should be restricted to authorised persons at authorised times.
2. **Control over computer operators:** The computer operators are responsible for operating the equipment in accordance with the operating instructions provided. Controls over computer operators include:
- a) The use of manuals laying down general standards of operating discipline;
 - b) Scheduling of work;
 - c) The provision of detailed operating instructions for each program;
 - d) The frequent and independent review of computer usage by reference to time and fault logs prepared by operators, and where there is a console typewriter by reference to operating logs produced thereon;
 - e) Requiring a minimum of two operators per shift;
 - f) Rotation of operator's duties;
3. **File control:** In view of the large number of files held on magnetic backing storage devices in most installations, it is necessary to provide controls to ensure that:
- a) Only the correct file can be used;
 - b) No files can be used for an unauthorised purpose;
4. **Controls employed for this purpose may be considered under the following headings:**
- a) File storage procedures;
 - b) File identification procedures;
 - c) Fire precautions and standby arrangements.

Alternate Answer: For evaluating the reliability of internal control system in CIS, the auditor would consider the following:

- 1. Authorised, correct and complete data is made available for processing.
- 2. That it provides for timely detection and corrections of errors.
- 3. That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
- 4. That it ensures the accuracy and completeness of output.
- 5. That it provides security to application softwares & data files against fraud etc.
- 6. That it prevents unauthorised amendments to programs.

Q.No.12. What are the specific risks related to internal control in an IT environment? (B)
(M 16 – 5M)

Risks related to internal control in IT environment: The specific risks related to internal control in an IT environment includes the following:

- 1. Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

2. Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
3. The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
4. Unauthorized changes to data in master files.
5. Unauthorized changes to systems or programs.
6. Failure to make necessary changes to systems or programs.
7. Inappropriate manual intervention.
8. Potential loss of data or inability to access data as required.

THE END

11. AUDIT OF SHARE CAPITAL

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-
3.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-
5.	B	-	-	-	-	-	-	-	5	2	-	-	-	-	5	-	-	-	-	-	-	-
6.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	4
7.	B	-	4	-	2	-	2	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-
8.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-

Q.No.1. Give the important points to be considered for the audit of issue of share capital. (B)

1. See that the allotment was made in accordance with the conditions contained in the Prospectus or Statement in lieu of Prospectus / Red hearing or Shelf Prospectus.
2. See that the directors have passed a resolution for allotment of shares.
3. Verify that the first allotment was not made until the amount of minimum subscription stated in the Prospectus has been subscribed.
4. See that until the minimum subscription is received the money received was kept deposited in a Scheduled bank.
5. Confirm that the brokerage and underwriting commission was paid only at the rates authorised by the Articles of Association or as per the Act whichever is lower.
6. *Ensure that legal requirements as laid down in Sec.62 (dealing with right shares) have been complied with.*
7. *Ensure that the company intending to offer shares to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges for getting the permission for listing of shares (Sec.40).*
8. Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) have been followed.
9. *See that the internal control on receipt of amounts exists & they are operating well.*
10. *Verify compliance with legal provision relating to issue of shares at premium (Sec.52), issue of shares at discount (Sec.53), and issue of sweat equity shares (Sec.54)*
11. See that the return of allotment has been filed with the Registrar of Companies.
12. *See that the company has delivered share certificates within 2 months after the allotment of any of its shares.*
13. *Ascertain that the issued capital does not exceed the authorised capital.*

Similar Questions: General programme for verification of share capital

REFER PRACTICAL QUESTIONS: 1

Q.No.2. Verification of shares issued for cash. (B)

(N 12 – 8M)

Usually, there are three stages in the issue of shares for cash, namely:

- a) Receipt of applications for shares along with application money.
- b) Allotment of shares and receipt of allotment money and
- c) Making calls and receipt of call money.

The programme of work to be carried out (Audit Programme):

Applications: Verify the amount received along with the applications in following manner: **(PM)**

- a) Check the entries in Application book with the original applications.
- b) Trace the entries in Cashbook with Application book for the verification of amounts collected on applications.
- c) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret.
- d) Check the total column in the Application book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.
- e) Check that the amount payable on the application on every security is not less than five percent of the nominal amount of security or such other percentage or amount as may be prescribed by the SEBI.

Allotment:

(PM)

- a) See that the director's passed a resolution for allotment of shares.
- b) Compare copies of letters of allotment with entries in the Allotment Book.
- c) Trace entries in the Cashbook into the Allotment Book for the verification of amounts collected on allotment.
- d) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share holder's Register.
- e) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.
- f) Check whether the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on such application have been received by the company.

Calls:

- a) Examine the Director's resolution making the call.
- b) Trace entries in the Cashbook into the Calls Book for the verification of amounts collected on calls.
- c) Trace postings of the amounts received from the Calls Book (for calls due) and the Cash Book (for calls collected) into the Share Register.
- d) Verify the journal entry, debiting the Call Account and crediting the Share Capital A/c with totals of the amounts due.
- e) Check the calls in arrears and their treatment is properly done.

Legal matters: Refer to the previous question.

Similar Question: As an auditor, how will you verify application and allotment money received on shares issued for cash?
(PM, N14 RTP)

Q.No.3. Verification of issue of shares for consideration other than cash. (B)
(N 90, M 92, 98, PM, N15 MTP2 - 4M)

A company is permitted to issue shares for a consideration other than cash under Sec.39.

Circumstances: *A company may issue shares for consideration other than cash to vendors of the business in part payment of the purchase consideration, to shareholders of companies amalgamated, to promoters towards reimbursement of expenses, etc.*

The special steps for verification:

- a) See that shares are issued in accordance with the conditions of the contract against which shares issued for.
- b) See that the director's passed a resolution for allotment of shares.
- c) Ensure that proper accounting entry has been passed to record the acquisition of the assets or the business on one hand and the issue of shares on the other hand. If any premium/discount is involved, see that appropriate adjustment entry has been passed.
- d) Verify that the fact of such issue is clearly disclosed in the B/s as required by Schedule III.
- e) *Ensure that Sec.62 (dealing with right shares) has been complied with.*
- f) *Ensure that the company intending to offer shares to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges to obtain the permission for listing of shares (Sec.40).*
- g) Confirm that the guidelines issued by the SEBI have been followed.
- h) See whether the return of allotment has been filed with the Registrar of Companies.
- i) See that the Co. has delivered share certificates within 2 months after the allotment.
- j) Ascertain that the issued capital does not exceed the authorised capital.
- k) See that shares are not allotted without consideration e.g. as donation to charitable institution, as shares must be issued only for a valid consideration, though it need not be in cash.

Some clarifications:

- a) *The allotment of shares made against the cancellation of debt payable should be considered as allotment of shares against cash.*
- b) *Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.*

Q.No.4. Verification of issue of shares at a premium. (B) (M 91 - 4M, M15 MTP1 - 4M)

Meaning: When the issue price of the share is more than the face value, whether for cash or otherwise, the shares is said to be issued at premium. **E.g.:** When Rs.10 share is issued at Rs.12 Rs.2 represents premium.

Purposes: Companies Act merely discusses the restriction on utilisation of share premium as contained in Sec.52. The securities premium account can be utilised only for any of the following purposes:

- a) Issuing fully paid bonus shares to members.
- b) Writing off of the balance in preliminary expenses of the company.
- c) Writing off of the commission paid or discount allowed, or the expenses incurred on issue of shares or debentures of the company.
- d) For providing the premium payable on redemption of any redeemable preference shares or debentures of the company.
- e) For buy back of shares u/s 68.

Disclosure: The amount of premium shall be disclosed separately under Reserves and Surplus on the liability side of the Balance Sheet, with the caption Securities premium account.

Further the auditor shall also see compliance with SEBI guidelines.

Similar Question: "A portion of Share Premium utilised to declare 40% dividend." Comment.

REFER PRACTICAL QUESTIONS: 3

Q.No.5. Issue of sweat equity shares. (B)

(M 00, 02, 03, - 8M, N13 – 4M, PM, N15 RTP, M15 MTP2 - 4M, N15 MTP1 - 6M)

1. The shares must be of the class already issued i.e. the sweat equity shares issued by the company must be are of a class of shares already issued.
2. At least 1 year must have completed since the Co. became entitled to commence business.
3. The shareholders shall pass a special resolution authorizing the issue of such shares.
4. **The resolution authorizing the issue should specify:**
 - a) The number of shares,
 - b) Current market price,
 - c) Consideration, if any, and
 - d) The class of directors or employees to whom such equity shares are to be issued.
5. **Listed and unlisted co.'s:**
 - a) If the company is listed on stock exchanges, sweaty equity shares can be issued as per the regulations made by SEBI.
 - b) In the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the prescribed guidelines.

Q.No.6. Audit of buy back of shares. (Or) Power of company to purchase its own securities. (B)

(M 11 - 8M, M 16 – 4M)

Ans.: Refer to the lesson "Share Capital" lesson in company law material.

Q.No.7. Verification of re-issue of forfeited shares. (B)

(N 93, 06, 07, 13 - 4M, PM, M15 MTP1 - 4M)

- a) See that the articles permit such reissue.
- b) Check whether proper notice was given to member who has defaulted in payment.
- c) Refer to the resolution of the Board of Directors, re-allotting forfeited shares. See that Reissue is made at a price such that the total sum paid by the original owner of shares together with the reissue price is not less than the par value. In other words, the discount on re-issue should not exceed the amount forfeited on those shares.
- d) See that the profits resulting on the reissue of shares credited to the Capital Reserve Account.

REFER PRACTICAL QUESTIONS: 4

Q.No.8. Verification of issue of bonus shares. (C)

(N14 – 4M)

- a) It is authorized by its articles;
- b) It has, on the recommendation of the Board, been authorized in the general meeting of the company;

- c) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
- d) It has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
- e) The partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;
- f) It complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same.
- g) The bonus shares shall not be issued in lieu of dividend.

PRACTICAL QUESTIONS

Q.NO.1. SHARE APPLICATION MONEY PENDING ALLOTMENT HAS BEEN DISCLOSED IN THE BALANCE SHEET OF A COMPANY AS CURRENT LIABILITY.

Should be disclosed as "Share Application Money Pending Allotment" in the Balance sheet after 'shareholders funds' and before 'Non current liabilities'.

Q.NO.2. CALLS IN ARREARS INCLUDED AN AMOUNT OF RS.20,000 DUE FROM DIRECTORS OF THE COMPANY. THE ARTICLES OF ASSOCIATION PROVIDED FOR CHARGING INTEREST ON CALLS IN ARREARS. THE COMPANY DID NOT PROVIDE INTEREST ON THE AMOUNT DUE FROM DIRECTORS. COMMENT.

The articles of ABC Ltd. provided for charging interest on calls in arrears. Accordingly, interest due from Directors on account of calls in Arrears need to be provided for. Part I of Schedule III to the Companies Act, 2013 requires that the calls due from directors and by others, should be shown separately in the Balance Sheet. Therefore, neither the disclosure requirements as specified in Schedule III have been followed nor the interest has been properly charged as required by the articles of Association. Auditor should qualify the audit report.

Q.NO.3. Y LTD. HAS ACCUMULATED LOSSES OF RS.12 CRORES. THE COMPANY INTENDS TO ADJUST THE ACCUMULATED LOSSES AGAINST THE "SHARE PREMIUM ACCOUNT". IS THE COMPANY PERMITTED TO DO SO UNDER THE PROVISIONS OF THE COMPANIES ACT, 2013?

Refer to Q.No.4 in Theory questions. Hence, the Company is not permitted to adjust its accumulated losses.

Q.NO.4. SURPLUS ON THE RE-ISSUE OF FORFEITED SHARES STANDING TO THE CREDIT OF SHARE FORFEITED ACCOUNT CAN BE DISTRIBUTED AS DIVIDEND.

True: The surplus on re-issue of forfeited shares being a capital profit is credited to Capital Reserve Account. Capital profit may be distributed as dividend if authorized by the article of association.

Q.NO.5. THE REGISTER OF MEMBERS OF C LTD. HAS NOT BEEN WRITTEN UP-TO-DATE AND AS A RESULT THE BALANCES IN THE REGISTER DO NOT AGREE WITH THE AMOUNT OF ISSUED SHARE CAPITAL. AS AN AUDITOR HOW YOU WOULD REACT TO THE ABOVE SITUATION?
(M 97, 06 - 4M)

Statutory Register: Register of Members is a Statutory Book, which should be maintained properly and up-to-date by every Company.

Auditor's Duties: The auditor should advise the company to update the register and then examine its agreement with the amount of Issued Capital.

If the company fails to update the Register before completion of audit, he should qualify his report stating that proper books of accounts and records as required by law have not been kept, giving the nature of the defect noticed by him.

Q.NO.6. BRIEFLY DISCUSS THE PROVISIONS OF THE COMPANIES ACT, 2013 WITH REGARD TO ISSUE OF SHARES AT A DISCOUNT. (PM, M15 RTP)

Issue of Shares at a Discount: According to Section 53 of the Companies Act, 2013 except sweat equity issued as mentioned in section 54, any share issued by a company at a discounted price shall be void.

Where a company contravenes the provisions of this section the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

Q.NO.7. C LTD. DECLARED DIVIDEND AMOUNTING TO RS. 5 LACS OUT OF PROFITS FOR THE YEAR ENDED 31.3.2013. SUBSEQUENTLY, IT WAS NOTICED THAT COMPANY HAD FAILED TO MAKE PROVISIONS FOR OUTSTANDING EXPENSES OF RS. 7.80 LACS AND CLOSING STOCK WAS ALSO OVER VALUED, WHICH WAS NOT REPORTED BY AUDITORS OF THE COMPANY. MANAGEMENT OF C LTD. HELDS AUDITORS RESPONSIBLE FOR THIS SITUATION. COMMENT.

Failure to detect untrue and incorrect financial position of a company: In the given case, profit of the company has been inflated by non provisioning of outstanding expenses and by overvaluation of closing stock by Rs. 7.80 lacs and subsequently dividend of Rs. 5 lacs has been paid. Thus it can be said that dividend has been paid out "inflated profit". It was the duty of auditor to ascertain whether the Balance Sheet & P & L A/c of the company show a true and fair view of the financial position and revenue earning capacity. For that he has to exercise proper audit procedure of substantive test (i.e. vouching and verification) and valuation of P & L A/c & Balance Sheet items, particularly, whether provision for all outstanding expenses has been made or not, whether closing stock has been properly valued as per AS-2. If not, he should issue qualified report or adverse report. If he failed to do so, he will be held as guilty of gross negligence.

THE END

12. AUDIT OF DEBENTURES

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	-	-	-	-	-	8	-	-	-	-	-	-	-	-	-
2.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	C	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-
4.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

**Q.No.1. What are the matters to be verified in relation to allotment of debentures? (B)
(PM, N15 RTP)**

- See that the company has the authority under the memorandum for such borrowal.
- See that allotments have been made in accordance with conditions contained in the Prospectus.
- See that the terms & conditions of the debenture trust deed has been complied with.
- See that the director's passed a resolution for allotment of debentures.
- Confirm that the brokerage and underwriting commission has been paid only at the rates authorised by the Articles of Association or as per act which ever is lower.
- Ensure that the company intending to offer debentures to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges for getting the permission for listing of debentures (Sec.40).
- Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) have been followed.
- See that the internal control on receipt of amounts exists & operates well.
- Verify compliance with legal provisions relating to issue of debentures at discount.
- See that the company has delivered debenture certificates within the 6 months after the allotment or within the time extended by CLB.
- Where debentures are issued for a consideration other than cash, see the terms & conditions of the contract against which the issue was made, is complied with.
- Ensure the compliance with Sec.71 (appointment of debenture trustees and his duties) and (Creation of a security and debenture redemption reserve).
- In case any charge is created see that the requirements of Sec.77 of the companies act have been complied with.
- Check entries in the Application book with the original applications.
- Trace entries in the Cashbook into the Application book for the verification of amounts collected on application.
- Trace the entries in the Cash book into the Allotment Book for the verification of amounts collected on allotment.
- Compare the copies of letters of allotment with entries in the Allotment Book.
- Check the total column in the Application book and confirm the journal entry debiting Debenture Application Account and crediting Debenture Capital Account.

- s) Check the totals of amounts payable on allotment and verify the journal entry debiting Debenture Allotment Account and crediting Debenture Capital Account.
- t) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Debenture's Register.

REFER PRACTICAL QUESTIONS: 1

Q.No.2. What is the procedure for vouching of interest on debentures? (C)

- a) The payment of interest should be vouched with the interest warrants issued and in the case of bearer debentures with the interest coupons surrendered.
- b) See that the interest is paid as per the terms & conditions of the issue.
- c) The total amount paid should be reconciled with the total amount due and payable with the amount of interest outstanding for payment.
- d) Interest on debentures is payable whether or not any profit is made.
- e) The interest paid on debentures, like that on other fixed loans, must be disclosed as a separate item in the Profit and Loss Account.
- f) See that debenture interest is debited as expenditure at gross i.e. before TDS.
- g) See that interest accrued but not due has been provided.

Q.No.3. Write about re-issue of redeemed debentures. (C)

(M 11 - 4M)

- a) A company may issue debentures previously redeemed, either by reissuing the debentures or by issuing others in their place unless the Articles or a contract or resolution, recorded at a General Meeting, or terms of issue or some other act of the company expressly or impliedly state the intention that, on redemption, the debentures shall be canceled.
- b) However, the re-issue of redeemed debentures are treated as a new issue for the purpose of stamp duty and the rights and privileges attaching to the debentures that re-issued shall be the same as if the debentures had never been redeemed.
- c) On these considerations, it is necessary for the auditor to verify the reissue of debentures in the same manner as those issued for the first time.

Q.No.4. Write about issue of debentures as collateral security. (C)

- a) Quite frequently debentures are issued as collateral security to creditors, bankers or other parties.
- b) The amount of debentures is shown only in an inner column in the Balance Sheet.
- c) The collateral security becomes effective only in the event of default or the loan not being repaid when due.
- d) As soon as the loan is repaid, the debentures are automatically cancelled.
- e) The auditor should ensure that the existence of the collateral security is disclosed along with the liability concerned in the Balance Sheet.
- f) He should also examine the loan agreement and confirm that the issue has been approved by the Board of Directors and other formalities, as regards registration of the charge, etc., with the Registrar of Companies have been carried out.

PRACTICAL QUESTIONS

Q.NO.1. THE DEBENTURE TRUST DEED EXECUTED BY T LTD. STIPULATED THE CREATION OF A SINKING FUND FOR REDEMPTION OF DEBENTURES. IN TERMS OF THE TRUST DEED, A SPECIFIC AMOUNT WAS TO BE TRANSFERRED TO THE SINKING FUND FROM OUT OF THE PROFITS OF EACH YEAR. IN SPITE OF SUBSTANTIAL PROFITS IN A YEAR, NO AMOUNT IS FOUND TRANSFERRED TO THE SINKING FUND. STATE YOUR VIEWS.

In the course of his normal duties, the auditor is expected to check compliance with conditions specified in the Debenture Trust Deed. The auditor should draw the attention of the Shareholders to the failure of the Company to create the Sinking Fund in terms of the Debentures Trust Deed. Since, no amount as stipulated in the Deed has been transferred to Sinking Fund Account as observed by the auditor; the auditor should qualify his audit report.

THE END

13. AUDIT OF CASH TRANSACTIONS

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10 TO M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	4
2.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	A	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	4	-	4	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	A	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4
7.	A	-	4	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-
8.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-
10.	A	-	-	-	-	5	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-
11.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-
13.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
14.	A	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
16.	A	-	-	-	5	-	-	-	-	-	-	-	6	-	-	-	-	-	-	-	-
17.	A	-	-	-	-	-	-	6	-	-	-	-	-	-	-	-	-	4	-	-	-
18.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
19.	A	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
20.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
21.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
22.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
23.	B	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-
24.	B	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-
25.	A	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
26.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-
27.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
28.	B	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-
29.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-
30.	A	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
31.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
32.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
33.	B	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-
34.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
35.	A	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
36.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	4
37.	B	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-
38.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
39.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
40.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
41.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
42.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
43.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
44.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Aspects to be looked into by the auditor, while examining a voucher. (OR) 'in vouching payments, the auditor does not merely check proof that money has been paid away'. (C)
(M14 – 5M, PM, M15 RTP, M16 – 4M)

- a) Date of the voucher shall fall within the period.
- b) The voucher should be numbered serially & the correct number shall appear in the cash book.
- c) The voucher should be authorised by responsible official.
- d) The transactions should relate to the business of the client.
- e) The amount in words and figures should tally.
- f) Where it exceeds Rs 5000 it should be stamped.
- g) Any alteration in the voucher should be signed.
- h) A transaction is recorded in the proper account.
- i) Checking the arithmetical accuracy of the voucher.
- j) Checking the existence of evidence in support of the transaction.
- k) That the voucher is complete in all respects.
- l) After examination, each voucher should either be stamped or initialed so that it may not be presented again in support of another entry.

Q.No.2. Vouching is the essence of audit. Comment. (C)

Definition: Refer to 1st question.

Aspects to be looked into by the auditor, while examining a voucher: Refer to 2nd question.

The audit normally takes place long after the transactions have taken place, and the auditor, not being in picture at the time, cannot have the benefit of direct experience of the transactions. Necessarily, he has to depend on evidence like voucher.

Vouching is also the basis for verification of assets and liabilities: For example let us take an asset like sundry debtors. The auditor has to finally certify that it has been correctly stated in the Balance Sheet.

For this, he has to check the account of every debtor. This means that he should vouch the entries in the Sales Book, Sales Returns Book, Cash Book, Bill Receivable Book and the Journal in relation to the debtors.

He has to compare the entries with vouchers like invoices, credit notes and verify the posting into the debtors' accounts and see that bad debts have been written off and adequate provision has been made for doubtful debts. Hence it can be seen that vouching is the basis of verification of the balance of sundry debtors.

Hence it is true that vouching is the backbone of auditing or vouching is the essence of auditing.

Q.No.3. How will you vouch payment of income tax? (A)

(N 91, 97, M 92 - 4M, N15 – 4M, PM)

- a) Check the computations relating to total income & tax calculations.
- b) Check the rates of tax as per the relevant finance Act.
- c) See that the total amount of tax has been paid after taking into account the tax paid during the financial year by way of advance tax and tax deducted at source, if any.

- d) Verify the copy of receipted challans evidencing the I.T. payment.
- e) Check the income tax returns submitted by the enterprise.
- f) *Ensure posting of entries of amount paid to 'Income-tax paid Account' or to 'Advance Income-tax paid Account' in case of advance payment of taxes.*
- g) *Examine the demand notice issued by I.T.O. and the final assessment order, if any.*
- h) *See that the disclosure requirements of Sch.III, Part II have been complied with or not.*
- i) In the case of Companies, ascertain that undisputed taxes are paid regularly as required by CARO, 2016.

Q.No.4. What are the steps in vouching of VAT and CST? (A)

- a) Check the computations relating to total sales & tax calculations.
- b) Check the rates of tax as per the relevant Act.
- c) See that the total amount of tax has been paid after taking into account the tax paid during the financial year by way of input tax credit, if any.
- d) Verify the copy of receipted challans evidencing the VAT payment.
- e) Check the VAT returns submitted by the enterprise.
- f) *Ensure posting of entries of amount paid to 'output VAT Account' or to 'Input VAT Account'.*
- g) *The VAT payment may be in respect of the VAT or CST. The auditor should see that both are separately recorded.*
- h) *Examine the demand notice issued by C.T.O. and the final assessment order, if any.*
- i) *See that the disclosure requirements of Sch.III, Part II have been complied with or not.*
- j) In the case of Companies, ascertain that undisputed taxes are paid regularly as required by CARO, 2016.

Q.No.5. What are the steps in vouching of excise duty? (A)

(N 92, M 96, 99, 04, 08 - 4M, PM, M15 RTP)

- a) See that the provisions of the excise act have been complied with.
- b) Check the computations relating to Excise duty calculations.
- c) Check the rates of tax as per the relevant finance Act.
- d) See that the total amount of duty has been paid after taking into account the advance excise duty paid & Cenvat credit.
- e) Verify the copy of receipted challans evidencing the duty payment.
- f) Check the excise returns submitted by the enterprise.
- g) *Examine the demand notice issued by Excise officers, if any.*
- h) *See that the proper register's as required by the excise act are maintained for.*
- i) *See that the duty paid for the purchase of machinery is debited to the machinery account.*
- j) *See that the duty paid for the purchase of materials is debited to the purchases account.*
- k) *In the case of Co., ascertain that undisputed taxes are paid regularly as required by CARO 2016.*
- l) Ascertain that in case of dispute about the amount of duty payable, a provisional amount may be paid in lieu of final amount. In such cases, the final amount determined as payable should be verified. If the provisional payment was more than the actual amount, the refund of such excess amount should be vouched.

Q.No.6. How will you vouch customs duty? (A)N 92, M 96, 99, 04, 08 - 4M,M16 – 4M PM)

- a) See that the provisions of the customs act have been complied with.
- b) Check the computations relating to customs duty calculations.
- c) Check the rates of tax as per the relevant finance Act.
- d) If payment is made directly by the client, verify the Bill of Entry and the challans evidencing payment of customs duty.
- e) In some cases, the customs duty is paid through the clearing and forwarding agent of the client. In that case, examine the agent's bill with the Bill of Entry.
- f) *Examine the demand notice issued by custom's officers, if any.*
- g) *See that the duty paid for the import of machinery is debited to the machinery account.*
- h) *See that the duty paid for the import of materials is debited to the purchases account.*
- i) *In the case of Companies, ascertain that undisputed taxes are paid regularly as required by CARO, 2016.*
- j) Ascertain that in case of dispute about the amount of duty payable, a provisional amount may be paid in lieu of final amount. In such cases, the final amount determined as payable should be verified. If the provisional payment was more than the actual amount, the refund of such excess amount should be vouched.

**Q.No.7. What are the steps in vouching of travelling expenses? (A)
(M 88, N 90, 06 - 4M, N 12- 8M, PM, M15 RTP)**

- a) Check whether there are any travel rules framed by the Client.
- b) *See whether the travel is authorised by responsible official.*
- c) In the case of foreign travel check that it is approved by BOD by passing a resolution.
- d) In the case of foreign travel check whether RBI's permission has been obtained.
- e) Check the calculations in the travelling expenses statements.
- f) See whether the reports of travelling expenses, submitted by the employees are supported with all the possible evidences for the amounts spent.
- g) Whether amount claimed for sundry expenses such as tips etc. is reasonable.
- h) *See that any personal expenses of the employees are not shown as traveling expenses.*
- i) Where an advance for traveling expenses is given to the employee, see that the same is adjusted latter.
- j) Where the traveling allowance is given in the place of traveling expenses see the calculations.
- k) *If the company had booked tickets or hotel room directly and made payments to the airlines railways/hotels directly, see that these have not been claimed as reimbursement by the employee.*
- l) *See that the disclosure requirements of Sch.III, Part II have been complied with or not.*

Q.No.8. What are the steps in vouching directors traveling expenses? (A)

Attending the Board meeting:

- a) Verify the AOA and see whether it permits the payment of traveling expenses.

- b) Confirm the attendance of the director at the meeting by checking the board meeting's attendance register.
- c) See the resolution fixing the traveling expenses of the directors per meeting.
- d) *The voucher should be supported by receipts given by the directors.*
- e) *See whether the reports of travelling expenses, submitted by the directors are supported with all the possible evidences for the amounts spent.*
- f) Check the calculations in the traveling expenses statements.
- g) Where the traveling allowance is given in the place of traveling expenses see the calculations.
- h) *See that the disclosure requirements of Sch.III, Part II have been complied with or not.*

Business traveling: See the previous question.

Q.No.9. What are the steps in vouching of repairs to assets? (A)	(M15 – 4M)

- a) *The auditor should see that the work of repairing has been authorised by a responsible officer.*
- b) See that the expenditure is properly classified as capital and revenue.
- c) *The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life, should be treated as capital expenditure.*
- d) Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained.
- e) If the work of repairs is based on A.M.C., see that the payments are made as per the agreement.
- f) If Repairing is done through a contractor, the auditor should verify the bill of the contractor.
- g) *See that the voucher is supported by the receipt of the contractor for the payment of the bill.*
- h) *See that the disclosure requirements of Sch.III, Part II have been complied with or not.*

Q.No.10. What are the steps in vouching of R & D expenditure? (A)	(M 00 - 4M)

- a) Ascertain whether the concerned research activity is authorised by the Board.
- b) **Treatment:** See that all the research expenses are charged to revenue whether research is successful or not. Development expenses are treated as capital expenditure, if research is successful.
- c) *Ensure that if any machinery and equipment have been bought specially for the purpose of research activity, the depreciation thereon is charged to the R&D a/c.*
- d) See that if any amount is paid towards the technical know how relating to R&D, the same is charged to the R&D a/c.
- e) *See that no unrelated expenses to the research and development programme are allowed to be debited to Research and Development Account.*
- f) See that tax benefit arising on the research expenses is considered in creating tax provision.
- g) See that the miscellaneous income resulting on sale of the chemicals etc. is properly accounted for.
- h) See that AS - 26 has been complied with.
- i) *See that the disclosure requirements of Sch.III have been complied with or not.*

Q.No.11. How will you vouch advertisement expenses? (A) (M 05, 07, 08, 13 - 4M, PM)

1. Obtain the complete list of media of advertisement i.e., newspaper, slides, hoardings, magazines, television, radio etc. showing the dates, exact location, timings, etc. along with the amounts paid in respect of each category.
2. *The auditor should see that the advertisement has been authorised by a responsible officer.*
3. See that the advt. exp. incurred for acquisition of capital asset is added to cost of such asset.
4. Where an advance for advt. is paid for, the auditor should see that the same is adjusted latter.
5. If there is a regular contract with an advertising agency, see that regular statements are obtained from the agency showing the advertising media and amounts debited to the client.
6. *See that the voucher is supported by the receipts or paper-cuttings of all the advertisements.*
7. *See that the disclosure requirements of Sch.III have been complied with or not.*

Q.No.12. How do you vouch the selling agent's commission? (A) (M 90, N 05 - 4M, PM)

- a) *See whether the payment is properly authorised.*
- b) Check the agreements with the agent and see whether they are complied with.
- c) *Check the correctness of the calculations.*
- d) In case commission is given only on the realisation from the debtors verify the amounts received and check the calculations accordingly.
- e) *See that the vouchers are supported by the receipts given by the agent.*
- f) *See that the sales returns are properly treated at the time of calculating the commission.*
- g) *See that the disclosure requirements of Sch.III have been complied with or not.*

**Q.No.13. What are the steps in vouching of remuneration to directors? (A)
(N 92, 93, 03, M 97, 99 - 4M, N13, 15 - 4M, PM)**

- a) See the general or board meeting resolution for the terms of appointment of the director.
- b) Check agreement with the director.
- c) Ensure compliance with the provisions of Sec.'s 197, 198 & schedule V of the Companies Act, 2013, where appropriate.
- d) Check computation of the net profits.
- e) *See that the voucher is supported with the receipt issued by the directors.*
- f) See whether the director's remuneration is disclosed separately in the P & L account.
- g) *See that the excess remuneration paid is shown separately.*
- h) See that disclosure requirements as per AS-18 have been complied with.

Q.No.14. What are the steps in vouching directors sitting fees? (A)

(N 88, 90 - 4M, N15 - 6M)

- a) Check the AOA regarding the payment of sitting fees to the directors.
- b) Verify Board meetings attendance register to confirm that directors have attended meetings.
- c) *See that the voucher is supported with the receipt issued by the directors.*
- d) Confirm the correctness of the sitting fees on an overall basis by taking into account the number of board meetings held, the no. of directors attended and the fees fixed as per AOA.
- e) See that it does not exceed limits fixed as per Sec.197 of the Companies Act.
- f) Ensure that the full time Directors (employed) with the company including Managing Director are not paid director's fees for attending Board Meetings.
- g) *See that these expenses are expensed i.e. charged to Profit and Loss Account as and when incurred.*
- h) See whether the director's sitting fees is **disclosed** separately in the P & L account.
- i) See that disclosure requirements as per AS-18 have been complied with.

Q.No.15. What are the steps in vouching of insurance premium? (A)

(N 06 - 4M)

- a) Where the number of policies is more, the auditor should ask the client to prepare a statement giving all the details of the insurance policies.
- b) *See whether the payment is properly authorised.*
- c) Check the policy document physically.
- d) See that the voucher is supported with the receipt for the premium paid.
- e) Find out whether the insurance coverage is adequate.
- f) See that the insurance premium paid for the part of the next year is debited to prepaid expenses account.
- g) *Where the policy is not renewed the auditor should enquire into the reasons.*
- h) *See that the disclosure requirements of Sch.III have been complied with or not.*

Q.No.16. What are the steps in vouching of clearing charges? (A)

- a) Normally, clearing of the goods is done through the shipping agents or clearing agents.
- b) The bill of the shipping agent should be supported by evidence for the payments made by him on behalf of the company.
- c) The voucher must be supported by the agent's bill and the receipt.
- d) *If the expenses are in respect of fixed assets, it should be capitalised.*
- e) *If the expenses are in respect of materials, it should be debited to purchases account.*
- f) The auditor should see that the bill is in the name of the client.

Q.No.17. How do you vouch the retirement gratuity? (A)

(M 90, 95, 08, N 02, 07, 14 - 4M, M 12 - 6M, PM)

- a) Examine the basis on which the gratuity payable to employees is worked out.
- b) Check the computations/amount of gratuity paid to employees who were retired during the year with reference to number of years of service rendered by them.

- c) See that the annual contributions have been charged to Profit and Loss Account in case the concern is making the contributions to an outside fund.
- d) See that the annual premium has been charged to Profit and Loss Account in case the concern has taken a policy from LIC.
- e) *See that the contributions/premium paid is adequate.*
- f) *See that gratuity is recognized on accrual basis.*
- g) See that the provisions of the gratuity act have been complied with.
- h) The auditor should treat the actuary as a expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 620.
- i) *The auditor should check the technical competence of actuary, the input fed to the actuary, the assumptions made by the actuary, the methodology adopted by the actuary, opinion given etc.*
- J) The auditor should bear in mind the relevant pronouncements of AS 15 "Employee benefits" in this regard. He should check whether the expenses of provision for gratuity are towards a defined benefit plan or contribution plan.

Q.No.18. How do you vouch wages paid to seasonal labourer? (B)
(M 05 - 4M, PM, N15 MTP2 - 4M)

1. Internal Control:

- a) *Evaluate the Internal Controls for recruitment and usage of Seasonal Labourers.*
- b) See whether the attendance of Seasonal Labourers is checked by Staff in the Time Keeping Department.

2. Wage Analysis Sheet:

- a) *Obtain the list of persons who are entitled to receive wages.*
- b) Ensure that Seasonal Labourers have been employed only for the necessary purpose and their employment is authorised by a responsible official.

3. Wage Computation Sheet:

- a) Obtain the statement regarding the wages payable to the labourer from the Supervisor who supervise the jobs done by them
- b) Verify whether the wages have been properly paid to the Seasonal Labourer, from the records maintained by them and with the Cash Book.
- c) Verify whether eligible regular employees have been included in the list and examine cases of double inclusion in the payroll.
- d) *See whether all payments to Seasonal Labourers have been acknowledged by way of stamped receipts/ vouchers.*

4. General Ledger / Financial Statements:

- a) *Reconcile the number of Seasonal Laburers as per the Payroll with the Personnel Department's records and as per the Receipt Vouchers / Acknowledgements, to ascertain "dummy workers"*
- b) Compare – a) the ratio of Seasonal Labourers' wages to Total Labour Cost, and b) amount of expense, with that of previous years.

Q.No.19. How will you vouch / verify loss of stock by theft? (A)

(M 07 - 4M, PM)

1. Stock Register:

- a) Ascertain the quantum of loss as recorded in the Stock Register.
- b) *Examine the Verification Reports / Stock Statements of the person(s) who has conducted year-end / periodical physical verification of stock*
- c) *Ascertain the reasons for the total loss of stock classified into Normal and Abnormal (theft etc.) reasons.*

2. Internal controls:

- a) Evaluate the efficacy of internal control in relation to stock to find out whether there are weaknesses in the internal control system.
- b) Examine whether there is any continuing failure to correct major weakness in Internal Control.

3. Accounting Records:

- a) See whether the value of Stock Loss has been properly ascertained as per generally accepted accounting principles
- b) Examine whether there is any Insurance cover against the loss of stock by theft and verify whether a claim has been properly made.
- c) Ensure compliance with reporting requirements [**CARO 2016**] – whether material discrepancies noticed on physical verification have been properly dealt with in the books of accounts.

- 4. Reporting:** Ensure that the above loss of stock by theft has been appropriately disclosed / highlighted in – (a) Management Letter / Letter of Weakness, (b) Communication to those charged with governance, and (c) Auditor's Report to Shareholders.

Q.No.20. How will you vouch cash sales? (B)

(N 92, 97, M 07 - 4M, PM)

1. Accounting Manual & Internal Control:

- a) *Examine the internal control and ascertain whether it operates satisfactorily.*
- b) *Ensure proper co-ordination (& not collusion) between Billing & Despatch Sections.*
- c) *Identify possible loopholes in the system, whereby cash could be misappropriated*

2. Second Copy of Cash Bills:

- a) Verify actual collections on a given date based on the Second Copy of Cash Bills.
- b) Conduct examination in depth, for a few bills, in order to ascertain whether product description, model-wise, prices, discounts, quantities, etc. are properly calculated.
- c) *Ascertain whether rates of Excise and VAT on Sales have been calculated properly.*
- d) *Trace a few entries/items of Cash Sales into the Stock Register and confirm issue / dispatch postings.*
- e) *Examine the Bill serial Numbers to ensure that "dummy" bills are not included.*
- f) *Confirm whether dates of these bills correspond with the Cash Book entry date.*

3. Cash Sales Summary Book:

- a) *Where Cash Sales are numerous, the Firm maintains a Collection Chitta or Cash Sales Summary Book. Trace the collections into the Summary Book.*
- b) *Check the summary Book to ensure that castings, cross-totals, etc. are correct.*

4. **Cash Book:** Trace the daily total collections to the Cash Book from the following sources –
 - a) Second copy of Cash Bills.
 - b) Summary Book or Collection Chitta – in case collections are heavy.
 - c) Machine Printouts – in case of mechanised collections / cash registers.
5. **Originals of Cancelled Cash Bills:**
 - a) Where a cash bill has been cancelled, inspect its Original and confirm the cancellation.
 - b) Trace the entry into the Stock Register, and ensure that there is no dispatch against a cancelled invoice / bill.
6. **Bank Statements:** *In case daily cash collections are banked on the following day, trace the earlier day collection into the Bank Statement along with pay-in-slip counterfoil.*
7. **Sales Tax & Excise Duty:** *Examine whether the total sales (Cash and Credit) as per General Ledger tallies with the amount disclosed in Excise and VAT monthly returns submitted to the Sales Tax and Excise Authorities.*
8. **General Ledger:** Trace the total of Cash Sales & Credit Sales, into Sales account in the General Ledger.
9. Confirm the totals of the various heads of account, i.e. Sales, Excise Duty Collection, Sales Tax Collection, etc. tallies with the Subsidiary Register.

Q.No.21. How would you vouch collection from debtors? (B)	(N 93 - 6M)

1. **Internal Control:** *Examine the control system for Cash and Cheque collection from Debtors, and ascertain if there are any loopholes (for teeming and lading fraud, Misappropriation of cash, etc) and verify whether the system operates properly.*
2. **Ageing Analysis:** Check if there is a system of preparing an “Ageing Schedule” of Debtors, and regular follow-up action is taken for collection on a timely basis.
3. **Bank Statement:** *Trace the receipt of Cheques received from customers, into the Bank Statement.*

Ensure that Cheques received are deposited immediately and there is no delay between the date of receipt and the date of deposit in the Bank Account. Examine cases of dishonor of Cheques, if any, and see whether proper follow-up action is taken in respect of such situations.

4. **Debtors Ledger:**
 - a) Examine the general nature of settlement by customers, i.e. (a) Bill-by-Bill basis, or (b) “On Account” basis.
 - b) In case of “Bill by Bill” settlement, check whether there are any long outstanding bills, while subsequent bills on the customer have been settled.
 - c) In case of “On Account” basis payment by customers test-check the covering letters in a few cases, to examine accuracy and genuineness of the accounting entries.
 - d) Examine whether advances received from customers have been promptly settled / adjusted against final settlement received from the parties.
 - e) Verify the genuineness, authorization and accounting in respect of credits in Debtors’ Accounts towards – (a) Discounts Allowed, (b) Price, Rate and Quantity Differences, (c) Quality rejections, (d) Sales Returns, etc.
 - f) Examine whether Bad Debts written off, if any, are under proper authority.

5. Debtors Confirmation:

- a) Obtain Confirmation of Balances from Debtors to ensure that all transactions have been reflected in the books and accounts and eliminate chances of any fraud.
- b) Request the entity to obtain "Statements of Account" from a few Debtors, and cross-check the same with the entries reflected in the entity's books of account.

Q.No.22. How would you vouch expenditure incurred for promotion of a product? (A) (M 08 - 4M, PM)

- a) The expenditure incurred for promotion of a new or existing product may entail future benefits.
- b) *It may be like advertisement in the papers, television, sales exhibition, participation in trade fair, issue of promotional pamphlets, fees gifts etc.*
- c) *The auditor should vouch the authority and accuracy of the transactions.*
- d) Read the contract with advertisement agencies, promotional policies decided by the management from board minutes etc.
- e) *Check the amounts paid to the agencies from bank book.*
- f) Ascertain whether tax had been deducted in accordance with the tax law provisions if any applicable in this regard.
- g) Check whether the unpaid amounts and accrued liability towards promotional advertisement contracts had been duly provided for in the accounts.
- h) The huge expenditure should not be treated as deferred revenue expenditure. According to AS 26, these are not intangible assets that may be carried over the periods of accounting. These must be expensed with in the year in which these arise.

Q.No.23. How would you vouch balances with excise authority? (B) (M 08 - 4M, PM)

- a) The balance with excise authority in PLA account should be checked with the statements of accounts/ records kept with excise section of the unit.
- b) The remittance into the account, the utilisation out of it etc should be cross checked with bank book, clearance forms etc.
- c) The balance should be shown under other current assets in balance sheet.
- d) *It is to be ensured that the balances in PLA is used only to the extent of liability after adjusting cenvat credit where available.*

Q.No.24. How will you vouch production incentive paid to workers? (B) (J 09 - 10M, PM)

- a) *The auditor should trace the total production incentive paid to workers from P & L account to prime records / division wise / department wise records.*
- b) The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.
- c) The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by their accounts department.
- d) *He should check list of payment and also acquitted disbursement slips of select departments / periods for scrutiny of various data generated in the fields for their accuracy and completeness.*
- e) The auditor should make an overall analytical procedure of ensuring the expense booked is commensurate in quantum with statistical data on production and strength of workers.

Q.No.25. How will you vouch / verify bad debt? (A) (J 09 - 10M, PM, N15 MTP2 - 4M)

- a) The amount of bad debts should be traced to the schedule of bad debts written off during the year.
- b) Major amount of bad debts in the schedule be taken for scrutiny.
- c) Check that the amount considered in write off had been overdue for long and scrutinise the correspondence files.
- d) Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.
- e) The bad debts should be properly disclosed in statement of P & L according to its materiality.
- f) *If provision has already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.*

Q.No.26. What are the steps in vouching of rental receipts? (A) (N 92, M 07 - 4M, M15 - 4M, PM)

- a) The auditor should obtain a complete schedule of properties held, showing particulars as regards the name of the tenant, location of the property, amount of rent, period of payment etc.
- b) *Auditor should vouch the rent received with the help of the carbon copies of rent receipts.*
- c) *See that the terms & conditions of rental agreement have been complied with.*
- d) *Where the rent is collected by a collecting agent, the a/c of the agent should be scrutinised.*
- e) *The auditor should also vouch the entries for the rent outstanding.*
- f) The auditor should properly investigate into abnormal rent outstanding in particular.
- g) The auditor should also vouch the entries for the rent received in advance. Such advance receipts should not be credited to the rent a/c but to the rent received in the advance a/c. In the subsequent year, the reversal entry should be vouched.
- h) *The auditor should check arithmetical accuracy of rent bills and rent receipts and ensure amounts collected under various heads (e.g., taxes, water and electricity along with rent), are posted to correct accounting heads.*
- i) See that the refundable deposits collected from the tenants are not shown as rent.
- j) See that proper treatment was made for the TDS made by the tenants.
- k) *See that the disclosure requirements of Sch.III have been complied with or not.*

Q.No.27. What are the steps in vouching of royalty received? (A) (N 03 - 4M, PM)

- a) The auditor should see the relevant agreement and examine the important provisions relating to the conditions of payment of royalty, the rate of royalty, mode of calculation and the due dates.
- b) Check the computations for the royalty received.
- c) *Confirm the income with the carbon copies of royalty receipts.*
- d) See that treatment for special cases (free samples distributed) is in accordance with agreement.
- e) See whether all the terms and conditions as per agreements have been properly complied with
- f) *See that proper treatment was made for the TDS made by the payee.*
- g) *See that the disclosure requirements of Sch.III have been complied with or not.*

Q.No.28. What are the steps in vouching of interest received on loans? (B)

- a) Obtain the schedule of loans and advances.
- b) Examine the agreement, if any, to see the terms regarding the interest.
- c) Ensure interest is received on all loans and advances on which interest is receivable. If interest is not received make inquiries. If outstanding, see that accrued interest is brought into account. If it is doubtful of recovery, suitable provision to be made.
- d) *Inspect the counterfoil or carbon copies when receipts are issued. Trace the same into the cash/bank book to ascertain that entry has been passed for the correct amount.*
- e) *If installments are also received with interest, see that only the interest element is credited to the interest account.*
- f) In case of companies, see whether loans given to other companies are at a rate of interest not less than the bank rate as per Sec.186 of the Companies Act, 2013.
- g) *If interest is received on temporary deployment of borrowed funds, such interest should be netted off with interest paid on borrowings and net interest capitalised as part of cost of qualifying asset as per AS-16.*

Q.No.29. What are the steps in vouching of insurance claims received? (A)

(M15 – 4M, PM)

- a) Verify the insurance policy document to observe the terms and conditions of the policy.
- b) Check the basis of computation of the claim.
- c) *Verify that the insurance claims received are as per the claims lodged by the Company.*
- d) If claim is received against the fixed asset, see that proper adjustments are made to F.A. a/c.
- e) See that the amount accounted for in the books of account gets tallied with the amount mentioned in the claim discharge note.
- f) *Enquire the reasons for non settlement of claims which were long outstanding.*

Q.No.30. How will you verify refund of general insurance premium paid? (A)

(N 91, 99, M 95, N15 - 4M, PM, M15 MTP1 - 4M)

1. Insurance File:

- a) Ascertain the nature of General Insurance Premium refunded.
- b) Verify the nature and reason for refund, i.e. (a) Earlier provisional payment of premium, or (b) Acceptance of policy at a part amount, or (c) Cancellation of a policy at a later date.
- c) Scrutinize correspondence between the Insurance Company and the client.

2. Insurance Policy: Examine the Insurance Policy or Cover Note to find out the amount of premium.

3. Refund Advice: Examine the covering letter or refund advice sent by the Insurance Company, and ascertain the actual amount of refund.

4. Bank Statement: Trace the receipt amount in the Pay-in-Slip Counterfoils and Bank Statement.

Q.No.31. What are the steps in vouching of sale of scrap? (A)
(PM, N14 RTP, N14 MTP2 - 4M)

- a) Check whether the scrap register is maintained by the client showing therein the generation, disposal and closing stock of scrap.
- b) *See that sale is approved by proper authority.*
- c) *See whether competitive quotations are called for from bidders.*
- d) See that the sale made was at approved rates.
- e) If any contract is entered for sale of it see that the terms & conditions have been complied with.
- f) *Check whether the sale of scrap is accounted as other income in the P & L account.*
- g) Compare the sales income of the current & previous period and investigate the major variations.

Q.No.32. Vouching of sale proceeds of junk / rejected materials. (A)
(M 90, 08, N 94, 01, 02 - 4M, N15 – 4M, PM, N15 MTP1 - 4M)

1. **Internal Control:** Examine whether the control system for – (a) generation, (b) storage, (c) identification, (d) disposal, and (e) accounting of Junk Materials or Scrap, is working satisfactorily.
2. **Production Registers:**
 - a) *Review the nature and extent of records maintained for junk materials*
 - b) *Compare the actual scrap quantity during the period with standards set for normal loss, if any, in the Cost Accounting System.*
 - c) *Examine whether the percentage of scrap to production / consumption quantity, (i.e. loss and yield) is in tune with the industry norms, and inquire into abnormal variances if any.*
3. **Invoice Copies:**
 - a) Verify whether all junk materials have been billed and check calculations on rates.
 - b) Compare the rate of disposal of current year, with that of previous year and obtain explanations for abnormal differences.
 - c) Examine whether the Internal Control System ensures that good quality materials are not billed as “Junk Material / Scrap” to interested parties at lower rates.
4. **Excise and Sales Tax Returns:**
 - a) *Examine the records maintained under Central Excise Rules and compare the same with the amounts and quantities recorded in the books on accounts.*
 - b) *Examine the Sales Tax Returns and compare the same with books of accounts.*
5. **Financial Statements:**
 - a) Compare the income generated from sale of junk materials with preceding years. In case of substantial differences, call for adequate explanations.
 - b) Check whether Closing Stock of Scrap, if any, has been valued and disclosed properly.

Q.No.33. Vouching of income tax refund. (B)

- a) Check the assessment order received from Income tax department.
- b) *Vouch the entries passed for adjusting provision for taxation, advance tax and refund received.*
- c) Trace the receipt in the Bank Statement.

- d) See that interest received on excess tax paid is charged in statement of P & L.
- e) *Many times refund for one year is adjusted against some demand of some other year. See that proper accounting effect is given for the same.*

Q.No.34. What are the steps in vouching the sale of investments? (A)

(PM)

- a) Obtain a schedule of investments sold during the period.
- b) Check Board resolution authorising disposal of investments.
- c) Vouch with brokers sold note in the case of disposal of investments.
- d) See whether the profit on sale of investment has been correctly adjusted in the accounts.
- e) *If the investments relates to some earmarked funds, the profit or loss on the sale of investment should also be transferred to that earmarked fund account.*
- f) See that proper adjustment is made for ex-interest/cum-interest or ex-dividend/cum-dividend.
- g) Make the enquiries as required U/s 143 of Companies Act, 2013.
- h) *In case of doubt, check the sale prices with stock exchange quotations.*

Q.No.35. What are the steps in vouching of sale of assets? (A)

- a) Obtain a list of assets disposed off during the period.
- b) Check the Board approval for disposal of assets.
- c) *Trace the entries from the cash receipt book into cash book and finally into bank statement.*
- d) *See that related provision for depreciation has been adjusted for calculating the profit/loss on sale of assets.*
- e) Check whether proper adjustment has been made regarding profits on sale of assets.
- f) *See that loss on sale of assets has been adjusted against the revaluation reserve, if any.*
- g) In case the asset is sold through an auctioneer, check the accounts of the auctioneer.
- h) See whether proper entries are made for the assets disposed off from the fixed assets register.

Q.No.36. How will you vouch the recovery of bad debts? (A)

(N 91, 07, M 04, 14 - 4M, PM, M15 RTP, M15 MTP2 - 4M, M16-4M)

- a) The amount so received should be vouched with the dividend warrants received from the Official Receiver or Assignee indicating the total debts and the rate per rupee payable as dividend.
- b) Check correspondence between the debtor/the official receiver and the client in regard to the amount paid and the balance due.
- c) If the recovery is in respect of debts already written off, see that amount is credited to a separate a/c – Recovery of bad debts written off which, in turn, will be transferred to P&L a/c.
- d) *If the recovery is in respect of debts not yet written off, see that amount is credited to debtor's account and balance amount in his account, which is irrecoverable, is written off.*
- e) *See that suitable provision for income tax is made as per Sec.41 of the Income-tax Act, in respect of recoveries against bad debts allowed as deduction in previous years.*
- f) *See that excess provision against bad debts if any is written back.*

Q.No.37. How will you vouch grant received for reimbursement of revenue expenditure? (B) (N 07 - 4M, PM)

1. **Application:** *Examine the application made by the entity towards claim of Subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.*
2. **Subsidy File Correspondence:**
 - a) Examine correspondence and other documents for grant of subsidy and note the conditions relating to its use.
 - b) Verify whether the conditions, under which subsidy is granted, have been fulfilled.
 - c) Scrutinise the Statement of Account rendered to the Government / NGO / Scheme for having incurred the Revenue Expenditure, against which the Subsidy is granted as a reimbursement.
3. **General Ledger:**
 - a) Vouch relevant entries for receipts of Revenue Subsidy, tracing it into Cash Book and General Ledger.
 - b) Examine whether Subsidy Receivable, if any, has been properly accounted for.
4. **Financial Statements:** Ensure compliance with AS - 12 as regards accounting and disclosure, in case of Government Grants.

Q.No.38. How will you vouch / verify receipt of capital subsidy? (B) (N 00 - 4M, PM)

- a) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- b) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- c) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- d) Vouch relevant entries for receipt of Capital Subsidy, tracing it into Cash Book and General Ledger.
- e) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters contribution and accordingly accounted for as also compliance with the disclosure requirements.

Q.No.39. How will you vouch / verify receipt of special backward area subsidy from government? (B) (M 08 - 4M, PM)

1. See whether the Company has the right to receive Special Backward Area Subsidy.
2. Note the amount of Subsidy and the conditions subject to which it is sanctioned.
3. The claim for backward area subsidy submitted to the authorities should be studied.
4. It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature ipso facto.
5. The accounting of grant should be in accordance with AS 12 "Accounting for Government Grants" of ICAI. The revenue grant can be taken to income statement, with appropriate disclosure.
6. *The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to profit and loss account each year in proportion to depreciation of that asset charged in profit and loss account.*

7. *Examine whether the Subsidy amount has been utilized properly.*
8. *The receipt of the grant should be checked with bank statement, remittance challan etc.*
9. The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

Q.No.40. What is the significance of B.R.S? (B)

Meaning: Bank Reconciliation Statement points out the items causing difference between the two balances at bank, i.e. balance as per Cash Book and the balance as per the Pass Book.

Objectives of Verification:

- a) *To ensure that the balance at bank (as per Cash Book) is stated correctly in the B/s.*
- b) *To satisfy the genuineness of the items causing difference between Cash Book & Pass Book.*
- c) *To ensure the efficiency of internal control in recording of all deposits and withdrawals.*

Checking and reviewing the BRS is important in the following areas:

- a) **Entries for omitted items:** Sometimes bank charges, interest etc may be omitted in bank book.
- b) **Stale Cheques:** BRS may reveal long outstanding cheques issued which have to be cancelled and necessary adjustment entries passed. The auditor should enquire reasons for such cheques not presented for payment or not cleared for a long time.
- c) **Errors:** At times, there may be mistakes even in bank statements e.g. double debit for certain charges, wrong credit given etc. which are revealed by the BRS. Suitable follow-up action should be taken on the same, by duly communicating the error to the Bank.
If adjustment entries (e.g., interest, bank charges etc.) are needed, they should be passed.

Q.No.41.what are the transactions which requires prior approval of the company by way of special resolution to be entered with related parties? (B)

1. For the following Contract or Arrangements Criteria as mentioned below-
 - a) sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding 10% of the turnover of the company or Rs.100 crore, whichever is lower;
 - b) selling or otherwise disposing of or buying property of any kind, directly or through appointment of agents, exceeding 10% of net worth of the company or Rs.100 crore, whichever is lower;
 - c) leasing of property of any kind exceeding 10% of the net worth of the company or 10% of turnover of the company or Rs.100 crore, whichever is lower;
 - d) availing or rendering of any services directly or through appointment of agents exceeding 10% of the turnover of the company or Rs.50 crore, whichever is lower;

It may be noted that the limits specified above shall apply for transaction(s) to be entered into either individually or taken together with the previous transactions during a financial year.
2. s for appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding Rs.2.5 lakh;
3. Is for remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding 1% of the net worth.

It may be noted that the Turnover or Net Worth referred above shall be computed on the basis of the Audited Financial Statement of the preceding financial year. In case of wholly owned subsidiary, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company.

Q.No.42. How will you vouch / verify Payment for Acquisition of Assets? (B)
(N 15 - 4M, SM)

Payment for Acquisition of Assets: The following points must be considered regarding payment for acquisition of assets—

1. The purchase of an asset must be duly supported by the receipt for the amount paid.
2. In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore essential for an auditor to see that property has been registered in the purchaser's name as required by the relevant regulations and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.
3. In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards existence, value and title of the assets acquired.
4. It must also be verified that the assets were purchased only by a person who had the authority to do so. Companies Act, 2013 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset.
5. If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired.
6. In the case of an asset constructed or manufactured by the client himself, e.g., where a building has been constructed or a plant or machinery manufactured by the concern with its labour and materials, it must be verified that the cost of labour, materials and other direct expenses incurred has been charged as cost of the asset on a proper allocation of the total expenditure debited under these heads.
7. It must also be seen that neither expenses on repairs and maintenance have been capitalised nor the cost of additions to assets charged off as revenue expenses.

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.43. What is meant by vouching? What are the objectives of vouching? (C)

Definition: Vouching consists of comparing the entries in the books with the particulars in the voucher with regard to date, amount, name of the party etc. Vouching is a substantive auditing procedure designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

Objectives of vouching:

- a) To see that all the transactions and entries are properly accounted for in books of accounts.
- b) To confirm that no transaction which does not relate to business is entered in the books.
- c) To confirm that there are no fraudulent transactions recorded in the books of accounts.

- d) To see that all the entries and transactions are supported by proper evidences.
- e) To check that the entries and transactions are properly authorised.
- f) Transactions represented by the entries are not ultra vires the entity.
- g) Transactions have been recorded at the correct amounts.
- h) Transactions have been allocated properly between capital and revenue.
- i) Transactions represented by the entries have:
 - i) Actually occurred during the period under the audit, and
 - ii) Pertain to the entity under audit.

Q.No.44. Vouching vs. Verification. (C)

- a) Vouching is the test of details of transactions which occurred during the year under audit, Verification is the test of details of closing balances at the year end.
- b) Vouching deals with the examination of transactions at their points of origin whereas verification usually deals with the final balances contained in the final accounts.
- c) Vouching is usually carried out before the year-end i.e. before the books are closed. Verification is carried out after the books are closed at the year-end.
- d) Vouching aims to obtain sufficient & appropriate audit evidence regarding Occurrence, Completeness and Measurement of transactions. Verification aims to obtain audit evidence regarding Ownership, Existence, Valuation etc.
- e) Vouching uses the techniques of inspection of documents and computations for obtaining evidence. Verification of assets and liabilities uses the techniques of inspection of documents, inspection of assets and external confirmation.

PRACTICAL QUESTIONS

Q.NO.1. WHILE CARRYING ON THE AUDIT YOU FIND THAT THE COMPANY HAS KEPT FEW LAKHS OF RUPEES AS CASH IN HAND AND WHEN QUESTIONED, THE DIRECTORS STATED, THAT PRESENT AMOUNT OF CASH IS NOT WITHIN THE PURVIEW OF AUDIT AND ALSO THIS IS A MATTER OF POLICY, AND THAT THE AUDITOR NOT QUESTION THIS.

- a) The director's plea that the present amount of cash is not within purview of the audit is not acceptable because the verification of cash even on a date beyond the accounting period under review is an accepted auditing procedure.
- b) The contention of the directors that keeping such a heavy balance is a matter of policy is also not tenable. While it cannot be argued the companies should not have huge cash in hand, particularly at outlying places where banking facilities are not available, the amount of cash held should have relation to the current needs of the business.

Q.NO.2. A SUM OF RS.25,070 HAS BEEN SHOWN AS "PAID" SALARIES TO STAFF. HOWEVER ON YOUR PHYSICAL VERIFICATION OF CASH, YOU FIND THE MONEY LYING WITH THE CASHIER IN HIS CASH-BOX IN SEPARATE ENVELOPES BEARING THE NAMES AND CODE NUMBERS OF THE CONCERNED EMPLOYEES.

- a) It is wrong to say that Rs.25,070 has been paid for salaries while the amount is lying undisturbed with the cashier.
- b) An entry should be made in the books debiting salaries account and crediting salaries outstanding account.

- c) Only the amount of cash in sealed envelopes lying with the cashier can be regarded as part of the cash balance. Such a practice previously followed is highly objectionable and the directors should be advised to stop it.

Q.NO.3. AN AMOUNT OF RS.5,00,000 IN RESPECT OF INSURANCE OF MACHINERY FOR THE PERIOD FROM 1ST JANUARY, 2007 TO 31ST DECEMBER, 2007 HAS BEEN SHOWN AS INSURANCE IN THE PROFIT AND LOSS ACCOUNT. (YEAR ENDING IS 31.3.2007). COMMENT.

- a) The accounting treatment of debiting the profit and loss account for the year ended 31st March, 2007 with the full amount of Rs.5,00,000, is not proper, because Rs.3,75,000 of it is on account of the next accounting year.
- b) Therefore Rs.3,75,000 must be transferred from Insurance Account to Prepaid insurance Account, so that the amount of insurance to be debited to the profit and loss account for the year ended 31st March be Rs.1,25,000, Rs.3,75,000 being the amount of prepaid insurance will then be shown in the Balance Sheet as on 31st March, 2007 as an current asset.

Q.NO.4. NO ENTRY IS PASSED FOR CHEQUES RECEIVED BY THE AUDITEE ON THE LAST DAY OF THE YEAR, BUT NOT YET DEPOSITED WITH THE BANK. COMMENT.

- a) It is a quite normal that in any on going business entity many a times cheques are received from the customs on the last day of the accounting year.
- b) It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank.
- c) Though normally speaking it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank.
- d) Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.
- e) As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received.
- f) The person who is controlling the debtors, ledger should ensure that proper accounting entries have been passed by crediting respective debtors accounts.
- g) The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

Q.NO.5. AS A LIMITED HAD PROVIDED FOR DOUBTFUL DEBTS TO THE EXTENT OF RS.23 LAKHS TWO YEARS BACK. THIS AMOUNT HAD BEEN COLLECTED IN THE CURRENT FINANCIAL YEAR. ANOTHER DEBT OF RS.25 LAKHS HAD BEEN IDENTIFIED TO BE DOUBTFUL DURING THE CURRENT FINANCIAL YEAR. THE COMPANY MADE AN ADDITIONAL PROVISION OF RS.2 LAKHS DURING THE YEAR. THE PROFIT AND LOSS ACCOUNT FOR THE CURRENT FINANCIAL YEAR DISCLOSED IN THE DEBIT SIDE – PROVISION FOR DOUBTFUL DEBTS RS.2LAKHS. DO YOU AGREE WITH THE ABOVE TREATMENT? GIVE YOUR VIEWS. (N 07 - 4M)

- a) In case of recovery of debts in respect of which provision is made in the preceding years, the Provision for Doubtful Debts to the extent of such recovery must be written back by crediting the P&L A/c.

- b) A new provision has to be made for any debt which has become doubtful during the current period.
- c) In the above case, the amount recovered Rs.23 Lakhs for which provision has been made earlier, must be credited separately to the P & L A/c.
- d) The provision required in respect of debt identified as doubtful during the current financial year, should be separately debited to the P & L A/c
- e) **Auditor's Duties:** Netting off the amounts as done by the Company, is not proper. The auditor must suggest the correct accounting treatment to the Management. If it is not adopted, the auditor must suitably modify his report.

Q.NO.6. AS AN AUDITOR OF A LIMITED COMPANY, YOU OBSERVE THAT DURING THE MONTH OF MARCH, 2015, SALES INVOICES WERE NOT RECORDED IN BOOKS OF ACCOUNTS. YOU ALSO OBSERVE THAT PAYMENT OF WAGES WAS MUCH HIGHER COMPARED TO LAST YEAR. KEEPING IN MIND THE ABOVE, ANALYSE POSSIBLE WAYS OF MANIPULATION OF ACCOUNTS

Manipulation of Accounts: Accounts are falsified in order to conceal the true position of the business for some purpose. Frauds are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed-

- a) To avoid incidence of income-tax or other taxes by showing profits at a lower figure.
- b) For delaying a dividend when there are insufficient profits by showing profits at inflated figures.
- c) To withhold declaration of dividend even there is adequate profit.
- d) For receiving higher remuneration where managerial remuneration is payable by reference to profits. Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the **following nature-**
 - i) Recording fictitious sales or omission of sales
 - ii) Recording fictitious purchases or suppression of purchases
 - iii) Over valuation or under valuation of inventory.
 - iv) Recording fictitious expenses or omission of expenses
 - v) Taking credit for accrued income not likely to be received or omission of income.
 - vi) Revenue expenses changed to capital and vice-versa. SA 240 "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements" deals with the auditor's responsibilities for the detection of material misstatement resulting from fraud and error. It requires a considerable skill and vigilance on the part of an auditor. In doubtful cases he may refuse to believe the information supplied to him by any officer of the concern.

An auditor, who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

THE END

14. AUDIT OF TRADING TRANSACTIONS

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08 TO M-09	N-09	M-10	N-10	M-11	N-11 TO M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	B	-	12	2	-	-	-	10	-	8	-	-	-	-	-	-	-	6	-
2.	B	4	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-
3.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	B	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-
5.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	A	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	A	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-
8.	A	-	-	2	4	-	5	-	-	4	-	4	-	-	-	-	-	-	-
9.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
13.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What are the factors that determine profit from business operations? (B)
(M 11 - 8M)

Factors which increase profit from business operations: (PM, N14 MTP1 - 8M)

- a) Undervaluation of opening stock.
- b) Overvaluation of closing stock.
- c) Alteration of the basis of valuation of closing stock e.g. where the opening stock was valued at cost or market rate whichever was lower, valuing the closing stock at the market price which is higher than cost.
- d) Inclusion in the closing stock of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by customers, the cost thereof has not been credited to parties.
- e) Inclusion in the closing stock of goods received for the sale on approval or on a consignment basis.
- f) Treatment of goods sent out for sale on consignment basis etc. as regular sales.
- g) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated; provision for outstanding wages or carriage inward may not have been made.
- h) Wrong allocations of expenses e.g. carriage inwards either in whole or in part may be wrongly taken to the Profit and Loss Account.

The Auditor's duties involve the verification of the following possibilities: (N08 - 4M)

- a) Increase in Sale Prices and reduction in Discounts offered to Customers.
- b) Reduction in prices of materials cost of labor, and other direct costs.
- c) Increase in level of production, leading to economies of large scale production
- d) Possible change in product design, due to which unnecessary product qualities are eliminated, and cost of production is thereby reduced.

- e) Proper and consistent basis for valuation of inventory as per generally accepted accounting principles.
- f) Errors like double-booking of Sales, inclusion of Sales on approval as Actual Sale, inclusion of extra-ordinary items like insurance compensation, etc., as part of Sales Income.
- g) Reporting Sales on exclusive basis (i.e. exclusive of Excise / Customs Duty, Taxes, etc.) whereas it was reported on inclusive basis in the previous years.

Factors which decrease profit from business operations:

(N15 – 6M)

- a) Overvaluation of the opening stock.
- b) Undervaluation of closing stock.
- c) Alteration of the basis of valuation of stock e.g. closing stock having been valued at cost, which is below the market price, when the opening stock was valued at market price above cost.
- d) Inclusion in the current year, the amount of goods purchased in the previous year, that were received in the current year.
- e) Entry of sales returns twice or failure to account for purchase returns when the goods in question have been sent back.
- f) Excessive provisions have been made for wages or direct expenses.
- g) Failure to include in closing stock goods sent out for sale on approval or on a consignment basis.
- h) Inclusion in Trading Account expenses which should have been included in the P&L a/c.

REFER PRACTICAL QUESTIONS: 1, 2, 4, 6, 7.

Q.No.2. What is the procedure for audit of credit purchases? (B)

Composition: Raw materials, Stores and Spare parts, Loose tools, Packing materials, Fixed assets, Stationery.

Audit objective: The audit of credit purchases is to ensure that:

- a) All the goods purchased by the company are relating to the business of the enterprise.
- b) All purchases are supported by documentary evidences such as invoices, GRN etc.
- c) There are no frauds and errors while accounting the suppliers invoices.
- d) To ensure that there are no overstatement or under statement of purchases.
- e) To check that purchases have been properly disclosed in the financial statements.

General matters to be verified:

- a) The date of the invoice should be within the accounting period
- b) The invoice should be addressed to the client.
- c) Arithmetical accuracy of the invoice to be ensured.
- d) It should be authorised by responsible official.
- e) It should be properly accounted for through nominal account.
- f) It should be supported by proper evidences.

Special steps for verification:

- a) See whether proper records are maintained for purchases on credit basis.
- b) Check whether there is proper internal control system in existence regarding purchases.

- c) Vouch whether proper accounting entries are passed in the books of accounts.
- d) See that the difference between capital & revenue items is considered.
- e) See whether the terms & conditions in the purchase order (i.e.) price, discount, delivery, etc. have been duly complied with by the supplier.
- f) Where the invoice is not raised in the name of the client but raised in the name of an employee check whether the goods or services mentioned in the invoice have been duly received.
- g) Where the purchase order includes certain personal purchases of the employees who have requested for the supply of goods with a view to take advantage of trade discount, check whether the personal account of the employee is debited for.
- h) Where the goods have been directly delivered at the site/factory ensure that the confirmation from the site/factory personnel has been obtained before accounting the Invoice.
- i) In the case of duplicate invoices ensure that both original & duplicates are not accounted for simultaneously.
- j) *Check whether the gross amount of invoice has been accounted for (i.e.) the amount without adjusting the advance, if any paid.*
- k) *In the case of purchase returns, check whether the credit notes have been obtained from the supplier.*
- l) *In the case of shortages, see whether claims have been lodged with the insurers or transporters or proper adjustments are made against bills.*
- m) Auditor can go for direct confirmation procedure.
- n) Calculate the GP ratio for the current and previous periods and check whether there are any discrepancies and if so, ascertain the reasons thereof.
- o) *Examine the client has prepared the quantitative reconciliations in respect of major items (i.e.) opening stock, consumption and closing stock should be related to arrive at the quantum of purchases.*
- p) Find out whether the disclosure requirements as per the statute are duly complied with.

Q.No.3. How will you verify / vouch the purchase return? (B)

(PM)

- a) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.
- b) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in this documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.
- c) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.
- d) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

Q.No.4. Write the procedure for audit of credit sales. (B)

(N05 – 8M, N06 – 5M, PM, N15 RTP)

Composition: Sale of finished goods, Sale of Scrap & Sale of fixed assets.

Audit Objectives:

- a) *All sales are supported by documentary evidences such as sales invoices etc.*

- b) *There are no frauds and errors while accounting the sales.*
- c) *To ensure that there are no overstatement or understatement of sales.*
- d) *To check that sales have been properly disclosed in the financial statements.*

General Matters to be verified:

- a) *The date of the invoice should be within the accounting period.*
- b) *The invoice should be addressed to the client.*
- c) *It should be supported by proper evidences.*
- d) *It should relate to the goods dealt with by the company.*
- e) *Arithmetical accuracy of the invoice to be ensured.*
- f) *It should be authorised by responsible official.*
- g) *It should be properly accounted for through nominal account.*

Special matters to be verified:

- a) See whether proper records are maintained for sales on credit basis.
- b) Check whether there is proper internal control system in existence regarding sales.
- c) Vouch whether proper accounting entries are passed in the books of accounts.
- d) See that the difference between capital & revenue items is considered.
- e) See whether the terms & conditions as per sales order have been duly complied with.
- f) Where the goods have been sold to the firms, companies end person in which directors are interested see whether the rates charged are as per the usual approved rates.
- g) See that discounts allowed are with the proper authorisation.
- h) See that there exists a procedure to ascertain the credit analysis of debtor's.
- i) *Where goods have been sold to employee check whether the approved rates have been collected.*
- j) *See whether the transactions which are not yet sales are taken as sales. (E.g.: Goods sold on approval basis and the time given for acceptance not yet completed.)*
- k) *Check whether the gross amount of invoice has been accounted for (i.e.) the amount without adjusting the sales advance, if any paid.*
- l) *See that sales returns are evidenced by debit notes issued by the customer.*
- m) *Auditor can go for direct confirmation procedure.*
- n) *Calculate the GP ratio for the current and previous period and in case there are variations, examine the reasons there of.*
- o) *Test check the quantitative reconciliations of stock.*
- p) Check the correctness of the sales accounted for through Sales tax payments.
- q) Find out whether the disclosure requirements as per the statute are duly complied with.

Similar Question: A trader is worried that in spite of substantial increase in sales as compared to the earlier year, there is considerable fall in gross profit. After satisfying himself that sale and expenses are correctly recorded, he wants you to ensure that the purchases have been truthfully recorded. In the circumstances, how you would proceed with the assignment?

Ans. Same as above.

Q.No.5. How do you audit sales of empties and gunnies?(A)

(PM)

- a) See whether proper records are maintained for sales of empties and gunnies.
- b) See that the sales are made with proper authority.
- c) Check whether quotations have been called for.
- d) See that the quantity of empties etc. are properly reconciled with that of the purchases.
- e) Compare the sales of empties for the current period with that of the previous period and see whether there is any major variation and if so, examine the reasons thereof.
- f) See that the sales income is shown as other income.

Q.No.6. How do you audit consignment sale? (A)

(M 97, 03, 06 - 4M, PM)

- a) Ascertain that profits have been recognised only for those goods sold through the consignee before the year-end. No profit should be taken for the profit on goods remaining in the hands of the consignee.
- b) *See that consignment account is debited with the goods sent to consignee, all expenses incurred on his consignment like freight, carriage, insurance, loading etc., including those incurred by the consignee should also be debited to this account.*
- c) Credits in the Consignment Account should be verified with the help of the Account Sales received from the consignee.
- d) Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the Consignment Account.
- e) Obtain confirmation of the balance in the account of the consignee from the consignee.
- f) See that the consignment agent is sending the cash collections made by him periodically.
- g) If the goods are sent at invoice price, the auditor should see that the necessary adjustments to remove the loading are made at the end of the year.
- h) Ensure that the stock lying with the consignee is shown in balance sheet at cost.

Q.No.7. How do you audit goods sent out on sale or return basis? (A)

(PM, N15 RTP, M15 MTP2 - 4M)

- a) Verify the terms of agreement between the client and the proposed buyer.
- b) *Verify that profits have been recognised, only if:*
 - i) *The customer has accepted the goods or*
 - ii) *The period stipulated in contract for return has expired or*
 - iii) *If no period for return is prescribed, a reasonable time has elapsed.*
- c) If these have been accounted as sales for control purposes, then see that entries are reversed in respect of those sales for which criteria in (b) above is not satisfied.
- d) Obtain confirmation from the other party to whom goods have been sent.
- e) Ensure that the stock lying with the other party is shown in balance sheet at cost.

Q.No.8. What is the meaning of the term “cut off procedure”? (A)

(M 11, 14 - 4M, PM)

- 1. Business is a continuous affair involving various activities such as purchase, manufacture, selling etc. Consequently, accounting of these transactions is also a continuous affair.

2. The primary object of the audit is to form opinion with regard to the true and fair view exhibited by financial statements.
3. Hence it becomes, necessary that the transactions relating to different periods are segregated so that true and fair profit can be arrived at.
4. The accounting process by which such segregation takes place is called cut off procedure. Such procedure is adopted in respect of purchases, sales, and inventory.
5. These are also known as "cut of arrangements".
6. **Ex 1:** while closing the books of accounts for the year ending 31st March 2002, the company should ensure that the sales made in the month of April are not considered in the accounts and at the same time the sales made in the month of March are not included in the subsequent years accounts.
7. **Ex 2:** a sale may be recorded in one year, whereas the goods may be dispatched in the beginning of the next year.
8. Such occasion may be caused either due to unintentional error on the part of the accountant or due to manipulative tendencies on the part of top management.
9. By adopting this procedure, the auditor is in a position to satisfy himself that the profit or loss disclosed by financial statements is not affected by fictitious entries.

These procedures are applied to ensure that:

- a) Goods purchased, the property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase.
- b) Goods sold have been excluded from the inventories and credit has been taken for the sales, if the value of the sales is to be recovered, the concerned party has been debited.

AN ILLUSTRATIVE VOUCHER

MASTER MINDS PVT. LTD.,				PAYMENT VOUCHER No. 			
Paid Rs. 		Account Head		Date 			
Rs.		Amount		Rs.		Paise	
by Cash / Chq. / D.D. No.		Total		Rs.		Paise	
Date :		On		Total		Rs.	
To M/s.		Initiated by		Verified by		Approved by	
Initiated by		Initiated by		Verified by		Approved by	

QUESTION FOR ACADEMIC INTEREST ONLY

Q.NO.9. One of your clients complaints that he has incurred loss during the year as against profit in last year even though the total turnover is same and there is no change in the commodities dealt with and the purchase and sale price remained unchanged. The other total expenses are also same. There is no fraud or error. Give the reasons with example. (C)

Normally speaking, the main reasons for incurring loss during a particular year as against the profits during previous year may be as under:

- a) Change in the purchase/sale prices, i.e. higher purchase prices or lower sales price or both.
- b) Decrease in total turnover i.e. the client has not been able to sell the goods.

- c) *Change in the composition of turnover i.e. if the client is selling number of commodities, it is quite possible that all of them do not contribute equally to the profit of the client. If the commodities having lower contribution have been sold in larger quantity in the current year as compared to the previous year, it may reduce profit or even lead to a loss.*
- d) *Increase in total expenses.*
- e) *Omission of recording of sales.*
- f) *Change in method of valuation of stock.*
- g) *Misappropriation and defalcation of assets.*

It has, however, been reported that the total turnover was same and there was no change in the commodities dealt with and the purchase and sale prices remained unchanged. The method of valuation of closing stock and other total expenses were also same as those of the previous year. There are no defalcations or misappropriations. If commodities with higher returns were sold in lesser quantities and the total turnover was maintained by sale of lower profit yielding or loss yielding items, there can arise a situation of loss, as illustrated here under:

Products	Gross Profit	Sales (lacks)	Gross Profit	Sales (lacks)	Gross Profit
Cars	30%	6	1,80,000	2	60,000
Spares	20%	2	40,000	2	40,000
Petrol	10%	<u>2</u>	<u>20,000</u>	<u>6</u>	<u>60,000</u>
		10	2,40,000	10	1,60,000
Expenses			<u>2,00,000</u>		<u>2,00,000</u>
Net Result			<u>40,000</u>		<u>(40,000)</u>

Q.NO.10. Casting or totaling is an important tool of audit for an Auditor. Comment. (C) (PM)

Casting or Totaling as an Audit Tool: Casting or totaling is an important tool of audit for an auditor as sometimes the totals of a wage bill are inflated by over totaling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from account receivables by under-totalling the receipts column of the cash book. At times, shortages in cash have been also covered up by over totaling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked. On these considerations, where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced. This would deter him from altering the totals on the totaling mistakes being discovered. Sometimes a fraud is committed in the following manner-

- a) Under casting the receipt side of the cash book;
- b) Over casting the payment side of the cash;
- c) Fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;
- d) Posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and
- e) Wrong totals or balances being carried forward in the cash book or in the ledger.

Q.NO.11. How do you audit Sales Return? (C) (PM)

1. Examine the accounting basis for such transactions with reference to corresponding Debit Note to Debit Note. The relevant correspondence may also be examined.
2. Verify by reference to relevant corresponding record in good inward book or the stores records. Further, the figures in these documentary evidences should be compared with the original invoices for rates and other charges and calculation should also be checked.

3. Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.
4. Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

Q.NO.12. Scrutiny of General Ledger (C)

(PM)

1. The General Ledger contains all the balances which are ultimately included in the Profit and Loss Account and the Balance Sheet. Its examination therefore is undertaken last of all.
2. The scrutiny of General Ledger should be carried out with due care in as much as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.
3. Entries in the General Ledger usually are posted in a summary form from the books of original entries such as Cash Book, Journal, Sales Book, Purchase Book and other subsidiary books. Therefore, it should be confirmed that all the postings on various accounts have been verified, totals, etc. checked.
4. It should also be ascertained that balances in all the income and expense accounts have been adjusted:
 - a) According to standard accounting practices (i.e., all unpaid, prepaid expenses have been adjusted and accrued Income and pre-recorded income is properly adjusted); and
 - b) On a consideration of the legal provisions which are applicable to the concern.
5. The balances in the General Ledger should be traced to the trial balance and from the trial balance to the final accounts.

Q.NO.13. How do you audit Personal Expenses of Directors? (C)

(PM)

1. Check the articles of association, service contract, minutes of general meeting, etc., to check the authorisation for such payment.
2. Enquire to ensure that personal expenses are not camouflaged in any other revenue items as contemplated under section 143(1) of the Companies Act, 2013.
3. Ascertain compliance with disclosure according to requirements of Schedule III to the Companies Act, 2013.
4. Check documentary evidences to examine the payments reimbursed.

PRACTICAL QUESTIONS

Q.NO.1. WHILE AUDITING THE ACCOUNTS OF A MANUFACTURING COMPANY, YOU DISCOVER THAT THE RATE OF GROSS PROFIT HAS SHARPLY RISEN IN COMPARISON TO THE PREVIOUS YEAR. STATE THE CAUSES.

(FOR STUDENTS SELF STUDY)

There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that for the previous year, the most likely of which are as follows:

- a) The selling price of the finished products may have been increased. A number of sales invoices in the current year should be compared with invoice in the previous year in order to ascertain the extent of any price changes.

- b) The costs of manufacture may have reduced substantially. This could be due to major reduction in raw material costs, as wages rates have tended to fall rather than rise.
- c) The 'mix' of sales may have been altered, resulting in the sales of more profitable items.
- d) The mechanisation of certain manufacturing processes may have resulted in considerable savings in labour cost of production, and this possibility could be easily verified by comparison of wage records with those in previous periods, expressing the total labour costs as a percentage of the total cost of production.
- e) The company's cut-off procedures as regards closing stock and work in progress should be investigated. The auditor should test transactions near the company's year end, ensuring that items included in sales have been excluded from stock and that items included in purchases have likewise been included in the closing stock, even though undelivered at the balance sheet date.
- f) The possibility of items which have been sent to customer on 'sale or return' basis being included in sales, should be investigated.
- g) If the investigation along the lines suggested above fails to account entirely for the increase, the closing stock and work in progress valuation will have to be re-checked, particularly if the amount of closing stock, as shown, is a larger proportion of total purchases than was in the previous year.

Q.NO.2. A TRADER IS WORRIED THAT IN SPITE OF SUBSTANTIAL INCREASE IN SALES AS COMPARED TO THE EARLIER YEAR, THERE IS CONSIDERABLE FALL IN GROSS PROFIT. AFTER SATISFYING HIMSELF THAT SALES AND EXPENSES ARE CORRECTLY RECORDED AND THAT THE VALUATION OF INVENTORIES IS ON CONSISTENT BASIS, HE WANTS YOU TO ENSURE THAT THE PURCHASES HAVE BEEN TRUTHFULLY RECORDED. IN THE CIRCUMSTANCES, HOW YOU WOULD PROCEED WITH THE ASSIGNMENT.
(FOR STUDENT SELF STUDY)

The following steps may be taken to ensure that purchases have been truthfully recorded in the books of account.

1. Evaluate internal control system thoroughly relating to purchases right from the stage of Initiating purchase orders till disbursements are made. Infact, such an evaluation by performing compliance procedure may reflect weaknesses at a certain particular stage such as recording aspects which would require closer examination. In particular, attention must be paid to observance of cut off procedures to ensure that purchases pertaining to a specific accounting period are not mixed up with purchases of the next accounting Period.
2. Perform substantive procedures to establish authenticity of a transaction recorded in the books of account. The exact timing, nature and extent of such procedures would, however, depend upon the evaluation of related control system. In particular, the following procedure may be adopted:
 - a) Examine purchases recorded in the records with reference to purchase invoices and underlying documents such as purchase requisition note, inspection report, goods received note, delivery challans, etc.
 - b) See that the purchase invoice has been properly authorised and is in the name of the trader, relates to accounting period, has been properly authorised, supported by relevant documentary evidence and all computation relating to calculation of discount, etc. are correct.
 - c) Ensure that invoice has been properly classified and correct recording has been done in the accounts.
 - d) See that where invoices run into several pages, the casting and carry forward are correctly done.

- e) Check entries recorded in Purchase Return Book with reference to copies of debit notes issued and ensure that particulars relating to amount, supplier's name, etc. are correct. Quantity stated is also correct.
 - f) Examine the numerical reference of purchase invoice and debit notice.
 - g) See whether there is any increase in the cost of purchases and if so verify whether the price charged in the invoices bills is the agreed price or otherwise in line with market price.
 - h) Special care should be taken that the same invoice is not entered more than once on the basis of duplicate or triplicate copies.
 - i) Eliminate the goods purchased for personal purpose or for non- trading purposes.
 - j) See that goods purchased but not received and taken into financial accounts at the end of the year is included in the inventory.
 - k) Ascertain that periodic statements have been sent to suppliers and the same have been received.
3. Perform analytical procedures to obtain evidence as to overall reasonableness of purchase. In such a case, compare purchases on a quarterly/monthly basis in the accounting period to note unusual fluctuations, actual purchases with budgeted purchases and work out product-wise purchases for previous years.

Q.NO.3. A SUM OF RS.10,00,000 IS RECEIVED FROM INSURANCE COMPANY IN RESPECT OF A CLAIM FOR LOSS OF GOODS IN TRANSIT COSTING RS.8,00,000. THE AMOUNT IS CREDITED TO THE PURCHASES ACCOUNT.

As per AS-5 receipt of such claim is an ordinary item. However, the cost of goods lost in transit is only Rs.8,00,000 while the insurance money received is 10,00,000. Purchases account need not be credited since it would distort the purchases done during the year and also the gross profit. Therefore, entire amount of Rs.10 lakhs needs to be taken to profit and loss account under an appropriate head. But as per AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Q.NO.4. YOU HAVE BEEN APPROACHED BY THE MARKETING DIRECTOR OF YOUR COMPANY WITH A TREND ANALYSIS OF THE SALES FOR THE TWO QUARTERS ENDING MARCH 1995, AS PER DETAILS BELOW:

Month	Sales [Rs. in lakhs]	Selling overhead [Rs. in lakhs]
1994 Oct.	50.00	30.00
Nov.	52.20	32.10
Dec.	66.00	40.00
1995 Jan.	75.00	45.80
Feb.	80.50	51.00
Mar.	85.00	59.00

You are required to analyse the given data and suggest your auditing procedures.

Sales have increased at a steady rate over the past 6 months. While the increase in sale is only 70% as compared to the base period of October 1994, selling overheads have gone up nearly by 100%. Thus the increase in selling overhead is disproportionate to the increase in sales.

In such circumstances the auditor should apply additional substantive tests to check the expenditure. The increase in selling overhead may be due to:

- a) Wrong classification of expenses (Like AOH taken as SOH).
- b) Recording and inclusion of non-business expenses.
- c) Taking prepaid expenses as current expenses.
- d) Prior period adjustments/expenses might have been included.

Auditor should ensure while checking that:

- a) Administrative or other unrelated expenses are not classified as selling expenses.
- b) Advance payments for selling programmes of subsequent months are not included in current month expenses.
- c) Personal expenses of sales executives are not charged under selling overhead.

Q.NO.5. A COMPANY MANUFACTURING PHARMACEUTICAL INTERMEDIATES RECEIVES ITS RAW MATERIALS IN BIG PLASTIC CONTAINERS. THESE CONTAINERS ARE SOLD OR DISCARDED BY THE COMPANY DEPENDING UPON THEIR CONDITION. THE CONTAINERS LYING IN THE GODOWN AT THE YEAR END, ARE NEITHER VALUED NOR ACCOUNTED FOR. CONTAINERS SOLD ARE ACCOUNTED FOR ON CASH BASIS. COMMENT AND GIVE YOUR VIEWS WITH REASONS.

The policy of the company to account for containers on cash basis as and when sold is correct in case the amount in respect of such containers is not material. Where however the amount involved is material, they shall be shown under the head "Current Assets" valued at their estimated net realizable value since their cost cannot be ascertained.

Q.NO.6. AN UNEXPLAINED DECREASE IN THE GROSS PROFIT RATIO MAY RESULT DUE TO FICTITIOUS SALES.

False: A fictitious sale will increase the gross profit ratio instead of decreasing it. GP ratio normally comes down if there are unrecorded sales or fictitious purchases or decrease in closing stock.

Q.NO.7. WHILE AUDITING THE ACCOUNTS OF A MANUFACTURING COMPANY, YOU DISCOVER THAT THE RATE OF GROSS PROFIT ON SALES HAS SHARPLY RISEN THAN THE PREVIOUS YEAR. STATE SOME POSSIBLE CAUSES OF SUCH INCREASE AND THE STEPS YOU WOULD TAKE TO SATISFY YOURSELF.

(STUDENTS SELF STUDY) (N 99 - 10M)

The reasons for sharp increase in the rate of Gross Profit on sales as compared to previous years and the Auditors' duties in each context are –

1. Increase in Selling Price:

- a) Obtain copies of the Company's Price Lists and compare with that of the previous years.
- b) Compare a number of Sales Invoices in the current year with that of the previous year to ascertain the extent of price changes, if any.
- c) Make enquiries and obtain explanations as to whether there have been general or specific price increases and reasons for the same.

2. Change in Sales Mix:

- a) See whether the Sales Mix is altered, resulting in the sales of more profitable items.
- b) Prepare month-wise & product-wise sales analysis for the two years to ascertain whether only the more profitable lines constituted a large proportion of the total sales.

3. Reduction in Cost:

- a) Wage rates generally increase or remain normal overtime periods. Analyse whether there are any major reduction in Raw Material Cost or in other cost elements.
- b) Examine stocks and purchase records in respect of large purchases of Raw Materials, comparing current costs with those in the previous periods.
- c) Obtain information supporting the possibility of reduced Raw Material Costs from the Company's Purchase Manager.

4. Mechanisation or Automation:

- a) Enquire whether the mechanisation or automation of certain manufacturing process has resulted in considerable savings in Costs of Production, particularly Wages.
- b) See if there is a reduction in labour cost, by comparing wage records with those of previous periods, expressing total labour costs as a percentage of total cost of production.
- c) See whether the Company has achieved economies of scale, due to automation process.

5. Change in basis of accounting:

- a) See whether the method of valuing stocks and WIP are consistently followed
- b) Enquire whether Directors have recently decided to include a further element of Works Overheads in the value of WIP. In such case, the effect of this change must be disclosed in the company's P&L Account.

6. Stock Valuation:

- a) Examine the Company's cut-off procedures for Closing Stock and WIP, as any change in the procedure compared with the previous year would cause a difference in Gross Profit Ratio.
- b) Test check transactions near the year-end, to ensure that items included in Sales have been excluded from Stock, and that items included in Purchases have been included in the closing Stock, even though undelivered at the Balance Sheet date.

7. Sales Returns not recorded:

- a) Investigate the possibility of items, which have been sent to customer on 'Sale of Return' Basis, being included in Sales or Sales Returns not being recorded.
- b) Enquire into the possibility of other errors in accounting, e.g. Purchase Returns recorded twice, Stocks at other locations valued wrongly, etc.

Q.NO.8. SMT ENTERPRISES ENTERED INTO A CONTRACT FOR SALE OF ITS GOODS WORTH RS. 24 LACS WITH ST LTD. THE GOODS WERE INSPECTED, APPROVED AND FINALISED BY THE INSPECTION TEAM OF ST LTD. MADE THE WHOLE PAYMENT OF RS. 24 LACS. HOWEVER, IT REQUESTED SMT ENTERPRISES TO DISPATCH THE GOODS IN SIX EQUAL MONTHLY INSTALMENTS FROM OCTOBER, 2009 TO MARCH, 2010. IN THE MONTH OF JANUARY, 2010, DUE TO NATURAL CALAMITY, ST LTD. INFORMED SMT ENTERPRISES TO STOP DISPATCHES OF THE REMAINING THREE INSTALMENTS UNTIL FURTHER NOTICE. AT THE TIME OF FINALISING ITS ACCOUNTS FOR THE FINANCIAL YEAR 2009-10, SMT ENTERPRISES BOOKED SALES AMOUNTING TO RS. 12 LACS AND SHOWED REMAINING RS. 12 LACS AS ADVANCE AGAINST SALES.

Recognition of Revenue (AS 9): AS 9 requires that revenue from sale of goods should be recognized when the following conditions are followed:

- a) The seller has transferred the property in the goods for a price to the buyer or all significant risks and rewards of ownership have been transferred to the buyer, and the seller has not retained effective control of the goods transferred to a degree usually associated with ownership.

- b) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods.

In the given case, the sale transaction carried by SMT Enterprise fulfills all the condition stated above. Hence, the accounting entry passed by SMT Enterprise recognising partial revenue to the extent of goods dispatched is not correct. The entire amount of Rs. 24 lakhs should be recognized as sales.

Q.NO.9. AS AN AUDITOR, COMMENT ON THE GEAR LTD. IS ENGAGED IN MANUFACTURING AND SUPPLY OF GEAR BOXES TO INDIAN AUTOMOBILE LTD. AS PER TERMS OF SUPPLY, FULL PRICE OF THE GOODS ARE NOT RELEASED BY INDIAN AUTOMOBILE LTD. BUT 10% THEREOF IS RETAINED AND PAID AFTER ONE YEAR, IF THERE IS SATISFACTORY PERFORMANCE OF THE PARTS SUPPLIED. GEAR LTD. ACCOUNTS FOR ONLY 90% OF THE INVOICE VALUE AS SALE AT THE TIME OF SUPPLY AND BALANCE 10% IS ACCOUNTED AS SALE IN THE YEAR OF RECEIPT OF PAYMENT.

According to AS 9 on Revenue recognition, revenue from sale of goods should be recognized when the seller has transferred to the buyer, the property in the goods for a price or when the seller has transferred all significant risk and rewards and the seller retains no effective control over goods and no significant uncertainty exists regarding the amount of consideration and its collectability.

In the given case the goods as well as the risk and ownership have been transferred by Gear Ltd., to Indian Automobile Ltd., on the basis of invoice and delivery of material. In the instant case, therefore, Gear Ltd., should recognize sale at full 100% of the invoice value in spite of the fact that 10% payment will be released after one year. However, depending upon the past experience regarding collectability of 10% amount, they can make a provision for the amount that is not likely to be realized.

Hence, the treatment given by the company is not correct and if they do not correct it, the auditor should qualify his report.

Q.NO.10. ON 31.12.2008, AMUDHAN COMPANY LIMITED INVESTED RS. 45 LAKHS IN CUMULATIVE FIXED DEPOSITS OF ALGAR BANK LTD. THE DEPOSITS CARRY INTEREST @10% PER ANNUM COMPOUNDABLE QUARTERLY AND AMOUNT OF INTEREST IS ADDED TO THE PRINCIPAL AND IS DUE AND PAYABLE ON THE MATURITY DATE WHICH IS 5 YEARS FROM THE DATE OF INVESTMENTS. FOR THE YEAR ENDED 31ST MARCH, 2009, THE COMPANY DID NOT BOOK ANY REVENUE OF INTEREST ON THE GROUND THAT INTEREST AMOUNT IS NOT AVAILABLE AT THEIR DISPOSAL TILL MATURITY DATE OF INVESTMENT. COMMENT.

According to Section 128 of the Companies Act, 2013 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies. Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown under current assets in the balance sheet as per Schedule III Part I requirement.

As such, the profits and current assets are understated and true and fair views of the accounts are thus vitiated. On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report.

Q.NO.11. WHILE AUDITING THE ACCOUNTS OF XYZ LTD., IT HAS COME TO THE NOTICE OF THE AUDITOR THAT RECEIPTS HAVE BEEN SUPPRESSED. DISCUSS EXPLAINING AT LEAST FIVE TECHNIQUES AS TO HOW RECEIPTS MAY BE SUPPRESSED.
(RTP M14)

Five Techniques of how receipts are suppressed are:

- a) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- b) Adjusting unauthorized or fictitious rebates, allowances, discounts, etc. to customer accounts and misappropriating amount paid by them.
- c) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- d) Not accounting for cash sales fully.
- e) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.

THE END

15. VERIFICATION & VALUATION OF ASSETS

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	A	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	4	-	-	-	-
5.	A	-	-	-	-	-	-	-	5	-	-	-	4	-	-	-	-	-	4	-	-	-
6.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	A	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
13.	A	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-
14.	A	4	4	2	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-
16.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
17.	A	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
18.	A	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-
19.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
20.	A	4	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-
21.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
22.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-
23.	A	5	-	-	-	5	-	-	-	2	-	-	-	-	-	-	-	-	-	4	-	-
24.	A	-	-	-	-	-	-	-	-	-	-	-	5	8	-	-	-	-	-	-	-	-
25.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
26.	A	6	4	-	-	-	2	5	-	-	-	4	-	-	-	-	-	-	-	-	-	-
27.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
28.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
29.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-
30.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
31.	A	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
32.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
33.	B	-	-	5	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
34.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
35.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
36.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
37.	B	-	-	-	-	-	5	-	-	-	-	-	-	4	-	-	-	4	-	-	-	4
38.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
39.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
40.	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
41.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
42.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
43.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
44.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
45.	C	-	4	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

46.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
47.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
48.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What are the steps involved in verification of plant & machinery? (A)
(N - 89, M - 91, 03 - 4M)

1. Verify existence of plant and machinery by physically inspecting it.
2. Verify ownership of plant and machinery by inspecting the purchase invoices.
3. **Register:** *In case number of P & M owned is large, a Register is generally maintained by the entity. The auditor should also examine it to ascertain existence & ownership.*
4. Verify the purchases by checking Board resolution & supporting evidences like invoices etc.
5. **Sale:**
 - a) Check the authority for sale with the board resolution.
 - b) Supporting evidences such as cash receipt.
 - c) Check whether related accumulated depreciation have been cancelled.
 - d) Check whether the profit on sale has been properly treated in the accounts.
6. *See whether proper depreciation is provided in the accounts.*
7. Ensure that the expenses incurred for installation of the machinery have been capitalised.
8. In case the plant and machinery is self generated see that no profits have been booked and only the cost incurred have been capitalised.
9. *Review the repairs account to confirm that distinction is made between capital & revenue exp's.*
10. *The auditor should also look into insurance policies taken for P & M.*
11. *Ascertain the charges, if any. Sometimes, a floating charge may be created over such assets. If they exist, see whether Sec.77 of the companies act have been complied with.*
12. Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

REFER PRACTICAL QUESTIONS: 1

Q.No.2. What are the steps involved in verification of furniture & fixtures? (A)

- a) Verify existence of Furniture & Fixtures by physically inspecting it.
- b) Verify ownership of Furniture & Fixtures by inspecting the purchase invoices.
- c) *In case number of F & F owned is large, a Register is generally maintained by the entity. The auditor should also examine it to ascertain existence & ownership.*
- d) Verify the purchases by checking Board resolution & supporting evidences like invoices etc.
- e) **Sale:**
 - i) Check the authority for sale with the board resolution.
 - ii) Supporting evidences such as cash receipt.
 - iii) Check whether related accumulated depreciation have been cancelled.
 - iv) Check whether the profit on sale has been properly treated in the accounts.
- f) See whether proper depreciation is provided in the accounts.
- g) *Ensure that the expenses incurred for installation of it have been capitalised.*

- h) In case the F & F is self generated see that no profits have been booked and only the cost incurred have been capitalised.
- i) The auditor should also look into insurance policies taken for F & F.
- j) Review the repairs account to confirm that distinction is made between capital & revenue exp's.
- k) Ascertain the charges, if any. Sometimes, a floating charge may be created over such assets. If they exist, see whether Sec.77 of the companies act have been complied with.
- l) The auditor should ensure that cost of the furniture and fittings which have become unserviceable or has been lost is written off to the P&L a/c under proper authority.
- m) Ensure that the assets are properly disclosed in the B/s as Schedule III Part I.

Q.No.3. What are the steps involved in verification of motor vehicles? (A)

(N 88, 05 - 4M)

- a) The auditor should verify existence of Motor vehicles by physically inspecting it.
- b) The auditor should verify ownership of Motor vehicles by inspecting the registration certificate.
- c) In case number of vehicles owned is large, a Vehicle Register is generally maintained. The auditor should also examine it to ascertain existence, ownership and possession.
- d) Verify the purchases by checking Board resolution & supporting evidences like invoices etc.
- e) **Sale:**
 - i) Check the authority for sale with the board resolution.
 - ii) Supporting evidences such as cash receipt.
 - iii) Check whether related accumulated depreciation have been cancelled.
 - iv) Check whether the profit on sale has been properly treated in the accounts.
- f) Cost includes purchase price and cost of accessories.
- g) Review the repairs account to confirm that distinction is made between capital & revenue exp's.
- h) The auditor should also look into insurance policies taken for motor vehicles.
- i) See whether accounting adjustments are made for prepaid insurance and taxes.
- j) Ascertain the charges, if any. Sometimes, a floating charge may be created over such assets. If they exist, see whether Sec.77 of the companies act have been complied with.
- k) See whether proper depreciation is provided in the accounts.
- l) The auditor should ensure that cost of the vehicles which have become unserviceable or has been lost is written off to the profit and loss account under proper authority.
- m) Ensure that the vehicles are properly disclosed in the B/s as per Schedule III Part I.

REFER PRACTICAL QUESTIONS: 2, 3

Q.No.4. What are the steps involved in verification of buildings? (A)

(M 90, 93 - 6M, M 14 - 4M, PM)

- a) The auditor should verify existence of Buildings by physically inspecting it.
- b) Verify the ownership by inspecting the title deeds. If the property has been mortgaged, the title deeds will be in the possession of mortgagee, from whom a certificate should be obtained.

- c) *In case number of Buildings owned is large, a Register is generally maintained by the entity. The auditor should also examine it to ascertain existence & ownership.*
- d) *Verify the purchases by checking Board resolution & supporting evidences like invoices etc.*
- e) **Sale:**
 - i) *Check the authority for sale with the board resolution.*
 - ii) *Supporting evidences such as cash receipt.*
 - iii) *Check whether related accumulated depreciation have been cancelled.*
 - iv) *Check whether the profit on sale has been properly treated in the accounts.*
- f) *See whether proper depreciation is provided in the accounts.*
- g) *In case the Buildings is self generated see that no profits have been booked and only the cost incurred has been capitalised.*
- h) *If any revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.*
- i) *The auditor should also look into insurance policies taken for Buildings.*
- j) *Review the repairs account to confirm that distinction is made between capital & revenue exp's*
- k) *Ascertain the charges, if any. If they exist, see whether Sec.77 of the Co.'s act is complied with.*
- l) *Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.*

REFER PRACTICAL QUESTIONS: 5

Q.No.5. How do you verify lease hold property? (A)

(N 89, 92, 14 - 6M, PM)

- a) *The auditor should verify existence of such property by physically inspecting it.*
- b) *See that Board has passed a resolution.*
- c) *Obtain a copy of lease agreement and review the terms and conditions of the lease.*
- d) *Ensure compliance with conditions such, as payment of rent on due dates, maintenance of property etc, stated in the deed. Non-compliance might result in cancellation of lease.*
- e) *Vouch the payment of lease premium with reference to the receipts from the lessor.*
- f) *Check whether the lease registration charges are capitalised. (A lease exceeding one year is not valid unless it has been registered.)*
- g) *Ensure that the cost of the lease is amortised over the life of the lease.*
- h) *In case the client has made additions to the lease property ensure that the cost of those additions are properly depreciated over the life of the lease. (Expl. 2 to Sec.32 of I. T Act)*
- i) *Review the repairs account to confirm that distinction is made between capital & revenue exp's.*
- j) *Where there is sub-lease check whether proper income from the sublease is accrued.*
- k) *Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.*

Q.No.6. What are the steps involved in verification of loose tools? (A)

(PM, M15 MTP1 - 4M, N15 MTP2 - 4M)

1. **Physical examination:** *The auditor will verify small tools-usually hand tools such as portable drills, sanders, files, and so forth-by actual physical examination of some of the items.*

2. Valuation would depend on method of accounting:

- a) **P&L A/c:** If tool purchases are small, they are charged to trading and profit and loss account at acquisition cost and, thus, no inventory of small tools exist in the balance sheet i.e. 100% depreciation is provided in the 1st year itself. Proper records are, however, maintained to prevent them from being stolen, lost etc.
- b) **Balance sheet:** Cost incurred on purchases of such items is debited to Small Tools Asset Account. The closing stock shown in the balance sheet consists of serviceable items only i.e., items lost, worn out or those which have become obsolete, are not counted in inventory. Trading account is debited with the difference between sum total of opening stock, and purchases, and closing stock as per inventory records.

Q.No.7. How do you verify fixed assets abroad? (A)

(M 91, N 02 - 4M, PM)

- a) **Certificate:** Obtain a schedule of fixed assets held abroad duly certified by a responsible official of the company.
- b) Ensure that a physical examination of such assets have been carried out periodically. Get a certificate from branch auditor of the foreign branch/or of a responsible official of the branch.
- c) Verify the purchases by checking Board resolution & supporting evidences like invoices etc.
- d) **Sale:**
 - i) Check the authority for sale with the board resolution.
 - ii) Supporting evidences such as cash receipt.
 - iii) Check whether related accumulated depreciation have been cancelled.
 - iv) Check whether the profit on sale has been properly treated in the accounts.
- e) *See whether proper depreciation is provided in the accounts.*
- f) *In case the asset is self generated see that no profits have been booked and only the cost incurred has been capitalised.*
- g) *If any revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.*
- h) *The auditor should also look into insurance policies taken for assets.*
- i) *Review the repairs account to confirm that distinction is made between capital & revenue exp's.*
- j) *Ascertain the charges, if any. If they exist, see whether Sec.77 of the Co.'s act is complied with.*
- k) Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

Q.No.8. What are the steps in verification of ships? (C)

- a) The cost of ships, if purchased outright, should be verified on a reference to the Bill of Sale and, if built to order, from the agreements with the shipbuilders.
- b) The ownership of the title should be verified from the certified copy of the entry in the port of registration.
- c) *Any mortgage or charge created on the ship is disclosed in the copy of 'entry' in case any exists, the same should be disclosed.*
- d) In addition, it should be ascertained that the ship is fully insured against all risks.

Q.No.9. What are the steps in verification of railway sidings? (A)

(M 93 - 4M)

- a) Physically verify the existence.
- b) Refer to the agreement with Railway for availing of the facility.
- c) The cost of such asset = All expenses connected with the laying of the railway sidings + Any amount paid to the Railway.
- d) The cost shall be appropriately depreciated keeping in view the terms of agreement.
- e) *Where the railways have taken up the task of construction check the agreement and the Architect's certificate confirming the satisfactory laying of the track.*
- f) Check the entries in the fixed asset registers.
- g) Review the repairs account to confirm that distinction is made between capital & revenue exp's.
- h) Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

Q.No.10. What are the steps in verification of live stock? (B)

(M 91 - 4M)

1. Live stock register:

- a) Examine Livestock Register and note various particulars like breed, year of purchase, purchase price, write-offs, etc. for various categories of animals.
- b) See that the animals have been identified by assigning identification number.

2. Yield Register: Examine the Yield and Employment Record to ensure that the same are in existence.

3. Financial Statements: Verify the basis of valuation, noting the following points:

- a) In case of animals purchased at the age of maturity, purchase price plus freight should be capitalised.
- b) Where an animal is reared from its conception and then brought to maturity, the cost of calving, cost of fodder etc. consumed till maturity and suitable share of overheads (water, maintenance of sheds, medicines, etc.) less sale proceeds if any, should be capitalised.
- c) *Verify that when the earning capacity of the animal starts declining, the cost accumulated up to the maturity stage of animal has been written off by straight-line method over the remaining life.*
- d) *See that disposal value at the end of life has been adjusted properly. Normally this value may be taken at Nil because the carcass does not fetch anything substantial.*

Q.No.11. Verification of loans given against the security of land. (A)

- a) Examine whether the objective clause of MOA permits the company to lend the loans.
- b) Obtain confirmation from the borrowers for the amount of loan.
- c) Check the title deeds of the land mortgaged.
- d) Check the entries in the Loan register.
- e) Examine the mortgage deed and find out whether it is properly executed. If it is a second mortgage, check whether the first mortgagee has been informed of the second mortgage and whether he (the first mortgagee) has the title deeds relating to the property.
- f) *See whether amount is being repaid as per the mortgage deed & if not whether reasonable steps have been taken by the company for recovery of the principal and interest.*

- g) See whether loans given to other companies are at a rate of interest not less than the bank rate as per section 186 of the Companies Act, 2013.
- h) Compliance of Sec.143.
- i) Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

Q.No.12. Steps in verification of loans against the security of goods. (A) (N 95 - 6M)

- a) Examine whether the objective clause of MOA permits the company to lend the loans.
- b) Enquire whether the borrower has a right to borrow money.
- c) Obtain confirmation from the borrowers for the amount of loan.
- d) Examine the loan agreement and find out whether it is properly executed.
- e) See whether amount is being repaid as per the loan agreement & if not whether reasonable steps have been taken by the company for recovery of the principal and interest.
- f) See that the goods are properly insured as they constitute security for the loan advanced.
- g) *Where the loan has been advanced against a Godown-keeper's Receipt, such a receipt should be examined to confirm that it was endorsed in favour of the company.*
- h) *If the loan has been advanced against the goods in transit, lorry receipt or railway receipt or bill of lading endorsed in favour of the entity should be inspected.*
- i) *See that the rent for the warehouse has been paid by the borrower. If it has not been paid then it should be added to the amount of the principal.*
- j) See whether loans given to other companies are at a rate of interest not less than the bank rate as per section 186 of the Companies Act, 2013.
- k) Compliance of Sec.143
- l) Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

**Q.No.13. Steps in verification of assets acquired under H.P. system. (A)
(N 90, 93, 97, 01, 08, M 07, 13- 4M, PM, N14 RTP, N14 MTP2 - 4M)**

- a) Examine the Board's Minute Book approving the purchase on hire-purchase terms.
- b) Examine the hire-purchase agreement particularly for description and cost of the asset, both cash price and hire purchase price, rate of interest, terms of payment, etc.
- c) Ascertain the proper accounting thereof in the books with respect to principal installments and interest charges respectively.
- d) *Ensure that relevant asset so acquired has been included at its cash price in the balance sheet*
- e) *Ascertain that balance payable thereon is properly reflected in the balance sheet.*
- f) *See that the depreciation is provided for the assets so purchased.*
- g) Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

REFER PRACTICAL QUESTIONS: 4, 6

Q.No.14. What are the steps in verification of investments? (A) (N 88, 94, M 06 - 4M, PM)

1. Obtain the schedule of investments in hand containing description, date of purchase, face value, book value, market value, rate of interest, date of payment of interest etc.
2. Examine whether the objective clause of MOA permits the company to make the investments.

3. See that purchases/sales are made only after the sanction of proper authority.
4. **Physical verification:**
 - a) The auditor should see the investment certificates.
 - b) The auditor should see the title deeds of immovable properties.
5. **Evidence:**
 - a) Check the prices paid/received with reference to the broker's contract note.
 - b) Check the prices paid/received with reference to stock exchange quotations.
6. *See that the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.*
7. **Cum/Ex:** *Special attention should be paid to investments purchased or sold cum-dividend, ex-dividend, cum-interest, ex-interest, cum rights/ex-rights or cum bonus /ex-bonus.*
8. **Other's name:** *If the entity is holding investments otherwise than in the name of the enterprise, the auditor should try to ascertain the reasons for the same and examine relevant documentary evidence. E.g.: if in the name of trustees, the auditor may obtain written confirmations.*
9. **Other's custody:** *The auditor should see the justification for keeping the investments in the custody of third parties.*
10. *Compliance of Sec.143.*
11. Satisfy that the investments are properly valued (AS-13) & disclosed (Sch.III).

REFER PRACTICAL QUESTIONS: 14

Q.No.15. Verification of investments in shares & debentures of subsidiary. (A)
(N14 - 4M, PM)

- a) The auditor should obtain a complete schedule of investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc.
- b) See that the objective clause of the MOA permits the company to make the investments.
- c) See that the purchases/sales of investments are made only after the sanction of the proper authority.
- d) Examine all the investments by inspection of the share certificates, debenture bonds etc.
- e) See that the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.
- f) **Cum/Ex:** *Special attention should be paid to investments purchased or sold cum-dividend, ex-dividend, cum-interest, ex-interest, cum rights/ex-rights or cum bonus /ex-bonus.*
- g) **Other's name:** *If the entity is holding such investments otherwise than in the name of the enterprise, the auditor should try to ascertain the reasons for the same and examine relevant documentary evidence. For ex., if investment is in the name of nominees to comply with the condition of minimum shareholders, auditor may obtain written confirmations.*
- h) *If the subsidiary has suffered a loss, a provision for the proportionate part of the loss should be made in the accounts of the holding company. (AS 21)*
- i) The provisions contained in Part I, Schedule III require that shares held in a subsidiary should be shown separately.

Q.No.16. Verify investment in the capital of a Partnership Firm. (A)

(M 95 - 4M)

- a) To establish the authenticity of this item the auditor should go through the partnership deed, noting the capital contributed by the company, and the latest Balance Sheet and the profit and Loss Account, duly audited.
- b) The amount of the loss, if any, falling to the share of the company should be debited to the profit and loss account; the share of profit should be similarly credited to the P&L A/c.
- c) This has to be disclosed separately.

Q.No.17. What are the steps in verification of cash in hand? (A)

(N 89, 90 - 6M)

- a) Obtain a list of places where cash is maintained.
- b) Check the closing cash balance by physical verification on the last working day and if it is not possible carry out physical verification on a subsequent day.
- c) Conduct surprise cash verification during the time of audit.
- d) Compare the physical balances verified with the balances as per cashbook. Where there are several cash balances, conduct simultaneous verifications.
- e) If there is a difference between actual & book balance, auditor should call for explanation.
- f) The postage stamps to be counted and compared with the postage register.
- g) Check the existence of Cash/fidelity insurance.
- h) Check the existence of procedures for safe custody of cash.
- i) Check that there is a segregation of duties relating to handling of cash & books.
- j) In the case of foreign currencies check that they are converted at the closing rates.
- k) Ensure that the cash balance is disclosed as per Sch.III.

Note: Cash includes Imprest cash.

REFER PRACTICAL QUESTIONS: 13.

Q.No.18. What are the steps in verification of cash at bank? (A)

(PM, N14 RTP)

1. Obtain a list of bank accounts maintained showing therein the nature of accounts.
2. See whether the closing balance is properly confirmed by a confirmation certificate.
3. See that whether the culture of preparing the BRS periodically is in existence or not.
4. Inspect fixed deposits receipts for verifying fixed deposits.
5. Verify the balance at bank in the following manner:
 - a) Compare the entries in the cash book and bank statements for the current period.
 - b) Trace the unmatched items in the cash book and bank statement of the current period into the BRS of the current period.
 - c) Trace the outstanding items as per the previous reconciliation statements into the current periods cash book and bank statement.
 - d) Enquire into the outstanding items still appearing in the BRS.
6. If there is a difference between actual & book balance, auditor should call for explanation.
7. Check the existence of procedures for safe custody of cheque books.
8. Check whether the bank balances are disclosed properly as per the requirement of Schedule III, Part I.

Q.No.19. What are the steps in verification of bills receivable? (A)

(M 96 - 4M)

- a) Obtain the schedule of Bills receivable in hand containing name of the parties, date of bill drawn, Amount, rate of interest, due date etc.
- b) Carry out a physical verification of the bills receivable on hand.
- c) See that they are in Safe custody.
- d) See that they are drawn under proper authority.
- e) See that they are properly drawn, stamped, duly accepted etc.
- f) Obtain confirmation certificate from bankers in case they are lying with bankers for collection.
- g) See that bills discounted by proper authority & the accounting entries passed are correct.
- h) If discounted bills have been dishonoured, the auditor should ensure adequate provision has been made for irrecoverable amount.
- i) The auditor should see that amount of bills discounted is shown as a contingent liability.
- j) Ensure that the assets are properly disclosed in the B/s as per Schedule III Part I.

Q.No.20. How will you verify discounted B/R dishonoured. (A)

(N 91, M 95, 97, 03, N 12 - 4M, PM)

1. Obtain a Schedule of Bills Discounted dishonoured and examine the same.
2. Trace the credit entry and subsequent dishonor entry in the Bank Statement.
3. Confirm that no debit is raised by the Banker for dishonour, without first crediting the amount to Entity's account
4. Verify whether B/R has been returned along with Banker's advice.
5. Ensure that the dishonor has been properly "noted" on the B/R.
6. Verify entries for dishonor passed in the parties account.
7. See whether Bank Charges, Noting Charges, etc. have been debited to party.
8. Examine correspondence with lawyer and other subsequent events, which may provide other evidence of the debt becoming doubtful or bad.

Q.No.21. What are the steps in verification of prepaid expenses? (A)

(N 94, M 99 - 4M)

- a) A few examples for such expenses - Insurance charges, subscriptions for magazines & clubs.
- b) Obtain a list of expenses containing nature of expenses, period to which they relate.
- c) Testing of computation of amount being carried forward particularly with respect to the apportionment between two accounting periods.
- d) Auditor can verify prepaid expenses charged to revenue by using the following four element equation: Beginning balance for prepaid insurance + premium paid during the period – closing balance for prepaid insurance = Insurance expense for the period.
- e) Ensure that prepaid expenses are disclosed under the head "Loans and Advance".

Q.No.22. What are the steps involved in verification of land holdings in the case of real estate dealer? (A)

(N13 – 4M, PM)

- a) The auditor should verify existence of Land by physically inspecting it.
- b) The auditor should verify ownership of Land by inspecting the registration certificate which contains information as to ownership etc.

- c) In case number of Land holdings is large, a Land holdings register is generally maintained. Examine it to ascertain existence, ownership and possession.
- d) Verify the purchases by checking Board resolution.
- e) See that the basis of distribution of the common charges between different plots of land acquired during the period is reasonable.
- f) Cost of each plot = Cost of acquisition (Direct/Appportioned) + Common charges distributed.
- g) *See that the plots of the land were sold for at the predetermined rate only.*
- h) *See that the sale deeds were made under the sanction of the appropriate authorities.*
- i) Since the land holding in the case of a real estate dealer is a current asset the same shall be valued at cost or market value which ever is less.
- j) See that this is disclosed under the head "Stock in trade" on the assets side of the B/s.

Q.No.23. How will you verify work in progress? (A)

(N 01, M 05, 08, 15 - 4M, PM, N14 RTP, N14 MTP2 - 4M,)

The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. Further steps:

- a) Ascertain that the cost sheets are duly attested by the works engineer and works manager
- b) *Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost sheets by reference to the records maintained in respect thereof.*
- c) *Ensure that the allocation of overhead expenses have been made on a rational basis.*
- d) Compare the WIP with that of the previous year. If they vary materially, investigate the cause.
- e) See that this is disclosed under the head "Stock in trade" on the assets side of the B/s.

REFER PRACTICAL QUESTIONS: 10

Q.No.24. What are the steps in verification of book debts? (A)

(M 12 – 8M, PM)

1. The extent of examination of books of accounts by an auditor with reference to the relevant basic documents (e.g. Sale invoices) depends upon the facts and circumstances of each case.
2. Obtain the schedule of debtors containing the name of debtor, nature of debt, number of days for which it was outstanding/overdue, status of the debt.
3. See that the amounts which are not due are not included in the debtor's list. (E.g.: Goods sold on approval basis and the time given for acceptance not yet completed.)
4. In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realised.
5. *Check whether there exists a procedure to ascertain the credit analysis of debtor's.*
6. *Check whether ageing schedules of debtors prepared at regular intervals.*
7. *See that proper steps were taken for non payment of debts.*

8. See bad debts written off or discounts allowed are with the proper authorisation.
9. See that the appropriate amount of provision for bad & doubtful debts is created.
10. **The following are some of the indications of doubtful and uncollectible debts:**
- a) The terms of credit have been repeatedly ignored.
 - b) Stagnation or lack of healthy turnover in the account.
 - c) *Payments are being received but balance is continuously increasing.*
 - d) *Payments, though being received regularly, are quite small in relation to total outstanding.*
 - e) *An old bill has been partly paid or unpaid, while later bills have been fully settled.*
 - f) *Cheques received from the debtor repeatedly dishonoured.*
 - g) *The debt is under dispute.*
 - h) Information about inability of debtor to pay e.g. debtor's insolvency.
 - i) Collection time-barred (i.e. barred by law of limitation).
11. **Direct Confirmation Procedure:**
- a) The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date.
 - b) *The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request wherein the debtor is requested to respond only if he disagrees with the balance shown.*
 - c) If the debtors are numerous, this may be done on a sample basis. While selecting the debtors to be taken for confirmation special attention should be paid to accounts with large balance accounts with old outstanding balances.
12. **See that the disclosure requirements as required by Schedule III are complied with:**
- a) *Debts outstanding for more than 6 months have to be shown separately.*
 - b) *All the sundry debtor's are required to be classified as under:*
 - i) *Debts considered good.*
 - ii) *Debts considered good for which the company holds no security.*
 - iii) *Debts considered doubtful or bad.*
 - c) *Disclosure is also required of debts due by directors or other officers or debts due by firms or private companies in which any director is a partner or a director or a member.*

Similar question: Write short notes on Direct Confirmation Procedure

Ans: Write the 11th point.

REFER PRACTICAL QUESTIONS: 11

Q.No.25. What are the steps in verification of stock in trade? (A)

1. The extent of examination of books of accounts by an auditor with reference to the relevant basic documents depends upon the facts & circumstances of each case.
2. **Attendance at Stock-taking:**
- a) Physical verification of inventories is the responsibility of the management of the entity.
 - b) The extent of auditor's attendance at stocktaking would depend upon his assessment of the efficiency of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity.

c) See the adequacy of the physical verification procedures followed by the entity:

- i) See that the instructions issued by the management are being actually followed.
- ii) Perform test counts to satisfy himself about the effectiveness of the count procedures.
- iii) There should be no movement of stocks when the physical verification is carried out.
- iv) See that the entity has instituted appropriate 'cut-off procedure'.
- v) See that the discrepancies (differences) noticed on physical verification have been investigated and properly accounted for.

3. Confirmations from Third Parties:

- a) Where stocks of the entity are held by third parties the auditor should also examine the justification for keeping the stock in the custody of third parties.
 - b) Also obtain written confirmation directly from third parties on the stocks held.
4. See that adequate provision has been made for obsolete and spoiled stock.
5. See that the write off's made against the proper authority.
6. Apply the analytical review procedures. Refer 2nd Lesson
7. Examine the existence & efficiency of internal control procedures in relation to the custody of stock in trade.
8. See that the stock is properly insured.
9. See that stock issues were made against proper/authorised requisitions (Like MRN).
10. Ascertain the charges, if any. If they exist, see whether Sec.77 of the Co.'s act is complied with.
- 11. Examination of Valuation and Disclosure:**
- a) See that valuation is made at Cost or NRV whichever is lower. See the compliance of AS - 2
 - b) See that the disclosure requirements as per Sch.III have been complied with.

REFER PRACTICAL QUESTIONS: 7, 8, AND 9

Q.No.26. What are the analytical review procedures in case of inventory? (A)

- 1. Quantitative reconciliation of inventories, i.e. Opening Stocks, Purchases, Production, Sales and Closing Stocks.
- 2. Comparison of current year quantities and value of major terms of inventories with those of the previous year.
- 3. Comparison of current year ratios of various items (i.e. Raw Materials, WIP and Finished Goods) of inventories to total inventories with the corresponding figures for the previous year.
- 4. Comparison of ratios of quantities and values of current year's inventories to the quantities and values of current year's sales and purchases with the corresponding figures for the previous year.
- 5. Comparison of current year's Gross Profit ratio with the corresponding figure for the previous year.
- 6. Comparison yield with the corresponding figure for the previous year.
- 7. Comparison of figures of Inventories, Purchases and Sales with the corresponding budgeted figures, if available.
- 8. Comparison of significant ratios relating to inventories with similar ratios for other Firms in the same industry and with the industry norms, if available.

Q.No.27. How do you verify “goods on consignment”? (A)

(N 90, 06 - 4M)

1. Verify terms of agreement between consignor and consignee to check commission and other expenses debited to Consignment Account and credited to Consignee's Account.
2. Verify the Account Sales submitted by the Consignee and peruse the quantitative details of goods sold and goods on hand.
3. Reconcile the figure of goods on hand, as given in the last Account Sales, with proforma invoices and Accounts Sales received during the year.
4. *If any Consignment Stock was with the Consignee at the beginning of year, the same should be taken into account for reconciliation.*
5. *Ensure that quantity of goods in hand with the Consignee has been valued at cost plus proportionate direct expenses, e.g. Freight, Customs Duty etc.*
6. *When market value is lower, stock in the hands of Consignee should be valued at Market Value.*
7. *See that allowance has been made for damaged and obsolete goods during valuation.*
8. Obtain confirmation from the Consignee, for goods held on consignment on the Balance Sheet date.
9. Check that goods in hand with the consignee have been shown distinctly under “Stock” in the Balance Sheet.

Q.No.28. Sundry debtors include charges made for returnable packing cases. how will you deal with the above? (B)

(N 96, M 02 - 4M)

1. **Nature of amounts due:** The packing cases are with the customers and are returnable. If the customers do not return the packing cases within the stipulated time, their accounts shall be debited with the cost of such items. Unless such time lapses, such costs shall not be included in their accounts.
2. **Disclosure:** The cost of packing cases should be shown in the Balance Sheet on the Assets side as “Packing cases with Customers” and should be valued at Cost Price less Depreciation. It should not be included in the account of the Sundry Debtors.

Q.No.29. How will you verify goodwill? (A)

(N 89, 95, M 92, 98, 05 - 4M, PM)

- a) If goodwill has been recorded in the books, ensure that some consideration in money or money's worth has been paid for it. Otherwise, goodwill should not be recorded in the books. (AS-26)
- b) See that internally generated goodwill has not been recognized as asset. AS-26 prohibits recognition of internally generated goodwill as asset.
- c) Whenever a business is acquired for a price which is in excess of the value of net assets acquired by the business, the excess is termed as 'goodwill'. See the agreement in that case.
- d) See that whether it is amortised over a period of time.
- e) The amortisation practice followed should be disclosed as a footnote to the balance sheet.

Q.No.30. How will you verify patent rights? (A)

(M 88, 90, 91, N 02, 03, 04 - 4M, PM)

- a) In case the number of patents is large, the auditor can obtain a schedule of patents.
- b) The auditor can verify the existence & ownership of a patent by examining certificates issued upon the registration of the patent.

- c) In case patent rights have been purchased, the assignment deed surrendering seller's right should be examined.
- d) The cost of a patent purchased includes its purchase price and the registration cost.
- e) *The cost of a patent if developed by the client it self, all research and development expenses, including registration fees and other direct costs incurred in creating it, should be capitalised.*
- f) *The auditor should ensure that renewal fees paid have been debited to profit and loss account. The latest renewal receipt should also be examined to ensure that patent rights are 'alive'.*
- g) *The auditor should ensure that patents are being shown at cost less amortisation charges.*
- h) *The cost should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter.*
- i) However, if it is found that the patent rights have already lost substantial part of their commercial value, it would be proper to value it at their residual commercial value, when it is less than the book value.
- j) In case the product covered by the patent rights does not have any sale value then patents should be shown at nil valuation notwithstanding any residual life.

Similar question: Intangible Assets

(PM)

Ans: Cover Goodwill, Patent rights, Copy rights.

Q.No.31. What are the steps in verification of copy rights? (A)

(M 92, 96, N 01, 08 - 4M, PM, N14 RTP2 - 4M, N14 RTP)

- a) In case the number of copy rights is large, the auditor can obtain a schedule of such.
- b) The auditor can verify the existence & ownership of a copy rights by examining certificates issued upon the registration of the copy rights.
- c) The cost of a copy rights purchased includes its purchase price and the registration cost.
- d) The cost of a copy rights if developed by the client it self, all research and development expenses, registration fees and other direct costs incurred in creating it, should be capitalised.
- e) *If the copy right meets the recognition criteria specified in AS-26, see that the expenditure is capitalised. Otherwise, see that expenditure is charged to Profit and Loss Account.*
- f) *The auditor should ensure that renewal fees, if any, have been paid on due dates and have been debited to profit and loss account. The latest renewal receipt should also be examined to ensure that copy rights are 'alive'.*
- g) *Ensure that copy rights are being shown at cost less amortisation charges.*
- h) *The cost should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter.*
- i) However, if it is found that the patent rights have already lost substantial part of their commercial value, it would be proper to value it at their residual commercial value, when it is less than the book value.
- j) In case the product covered by the copy rights does not have any sale value then patents should be shown at nil valuation notwithstanding any residual life.

Q.No.32. What are the steps in verification of trade marks? (A)

Similar to the previous answer.

Q.No.33. How will you vouch / verify advances given to suppliers? (B) (N07 – 5M, PM)

Non – adjustment of previous advances may be due to: (a) Inadvertent omission, or (b) Intentional act.

1. **Nature:** Examine the nature of advance made to Supplier. In case of a long-term supply contract, an advance of quasi-permanent nature may have been paid.
2. **Suppliers Ledger:** Scrutinise the Suppliers Ledger to study the mode of settlement of bills, i.e. extent of adjustment against advances and the amount paid towards full and final settlement.
3. **Receipts:** *Examine the receipts issued by the Creditors against balance payments on the bills and see that they confirm a full and final settlement.*
4. **Balance Confirmation:** *Obtain confirmation from the concerned parties that they are not holding any advance, as regards the matter under reference.*
5. **Error:** *where non-adjustment of advances was due to an inadvertent omission or a mistake, instruct the Management to correct the same in the accounts. To that extent, suppliers' balances (Liabilities) and Advances (Assets) will get reduced.*
6. **Fraud:** Sometimes, frauds may be committed by taking fictitious credits in the P&L Account while debiting the Suppliers' Accounts. In case of such fraud, the Auditor should disclose such fraud in his report in an appropriate manner.

Q.No.34. How do you vouch / verify advance given to a director of a company? (B) (PM)

1. Check whether there is any restriction in the Articles of Association towards such advance.
2. Verify the maximum amount that can be given as advance to Directors.
3. Check the Minutes Book for the resolution appointing the payment of advance to the Director.
4. Scrutinise whether the Director to whom the payment has been made is involved in approving the resolution.
5. Analyse the agreement between the Director and the Company to know about the interest and principal repayment details security given, if any.
6. Consider Loans given to Directors under CARO, 2016 reporting requirements.
7. See that the disclosure requirements as per Sch.III have been complied with.

Q.No.35. How do you verify contracts in the course of completion? (B)

1. **Schedule of Contracts undertaken:**
 - a) Obtain the schedule of contracts undertaken during the year.
 - b) Note the status of various contracts, i.e. Cost Plus or Fixed Price Contracts.
 - c) Verify the status of these contracts at the end of the year.
2. **Cost Plus Contracts:**
 - a) In respect of Cost Plus Contracts, see whether credit has been taken for the percentage of profit on cost actually incurred.
 - b) In case of uncertainty regarding completion of contract, ensure that no profit element is included
3. **WIP Statement:**
 - a) *Scrutinise the Contract WIP at the end of the year and ensure that it has been properly valued as – (a) Work Certified – based on architect's certificate, and (b) Work Uncertified – based on Contractor's own cost assessment.*

- b) *Ensure compliance with disclosure requirements under AS – 7*
- c) *See that the accounting principles relating to Contracts in the course of completion are consistently followed.*

Q.No.36. How do you verify endowment policies? (B)

(M 04 - 4M, PM, M15 RTP)

Endowment Policies or Sinking Fund Policies may be taken out for the purposes like – (a) redemption of debentures or (b) redemption of leases, etc. where a lump sum amount is required at a certain future date. They are considered as Quasi-Fixed Assets.

Matters to be verified / Auditors' Duties:

1. Inspect the policy and note the purpose for which it has been taken.
2. Determine the amount of insurance premium payable and the due date thereon.
3. Verify whether the last premium has been paid before the due date.
4. Vouch by reference to the premium receipt issued by the Insurance Company.
5. Verify whether the premium paid and the value of the policy has been properly disclosed in the Financial Statements.

Q.No.37. What are the steps in verification of preliminary expenses? (B)

(M 14 - 4M, M16 – 4M)

It is the expenditure-incurred incidental to the floating of a company. It consists of stamp duties, registration fees, legal costs, consultant's fees, expenses of printing of memorandum and articles, etc. The following are the steps for verification:

1. Check G.M.'s minute's book containing the resolution approving the expenses claimed by promoters as having been spent in formation of the company.
2. **Check the following to support the promoter's claims:**
 - a) Examine supporting evidences like contracts, agreements etc. to support promoter's claims
 - b) Also check the bills issued by the publisher/printer of the memorandum and articles of association, share certificates, etc.
 - c) Check receipt issued by the ROC for the registration fee paid.
3. Check whether any personal expenses are shown as preliminary expenditure.
4. See that whether it is amortised over a period of time.
5. The amortisation practice followed should be disclosed as a footnote to the balance sheet.
6. Disclosure requirements - Sch.III:

Q.No.38. Preliminary Expenses vs. Pre Production Expenses. (B)

(M 12 – 4M)

Particulars	Preliminary Expenses	Pre-production Expenses
Meaning	Preliminary expenses are incurred by promoters of a company to bring it into existence. They include: Legal costs in drafting the M&A, Registration Fees, Cost of printing the M&A etc.	Pre-production expenses are incurred by an industrial company after its incorporation. Revenue expenditure incurred during the course of factory set up are considered as Pre-production expenses.
Time point	These are incurred prior to incorporation.	These are incurred after incorporation and before commercial production.

Incurred by	These are first incurred by the Promoters. After incorporation, the members approves the same and it becomes the expenses of the Co.	These are incurred by the Company. They represent expenses in the accounts as they have been incurred in the pre-production period.
Nature	<i>These are one-time expenses incurred to bring the company into existence and represent a capital expenditure, but not backed by specific assets.</i>	<i>These are basically revenue expenditure in nature but cannot be capitalised as they do not result in an enduring benefit.</i>
Disclosure	These are carried forward in the B/s – Asset side under the heading “Other Non-current Assets”.	These are carried forward in the Balance Sheet – Asset Side under the heading “ Other Non-current Assets”.

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.39. How do you verify cash-in-transit? (C)

(M 92 - 4M)

Cash - in -transit arises where there is a Head Office and Branch Office(s)/Division(s). At the end of the year, cash might have been sent by the Head Office but not received by the Branch Office before the end of the accounting period or vice-versa.

Matters to be verified / Auditor duties:

1. Statements from Divisions / HO:

- Verify statements of Head Office and Branch Office accounts.
- Any cash received by the Branch or Head Office in the first week of the next accounting year might have been in transit on the last day of the previous year.

2. Cash Book:

- Trace the receipt of Cash into the Cash Book of the Head Office / Division, in the subsequent period book as to whether it is actually received or not.
- Examine the period within which the remittance is received , and obtain explanations in respect of abnormal delays, if any.

3. Bank Records:

- Verify pay in slip, if the amount is deposited into bank.
- Confirm the same by verifying the Bank Pass Book / Statements.

Q.No.40. How do you verify Petty Cash? (C)

Payments from petty cash should be verified as follows :

- Trace the amounts advanced to the petty cashier for meeting petty office expenses from the Cash Book in the Petty Cash Book.
- Vouch payments with docket vouchers which must be supported, wherever possible, by external evidence e.g., payee's receipted bill or invoices, cash memo, etc.
- Trace payments made for the purchase of postage stamps recorded in the Postage Book. The totals of the Postage Book should be test checked. The amounts of postage stamps in hand, at the end of the year, should be credited to Postage Account by debiting the amounts to Postage in Hand Account. It should be seen that the amount paid for postage stamps is not unduly large and the Postage Book is normally checked by the petty cashier from time to time before the amount of imprest is reimbursed. Confirm that the postage expenses for the year are reasonable as compared with that in the postage expenses from month to month.

- d) See where a columnar Petty Cash Book is maintained, that the extension have been carried forward into appropriate amount columns.
- e) Check the column totals and cross totals.
- f) Trace posting of the various columns in which payments are classified to the respective ledger accounts.
- g) Verify the cash balance in hand.
- h) Auditor should also verify whether the amount of petty cash imprest is fixed. Is this amount reasonable considering the total amount of petty cash payments made during a month or so?

Q.No.41. What is meant by valuation? What are its objectives? (C)

The term valuation refers to the process of establishing accuracy of the values of assets disclosed in the balance sheet. Both verification and valuation are considered as inseparable twins because the auditor has to satisfy himself both with regard to existence of the assets physically and proper valuation of them i.e. Valuation of assets is a part of verification. The auditor is not a technically qualified and competent valuer. However, he is closely connected with values because the financial statements which are certified by him are consisting of values only.

Objectives of Valuation: To ensure that different categories of assets are valued according to generally accepted accounting principles consistently, to confirm that there is no over or under valuation of various assets & to ensure that the values are properly disclosed in the financial statements.

Q.No.42. Verification vs. valuation of assets? (C)

- a) **Scope:** Valuation of assets is a part and parcel of verification. Verification includes ascertaining existence, ownership, possession, proper valuation and adequate disclosure of an asset.
- b) **Object:** The object of verification by the auditor is to satisfy himself with regard to existence, ownership, possession and valuation of an asset. The object of valuation of assets is to value the assets as per generally accepted accounting principles.
- c) **Responsibility:** The auditor has a duty to verify the assets and may be held guilty of negligence in case of improper verification of assets. Auditors, on the other hand, are not expected to be the valuers. Valuation is the duty of the management and the auditor can rely on a certificate issued by an authorised valuer.

Q.No.43. What are the auditor's duties with regard to valuation? (C)

- a) Auditor is not a valuer.
- b) He can rely on the representations made by the management and opinions and certificates issued by technical experts, surveyors, etc. for the purpose of valuing the assets.
- c) *Before relying on such certificates, the auditor should apply audit procedures to ensure that the valuation done by the management or as indicated by certificates issued by experts, is true & fair.*
- d) *If the auditor does not exercise reasonable care and skill for the purposes of verification or valuation of the assets, he may be held guilty of negligence.*

Q.No.44. What are the principles of valuation of assets? (C)

(M06 - 4M, PM)

1. **Fixed Assets:** They are not meant for resale and are depreciated over a period of time.
Ex. Land and buildings, plant and machinery, vehicles. These assets are valued at cost less depreciation.

2. **Current assets:** The valuation principles are as follows:
- Inventories like raw materials, packing materials, store and spare parts and loose tools - at cost or net realisable value whichever is lower.
 - WIP - at cost including material cost and labour and other cost.
 - Finished goods - At cost or selling price whichever is lower.
 - Sundry debtors - At realisable value less provision for doubtful debts.
 - Investments - At cost or market value whichever is lower.
3. **Wasting assets:** *They refer to the assets, which get depleted due to extraction, and excavation (e.g.) mines, quarries and oil fields. Normally these assets are acquired on lease basis by paying a lump sum premium. The lease amount is amortized over the period of the lease taking into account the extraction from the property. The formula is as follows: Lease amount divided by estimated qty of output over the lease period X actual quantity extracted during the financial year.*

Q.No.45. Valuation of stock in trade & investments. (C)

Refer to AS - 2 & 13.

Q.No.46. Fixed assets vs. current assets. (C)

Fixed Assets	Current Assets
These are acquired for the purpose of business with the object of earning revenue.	These are held by the enterprise for the day-to-day running of business activities.
They are not intended for resale and hence do not change from one form to another.	They change from one form to another i.e. raw materials to WIP, then to finished goods, then to Debtors, then to cash etc.
<i>They are subjected to depletion, depreciation or exhaustion due to wear and tear, efflux of time etc.</i>	<i>They are not subject to depreciation. However, there may be fluctuations in value.</i>
<i>They are stated at Original Cost less Depreciation.</i>	<i>They are stated in the Balance Sheet at Cost or Net Realisable Value, whichever is lower.</i>

Q.No.47. How do you verify Misappropriation of Goods? (C)

Misappropriation of Goods: Fraud in the form of misappropriation of goods is still more difficult to detect; for this management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists. For example, the gross profit ratio adjusted for any recorded change during the year, reveals whether the value of inventory is reasonable with reference to the amount of the sale. Similarly, the input-output ratio of production in terms of physical quantity may reveal whether output is normal with reference to the quantity consumed for production

Q.No.48. How do you verify Misappropriation of Assets? (C)

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

- a) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- b) Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- c) Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- d) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party). Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

PRACTICAL QUESTIONS

Q.NO.1. PLANT & MACHINERY HAVE BEEN SHOWN IN BALANCE SHEET AT RS.1,00,000 (AT COST LESS DEPRECIATION) AGAINST MARKET VALUE OF RS.40,000. COMMENT.

Plant & machinery are fixed assets and held permanently for maintaining the revenue earning capacity of the business and as such is not affected at all by fluctuations on their market value. In view of this, showing the plant & machinery at Rs.1,00,000/- (Cost less depreciation) when their market values is Rs.40,000 is in conformity with the accounting principle. The auditor should, however, ensure the adequacy of the provision of depreciation charged in the accounts. When the fall in market value is heavy and permanent, a note may be given in the balance sheet.

Q.NO.2. A COMPANY HAS ACQUIRED A 10 TONNE DELIVERY VAN VALUED AT RS.6.5 LAKHS AN INSTALLMENT BASIS FROM A DEALER. DURING THE YEAR, THE COMPANY PAID RS.1.15 LAKHS BEING THE INSTALLMENT FOR THE YEAR AND PROVIDED DEPRECIATION ON THE SAID AMOUNT PAID.

The delivery van was purchased at Rs.6.5 lakhs on installment basis and accordingly, the property passed on to the purchaser immediately whereas in the case of hire-purchase basis, property in goods passes only after payment of last installment. Therefore, the gross book value of the delivery van will be Rs.6.5 lakhs. Depreciation should thus, be provided on Rs.6.5 lakhs and not on the installment amount of Rs.1.5 lakhs paid. Auditor will have to qualify the audit report.

Q.NO.3. TRUCKS OWNED BY THE COMPANY COULD NOT BE PHYSICALLY VERIFIED AS THEY WERE LET ON HIRE. COMMENT.

The cost of Trucks should be verified with the invoices of the suppliers/manufacturers and the ownership is to be verified with documents relating to registration, Permits and Insurance Policy. A register if any on Trucks let out on hire should be verified. Confirmation from the party taken the Trucks on hire should be taken.

Q.NO.4. ASSETS PURCHASED UNDER HIRE-PURCHASE SYSTEM WERE REFLECTED AT THEIR FULL VALUE AND THE OUTSTANDING INSTALLMENTS PAYABLE HAVE BEEN INCLUDED UNDER SUNDRY CREDITORS.

In case of assets acquired under Hire Purchase System, the capital portion of the installments paid up to date of Balance Sheet should be debited to the Asset Account and the interest included in each installment to be charged off to revenue. However, if the full capital value of the asset has been adjusted at the outset, the total installments outstanding under the agreement will have to be reduced from the value of the asset. Therefore the treatment followed is not correct.

Q.NO.5. THE COMPANY ENTERED INTO "AN AGREEMENT FOR SALE" TO PURCHASE AN OFFICE SPACE IN A COMMERCIAL COMPLEX. THE COMPANY WITH THE CONSENT OF THE PROMOTERS STARTED OPERATIONS FROM THE SAID PLACE UPON SIGNING OF THE SAID AGREEMENT AND INCLUDED UNDER FIXED ASSETS, THE TOTAL CONSIDERATION PAYABLE.

The Company has entered into an "agreement for sale" only. The ownership of the asset has not yet passed on to the buyer from the seller since merely an agreement to sell does not confer transfer of title from seller to buyer. Occupancy and operation from the said office space also does not confer ownership. Unless the transfer of the asset is affected through a sale deed, the company does not become the owner of the said asset. Therefore, it would be incorrect to show the same under fixed assets. Hence auditor must qualify his report.

Q.NO.6. Z LTD. ACQUIRED A CAR FOR ITS MANAGING DIRECTOR, FOR OFFICIAL TRAVELING, ON HIRE-PURCHASE BASIS. THE INTEREST PAYABLE WAS ADDED TO THE COST OF THE CAR. COMMENT.

The Managing Director's car was acquired on hire purchase basis and should, therefore, be recorded in accounts at its cash price. The interest payable along with each installment should be debited to the interest account and not to the asset account. Under the circumstances, the auditor shall have to qualify his report.

Q.NO.7. THE COMPANY HAS SENT SEMI-FINISHED GOODS TO THIRD PARTIES FOR FURTHER PROCESSING, WHICH IS LYING WITH THEM AT THE END OF THE YEAR. COMMENT

Semi-finished goods being composite part of the inventories, normally, constitute significant item in case of any entity. It is the duty of the auditor to ensure that entire inventories which are owned by the enterprise on the date of balance sheet have been included for in valuation of inventories. The auditor should also obtain direct confirmation about the quantity of inventories lying with the processors at the end of the year. Also, the auditor should see that the valuation has been made properly with reference to the stage of completion in respect of work-in-process inclusive of expenses incurred in sending the goods for processing. In case, the amount happens to be material, such stock may be disclosed separately as stocks with processors.

Q.NO.8. AT THE END OF THE FINANCIAL YEAR, INVENTORY INCLUDED GOODS ALREADY BILLED TO CUSTOMERS BUT NOT DISPATCHED. COMMENT.

The Inventory value shown in the Balance Sheet should include only those goods/materials which are the property of the company valued at lower of cost and Market Price. In the problem the property held as custodian of the customer which are already billed and not dispatched. The same should be excluded from Inventory. Thus the auditor should qualify the audit report stating the impact of the same on the financial statements.

Q.NO.9. A SHORTAGE OF STOCK WORTH RS.1 LAKH WAS NOTICED AT THE TIME OF PHYSICAL VERIFICATION DURING THE PERIOD UNDER AUDIT.

The auditor should ascertain that the reasons for shortage have been properly investigated by the management and corrective measures have been taken on the report of the investigation. If the shortage valuing Rs.1 lakh is considered significant in comparison to the total value of stock, the auditor should ensure that the shortage is adjusted in the books of accounts in the year under audit. The auditor should also mention this and the action taken by the Management in his Report.

Q.NO.10. THE WORK-IN-PROGRESS IS VALUED BY COMPANY CONSISTENTLY AT DIRECT MATERIAL COST.

Work-in-progress includes direct material cost as well as direct labour and proportion of factory overhead for attaining the appropriate stage of production. Valuation of work-in-progress at direct material cost only is not inconsistent with normally accepted accounting principle. In view of this, the auditor should qualify his report, if the impact is material, notwithstanding the fact that this method has been followed consistently.

Q.NO.11. SUNDRY DEBTORS INCLUDE CHARGES MADE FOR RETURNABLE PACKING CASES. COMMENT.

It is not correct to include the cost of returnable packing cases in the accounts of Sundry Debtors. The packing cases are with the customers and are returnable and, therefore, unless the customers do not return the packing cases within the stipulated time, their accounts should not be debited with the cost of such items. The cost of packing cases should be shown in the Balance Sheet on the Assets side as "Packing cases with customers" and should be valued at cost price less depreciation. It should, however, not be included in the account of the sundry Debtors.

Q.NO.12. VARIOUS STAFF MEMBERS HAVE TAKEN ADVANCES WORTH RS.5,500 AGAINST SLIPS SIGNED BY THEM. HOWEVER SINCE NONE OF THESE PAYMENTS HAVE BEEN RECORDED IN THE CASH-BOOK, THE AMOUNT CONTINUE TO BE SHOWN AS PART OF CASH BALANCE.

Assuming that the advances to staff are made with the approval of some responsible officials of the company and that they are purely temporary, their treatment as part of the cash balance is improper because it omits to record the transactions taking place from day to day and in such a case it cannot be said that proper books of account as required by law have been kept. Therefore, Rs.5,500 should be debited to advances account and credited to cash account, thus decreasing the amount of cash in hand. Such advances will appear on the assets side of the balance sheet.

Q.NO.13. AS PER AS -13, INVESTMENT SHOULD BE CLASSIFIED INTO CURRENT INVESTMENT AND MARKETABLE INVESTMENTS.

False: According to AS-13, Investments are classified into current and long term investment. Marketable investments are short term and classified as current.

Q.NO.14. WRITE SHORT NOTES ON THE FRAUDS THROUGH SUPPLIER LEDGER. (4M)

Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take case of:

1. Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.
2. Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.
3. Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
4. Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.

Q.NO.15. STATE BRIEFLY THE DUTY OF AN AUDITOR WITH REGARD TO EACH OF THE FOLLOWING:

- a. NO DEPRECIATION HAS BEEN CHARGED FOR THE YEAR ENDED 31ST MARCH 2010, IN RESPECT OF A SPARE BUS PURCHASED DURING THE YEAR AND KEPT READY BY THE COMPANY FOR USE AS A STANDBY ON THE GROUND THAT IT WAS NOT USED DURING THE YEAR. **(N14 RTP)**
- b. A LOSS OF Rs.2,00,000 ON ACCOUNT OF EMBEZZLEMENT OF CASH WAS SUFFERED BY THE COMPANY AND IT WAS DEBITED TO SALARY ACCOUNT.
- c. DEFALCATION OF CASH **(M15 - 4M, PM)**

a) **Depreciation on Stand-by Asset:** As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare bus was kept ready for use as stand-by, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2010. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

b) **Embezzlement of Cash:** AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", requires that "all items of income and expense which are recognized in a period should be included in the determination of net profit or loss for the period". It further states that "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Embezzlement of cash during the course of business is a 'business loss'. It is a business hazard which can occur once in a while. Being material item, it is required to be disclosed under a distinct head in the profit and loss account.

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

By inflating cash payments.

Examples of inflation of payments:

- i) Making payments against fictitious vouchers.
- ii) Making payments against vouchers, the amounts whereof have been inflated.
- iii) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.
- iv) Casting larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

Q.NO.16. AS AN AUDITOR, COMMENT ON THE FOLLOWING SITUATION/STATEMENT.

A COMPUTERIZED MACHINERY WAS PURCHASED BY TWO COMPANIES JOINTLY. THE PRICE WAS SHARED EQUALLY. IT WAS ALSO AGREED THAT THEY WOULD USE THE MACHINERY EQUALLY AND SHOW IN THEIR BALANCE SHEETS, 50% OF THE VALUE OF THE MACHINERY AND CHARGE 50% OF THE DEPRECIATION IN THEIR RESPECTIVE BOOKS OF ACCOUNTS.

Joint Assets: AS 10, "Accounting for Fixed Assets", issued by the Institute, prescribes that in case of fixed assets owned jointly by enterprises, the extent of the entity's share in such assets, and the proportion in the original cost, accumulated depreciation and written down value should be stated in the Balance Sheet. Accordingly, the treatment followed by the companies reflecting 50% of the value of the machinery and charging 50% depreciation in their respective books of account is proper. However, such jointly owned assets should be indicated separately in the Fixed Assets Register maintained by the company.

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

Q.NO.17. GIVE YOUR COMMENTS ON "THE CC LTD., A PHARMACEUTICAL COMPANY, WHILE VALUING ITS FINISHED STOCK AT THE YEAR END WANTS TO INCLUDE INTEREST ON BANK OVERDRAFT AS AN ELEMENT OF COST, FOR THE REASON THAT OVERDRAFT HAS BEEN TAKEN SPECIFICALLY FOR THE PURPOSE OF FINANCING CURRENT ASSETS LIKE INVENTORY AND FOR MEETING DAY TO DAY WORKING EXPENSES".

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

Q.NO.18. HOW WOULD YOU PROCEED TO CHECK THE MISAPPROPRIATION OF CASH IN A TRADING CONCERN?

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

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

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

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

1. Omission of cash receipts:
 - a) cash sales not recorded;
 - b) teeming and lading;
 - c) casual receipts of miscellaneous nature not entered; and
 - d) Sale proceeds of fully written off assets not recorded.

2. Recording of less amounts than that actually received.
3. Recording of more amounts than that actually expended, e.g., discounts or rebates not taken into account while making payments, etc. Inclusion of fictitious payments in cash book e.g. wages paid to 'ghost' or 'dummy' workers, salary paid to apprentices whose tenure of services expired, etc.
4. Intentional errors in totaling, balancing and carrying over of cash book balances. With a view to check misappropriation of cash, the existence of internal check system is quite essential. In particular, the following may be noted:
 - a) Ascertaining the existence of system of cash receipts and disbursements of cash sales and purchases and existence of internal checks at various stages is quite important. In particular, the separation of duties and incompatible functions, e.g. an employee who receives and deposits cash and cheques should not prepare sales invoices, or reconcile bank accounts, and authorized signatory should not approve vouchers for payment.
 - b) Checking of cash receipts with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by it would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated.
 - c) Checking of date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.
 - d) Verify cash sales with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof, as entered in the Cash Book.
 - e) Check receipt of cash from the customers against price of goods sold with the counterfoils of receipt issued to them. Also compare entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a prima facie evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in customers' accounts, which ought to have collected in whole, are cleared in small installments.

THE END

16. VERIFICATION OF LIABILITIES

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	A	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	A	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	A	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6.	A	-	-	-	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7.	B	-	-	5	-	-	-	2	3	-	-	-	-	-	-	-	-	-	-	-	4	-
8.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-
9.	A	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	C	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-	-
12.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
13.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
14.	C	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. What are the steps in verification of trade creditors? (A) (N 07 - 4M, PM)

- a) Obtain the list of creditor's.
- b) Check the posting in the purchases Ledger from various books of journal entry for a part of the period under audit.
- c) Ascertain by reference to the Goods Inward book/stock records that all the goods received during the last few weeks of the period under audit have been duly accounted for.
- d) Examine the purchase invoices for some weeks immediately following the close of the year to verify that none of them relate to the period under audit.
- e) Test the record of returns outwards to ascertain that they are supported by the credit notes of the suppliers.
- f) Compare the percentage of gross profit earned with that in the preceding period for finding out some clue as to the possibility of some of the purchase invoices or expenses having been omitted, or some fictitious invoices or expenses having been included.
- g) Find out reasons for non-payment of a balance where it has remained unpaid for a long time.
- h) The auditor may get confirmations from the creditor about the amount due from them.
- i) See that the disclosure requirements of Sch.III have been complied with or not.

REFER PRACTICAL QUESTIONS: 2, 6

Q.No.2. What are the steps in verification of outstanding liabilities for expenses? (A) (M 90, 99, N - 92, 96 - 4M)

- a) Obtain the list of outstanding expenses classified by nature of expenses.
- b) Compare the list of this year's outstanding expenses with that of the last year to see whether there are significant variations.

- c) Verify the basis of estimation carefully in case outstanding expenses are provided on an estimated basis.
- d) See that the usual outstanding expenses have been paid off by the time of audit.
- e) Ensure that all the usual outstanding expenses, like salary and wages or rent have been provided.
- f) See that the disclosure requirements of Sch.III (Under current liabilities) have been complied with or not.

Q.No.3. What are the steps in verification of loan taken from banks or borrowings from banks. (A)
(M 88, 93, 03, 08 - 4M, PM, M15 MTP2 - 4M, N15 MTP1 - 4M)

- a) Reconcile the balances in the loan account with that shown in the pass books.
- b) Confirm it by obtaining a certificate from the bank.
- c) Verify the authority under which the loan has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan from a bank.
- d) In case any charge is created, see that Sec.77 of companies act has been complied with.
- e) *See that the conditions contained in Sec.180 and Sec.186 of the companies Act have been complied with.*

(S.180 – Board of directors should obtain the approval of members for taking a loan above the limits prescribed in this section)

(S.186 – The Company should obtain the permission of Banks / Financial institutions from whom they have borrowed monies while giving a loan to the parties mentioned in this section)

- f) *See that the purpose for which loan has been raised and the manner in which it has been utilised.*
- g) See that the terms & conditions of the loan agreement have been complied with or not. (For example, restrictions as to dividend payment, maintenance of debt equity ratio etc.).
- h) **Secured loan:** Where the market value of an asset offered as a security against loan has fallen below the amount of a loan outstanding, the auditor should ensure that the loan is classified as secured only to the extent of market value of security.
- i) If any loan has been discharged get it confirmed with the loan discharge certificate.
- j) See that the disclosure requirements of Sch.III have been complied with or not.

REFER PRACTICAL QUESTIONS: 8, 9

Q.No.4. What are the steps in verification of loan on mortgage of property? (A)
(FOR STUDENTS SELF STUDY)

- a) Examine the copy of mortgage deed for verifying the amount of loan raised, the rate of interest, the terms of repayment agreed to and the rights created in the property by the mortgage deed.
- b) See that the terms & conditions of the loan agreement have been complied with or not. (For example, restrictions as to dividend payment, maintenance of debt equity ratio etc.).
- c) Confirm it by obtaining a certificate from the lender.
- d) Verify the authority under which the loan has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan from a bank.

- e) In case any charge is created, see that Sec.77 of companies act, has been complied with.
- f) *See that the conditions contained in Sec.180 and Sec.186 of the companies Act have been complied with.*
- g) *See that the purpose for which loan has been raised and the manner in which it has been utilised.*
- h) *If any loan has been discharged get it confirmed with the loan discharge certificate.*
- i) **Secured loan:** *Where the market value of an asset offered as a security against loan has fallen below the amount of a loan outstanding, the auditor should ensure that the loan is classified as secured only to the extent of market value of security.*
- j) See that the disclosure requirements of Sch.III have been complied with or not.

REFER PRACTICAL QUESTIONS: 4

Q.No.5. What are the steps in verification of amount due to a subsidiary company? (A)
(N - 95, 08, M - 99, 06 - 4M, PM)

- a) Confirm it by obtaining a certificate from the subsidiary company.
- b) Verify the authority under which the loan has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan from subsidiary company.
- c) Examine whether the subsidiary company is authorised by its Memorandum of Association to advance loan to the holding company.
- d) In case any charge is created, see that Sec.77 of companies act, has been complied with.
- e) See that the conditions contained in Sec.180 and Sec.186 of the companies Act have been complied with.
- f) *See that the purpose for which loan has been raised and the manner in which it has been utilised.*
- g) *See that the terms & conditions of the loan agreement have been complied with or not. (For example, restrictions as to dividend payment, maintenance of debt equity ratio etc.).*
- h) **Secured loan:** *Where the market value of an asset offered as a security against loan has fallen below the amount of a loan outstanding, the auditor should ensure that the loan is classified as secured only to the extent of market value of security.*
- i) See that the disclosure requirements of Sch.III have been complied with or not.

Q.No.6. What are the steps in verification of bills payable? (A) (N 98 - 4M, PM)

- a) Obtain the schedule of Bills payable in hand containing name of the parties, date of bill drawn, Amount, rate of interest, due date etc.
- b) See that they are accepted under proper authority.
- c) In case any charge is created, see that Sec.77 of companies act, has been complied with.
- d) Obtain confirmation from the drawers or holders of the bills regarding amounts due thereon may be obtained.
- e) Ask the reasons for long outstanding of any bill payable.
- f) See whether any notices were received by the company for non payment of the bill payable within the time limit.
- g) See that disclosure requirements of Sch.III to the Companies Act, 2013 have been followed in case of a company.

Q.No.7. A. What is contingent liability? how will you verify the same?

B. How will you disclose the contingent liability in the b/s.?

C. What will be the effect in the event of maturity of it? (B)

(N - 94, M - 98, 04, 07 - 4M, PM, M15 RTP)

Meaning: Contingent liabilities refer to obligations relating to past transactions or other events, that may arise in consequence of one or more future events which are presently deemed possible but not probable. The possibility of a contingent liability crystallising into an actual liability, thus, depends upon happening/non-happening of an event. Examples of contingent liabilities include the following:

- a) *Pending litigation against the entity.*
- b) *Guarantees of third party obligations.*
- c) *Discounted bills receivable.*
- d) *Membership of a company limited by guarantee.*
- e) *In the case of partly paid-up shares.*
- f) *Grants & conditions received with conditions attached.*

Verification:

- a) Examine bank letters in respect of bills discounted and not matured.
- b) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
- c) See the letter's/Notices received from suppliers, customers, lawyers, etc. to ascertain the existence of contingent liabilities.
- d) Discuss with various officers of the company about the possibility of contingent liability existing in their respective fields.
- e) Review terms and conditions of grants to see the possibility of resulting any contingent liability.
- f) Examine the contracts entered into by the company and the likelihood of contingent liabilities resulting there from.
- g) Inspect the minute's books of the company to ascertain all contingent liabilities known to the company.

As per Sch.III contingent liabilities should be disclosed by way of a foot note to the Balance Sheet.

Disclosure by way of a provision: Refer to AS-4.

Effect of the maturity of contingent liability: *The maturity of a contingent liability may either result into acquisition of corresponding asset or loss to the company. For instance, the payment of call money on partly paid-up shares will result into acquisition of investment in fully paid-up shares. On the other hand suit filed against the company for alleged illegal termination of service of an employee might result into loss to the company.*

Q.No.8. What are the steps in verification of provision for income tax? (A)

(N14 – 4M, PM)

- a) Check the computations relating to total income & tax calculations.
- b) See that the provisions of the income tax act have been taken into consideration for creating such provision.
- c) **Sufficiency:** See that the amount of provision on the date of the balance sheet adequate having regard to the advance tax paid, refunds, TDS & brought forward losses.
- d) Check the rates of tax as per the relevant finance Act.
- e) Check the evidences for advance tax paid, TDS, Refunds.

- f) Examine a copy of the Income-tax return, if already filed.
- g) Review the assessments completed, revised upto the time of audit and ensure suitable adjustments have been made in respect of additional demands or refunds.
- h) See that the disputed tax liability has been treated as contingent liability.
- i) See that the disclosure requirements of Sch.III have been complied with or not.

REFER PRACTICAL QUESTIONS: 3, 5

Q.No.9. What are the steps in verification of provision for depreciation? (A)

- a) See that the cost of the asset has been allocated on a systematic basis to each accounting period during the useful life of the asset.
- b) See that useful life of the assets have been estimated properly.
- c) See that the depreciation rates as given in the Sch.II have been complied with. In case depreciation rate has been higher than the Sch.II rates auditor should get explanation from the management.
- d) *Ensure that pro rata depreciation has been provided for in respect of assets used for part of the time during the year.*
- e) *See that the provisions of Sec.123 of the companies act have been complied with.*
- f) *See that on sale of any asset the provision for depreciation relating to such asset has been cancelled.*
- g) *It is to be seen that the method of depreciation is consistent with the one used in the previous year. In case, there is a change, see that the requirements of AS 5 has been complied with.*
- h) *When useful life of the asset is revised, the depreciation shall be adjusted during the remaining useful life. (i.e. prospective effect)*
- i) *When there is revaluation of assets, depreciation shall be calculated on the revalued amount prospectively. (i.e. prospective effect)*
- j) See that the disclosure requirements as per the Sch.III have been complied with.

Q.No.10. What are the steps in verification of proposed dividends? (A)

(PM)

- a) Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.
- b) See that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Sec.123
- c) See the compliance with "transfer of profits to reserves rules, 1975".
- d) See the compliance with "declaration of dividends out of reserves rules, 1975".
- e) *Inspect the shareholder's Minutes Book to verify the amount of dividend declared and confirm that the amount is recommended by the directors.*
- f) *If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.*
- g) *Check the particulars of members as are entered in the Dividend Register by reference to the Register of Members.*
- h) *Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in Dividend Bank A/c.*

- i) Check that the amount of dividend which remains unpaid is deposited in a special bank a/c namely "Unpaid Dividend A/c of ... Company Ltd/Company (Pvt.) Ltd". (Sec.123).
- j) Check that the amount of dividend which remains unpaid for a period of 7 years is transferred to Investor Education and Protection Fund (Sec.125).

Q.No.11. What are the steps in verification of payment of interim dividend? (C)
(M 12 – 8M)

- a) A Company may distribute part of its profits during the two annual general meetings. That means a company may declare dividends before the close of the accounting year and finalization of accounts.
- b) Reg. 86 of Table'F' provides that the Board may from time to time pay to the members such interim dividend as appeared to be justified.
- c) The amount of dividend including interim dividend shall be deposited in a separate bank account bank account within five days from the date of declaration of such dividend.
- d) Such amount so deposited shall be used for payment of interim dividend.
- e) Sections 123, 125, 126 and 127 shall also apply to interim dividend.
- f) See the compliance with "transfer of profits to reserves rules, 1975".
- g) See the compliance with "declaration of dividends out of reserves rules, 1975".

As an auditor we have to look into the compliance of the above provisions.

Q.No.12. How do you vouch / verify deferred tax liability? (B)
(N 07 - 4M, PM)

- 1. Identify the items which give rise to the creation of Deferred Tax Liability in the previous year
- 2. Check the basis for classification of Permanent and Timing differences.
- 3. Check whether any timing difference reverses during the current period.
- 4. Ensure that the creation / reversal of Deferred Tax Liability is disclosed as required by AS-22.
- 5. In case of non-compliance with AS-22, qualify the Audit Report.

Q.No.13. How do you verify repayment of foreign currency loan for purchase of an asset? (B)
(N 07 - 4M, PM, N15 MTP1 - 4M)

- 1. Verify the Loan Agreement and note the terms regarding interest, principal repayment, method of payment, currency and period of repayment.
- 2. Check whether any earlier repayment is made in the preceding years.
- 3. Analyse the payments to ensure that they are in accordance with the agreement.
- 4. Check whether permission from RBI, wherever applicable, has been obtained in respect of payments in foreign currencies.
- 5. Obtain confirmation from the Creditor regarding the balance amount due to at the year-end.
- 6. Ensure that the repayment is properly accounted in the books in Indian Rupees.
- 7. Examine the treatment in respect of Interest on Foreign Currency Loan.
- 8. Check Whether AS-11 is properly complied with, as regarding repayment amount and closing balance of Liability.
- 9. See whether Foreign Exchange earnings and payments have been properly reported in the Board of Directors' Report for the relevant period.

Q.No.14. How do you vouch / verify bank overdraft. (C) (N 09 - 4M, PM, N15 MTP2 - 4M)

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

PRACTICAL QUESTIONS

Q.NO.1. S LTD. HAS ISSUED DEBENTURES, WHICH HAVE BEEN GUARANTEED BY THE GOVERNMENT OF INDIA BOTH AS TO THE REPAYMENT OF THE PRINCIPAL AND INTEREST. THE COMPANY DISCLOSED THE SAME AS "SECURED LOANS" IN THEIR BALANCE SHEET.

The expression 'secured Loans' covers only those loans which are secured by way of a charge on tangible assets whether or not belonging to the borrower. Debentures which are guaranteed by Government cannot be classified as secured since they are not secured by any tangible assets. Of course, for debenture holders, there is a greater security as the repayment is guaranteed by the Government, but that does not make the debentures secured. According to Part I of Schedule III to the Companies Act, 2013 the nature of security should be specified in case of Secured Loans which include debentures. Therefore, the debentures, under the given case, should be classified as "Unsecured Loans" (Non current liabilities) in the balance sheet with a disclosure of the fact of the Government guarantee.

Q.NO.2. THE AMOUNT PAYABLE TO SUPPLIERS OF MACHINERY UNDER DEFERRED PAYMENT ARRANGEMENTS HAS BEEN SHOWN AS CURRENT LIABILITIES. THE COMPANY ACCEPTED THE BILLS DRAWN BY THE SUPPLIER AND OFFERED ITS OTHER FIXED ASSETS AS A COLLATERAL SECURITY. COMMENT.

The machineries were purchased under deferred payment arrangements with the supplier and company accepted the bills drawn by the suppliers and offered its other fixed assets as a collateral security. If fixed assets are offered as primary security, then the loans has to be shown under "secured loans". Since the fixed assets are not offered as primary security these are to be shown as a long term liability under 'Unsecured Loans'. However, the installments payable within 12 months of the date of the Balance sheet should be shown as current liabilities. Therefore, amount payable to supplier under deferred payment arrangement as "Current Liabilities" is not correct.

Q.NO.3. THERE IS NO PROVISION FOR INCOME TAX OF 50 LAKHS IN RESPECT OF PROFITS MADE IN THE FINANCIAL YEAR. COMMENT.

Income-tax in respect of profits made in the financial year should be provided for in the accounts. Liability for income-tax arises with the earning of income, though the amount of liability is quantified subsequently after the close of financial year, in assessment proceedings. Though the exact amount of tax liability cannot be anticipated, liability for taxation having been incurred for the profit made, liability for tax should be provided for on a reasonable basis. There fore the auditor can qualify the audit report.

Q.NO.4. A SECURED LOAN OF RS.25 LAKHS BORROWED FROM ONE OF ITS DIRECTORS REMAINS UNPAID. INTEREST ACCRUED BUT NOT DUE ON THE LOAN IS RS.1.25 LAKHS. BOTH THE LOAN AND THE INTEREST HAVE BEEN SHOWN UNDER "SECURED LOAN" - "OTHER LOANS & ADVANCES FROM DIRECTORS". COMMENT.

The sum of Rs.1.25 lakhs represents interest accrued but not due on the loan. This cannot be included under "other secured loans and advances". This should be correctly exhibited at the appropriate place under "Current Liabilities" with a suitable disclosure that the amount related to Director's loan. The disclosure of loan outstanding on date as "other loans and advances" under the head "secured loans" is proper.

Q.NO.5. M LTD. HAD FILLED SUIT AGAINST INCOME TAX LIABILITY ON CERTAIN GROUNDS WHICH WERE NOT PRIMA FACIE BONAFIDE. WHAT SHOULD BE THE MANNER OF DISCLOSURE OF THESE LIABILITIES? WILL YOUR ANSWER BE DIFFERENT IN CASE THE LIABILITIES HAVE BEEN CONTESTED ON BONAFIDE GROUND?

Where the income tax liability has been contested not on bonafide grounds it does not fall with in the word "contingent liabilities" but it is a real liability. The answer will be different if they have been contested on bonafide grounds because in such case they have to be disclosed as a foot note in the accounts as contingent liability.

Q.NO.6. CERTAIN ADVANCES TO SUPPLIERS TOTALING TO RS.1,00,000 STILL CONTINUE TO BE SHOWN AS ADVANCES THOUGH THE FINAL BILLS OF SUCH SUPPLIERS HAVE ALREADY BEEN SETTLED.

In this case there are two points for consideration by the auditor, namely, whether the entries of the accounts are due to genuine mistake or whether they are manipulated for a fraudulent purpose. If there is an honest mistake the suppliers' accounts are credited with the full amount of purchases but they are debited with only the actual cash paid representing the net amount of bills. In such a case the supplier's accounts will have credit balance equal to rupees one lakh. In order to correct this mistake, the advances account should be transferred to the debit of supplier's accounts. On the other hand, if there is a fraudulent manipulation of accounts, the supplier's accounts are credited with only the net amount of bills and debited with the same amount, thus omitting purchases to the extent of rupees one lakh. This may have been done to increase profits. In order to correct this mistake the suppliers' accounts should be credited with rupees one lakh more purchases and debited with the amount of advances of rupees one lakh.

Q.NO.7. THE TOTAL PROVIDENT FUND DUES WAS KEPT BY THE COMPANY AND INVESTED IN THE SHARES OF A SUBSIDIARY COMPANY.

A company is required to deposit the P.F. dues of employees in special account to be opened by the company for the purpose. The employees and employer's contributions have to be deposited regularly and within the stipulated time. Hence it is wrong to keep the total amount of P.F. with the company itself and invest in the shares of its subsidiary company. The auditor should report that such action on the part of the company is in contravention of the provisions of the Act.

Q.NO.8. INTEREST ACCRUED ON OVERDRAFT NOT-CHARGED BY THE BANK WITHIN 31ST MARCH 1997, WAS NOT ACCOUNTED FOR. COMMENT.

The auditor should qualify this as non-provision of interest accrued on Bank overdraft amounting to Rs..... with consequential effect on Profits and Revenues.

Q.NO.9. INTEREST ACCRUED BUT NOT DUE ON “SECURED LOANS” IS REQUIRED TO BE SHOWN UNDER APPROPRIATE SUB-HEADS UNDER THE HEAD “SECURED LOANS”.

False: Part I, Schedule III to the Companies Act, 2013, prescribes the form of balance sheet and the requirements relating thereto. According to this, the interest accrued and due on “Secured Loans” should be included under the appropriate sub-heads under the head “Secured Loans,” but the interest accrued but not due on secured loans is required to be shown under “Current liabilities”.

Q.NO.10. THE TERM “FUND” AND ‘RESERVE’ CAN BE USED INTERCHANGEABLY.

False: The word “fund” in relation to any “Reserve” should be used only where such reserve is specifically represented by earmarked investments. The reserve is created out of the profits but it is not necessary the same amount is present in that reserve actually, but in case of fund the equal amount is appropriated to the fund.

THE END

17. INTERNAL CONTROL

QUESTION - WISE ANALYSIS OF PREVIOUS EXAMINATIONS

No.	ABC	M-06	N-06	M-07	N-07	M-08	N-08	M-09	N-09	M-10	N-10	M-11	N-11	M-12	N-12	M-13	N-13	M-14	N-14	M-15	N-15	M-16
1.	C	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3.	A	-	-	-	7	-	-	-	-	-	-	-	-	-	-	-	8	-	-	6	-	-
4.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8	4	-	-	-	-	6
5.	B	-	-	5	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-
6.	B	8	6	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	-	-
7.	C	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	B	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
9.	B	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
10.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
11.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	A	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	-
13.	A	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	2	-	6
14.	B	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
15.	B	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-
16.	C	-	-	-	-	-	2	6	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Q.No.1. Internal control and its uses to the auditor. (C)

- a) **Compliance procedures:** The auditor conducts compliance procedures to obtain audit evidence that internal control system, on which he intends to rely, was functioning properly throughout the period. Based on the results of his compliance procedures, the auditor determines whether the existing controls are adequate and can be relied on to restrict the extent of substantive tests.
- b) Auditor can formulate his entire audit programme only after he had a satisfactory understanding of the internal control system and its actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers.
- c) A proper understanding of the internal control system and its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme. In a situation where the internal controls are considered weak in some areas, he might extend certain tests to cover a large number of transactions or he may perform additional tests to bring him the necessary satisfaction.

Q.No.2. What is the purpose of Internal Control. (B)

Purpose of Internal Control: Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern-

1. The reliability of the entity's financial reporting;
2. The effectiveness and efficiency of its operations;

3. Its compliance with applicable laws and regulations; and
4. Safeguarding of assets.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Q.No.3. what are the Inherent Limitations of Internal Control system? (A)
(N08 - 8M, N 13 – 8M, M15 – 6M, PM, M15 MTP1 - 4M, N14 MTP2 - 4M)

Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as:-

- a) Management's consideration that cost of an internal control does not exceeds the expected benefits.
- b) Most controls do not tend to be directed at unusual transactions.
- c) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.
- d) The possibility that control may be circumvented through collusion with employees or outsiders.
- e) The possibility that a person responsible for exercising control may abuse that authority.
- f) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.
- g) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.
- h) Inherent limitations of Audit.

Similar Questions: "Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved." Explain. (M15 RTP)

Q.No.4. What are the techniques used to Review of the internal control system by the auditor. (A)

TECHNIQUES OF EVALUATION

1. **Narrative record:** The narrative record is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases of small business.
2. **Check list:** A checklist is a *series of instructions or questions*, which a member of the auditing staff must follow and answer. When he completes instruction, he initials the space against the instruction. Answer to the checklist instructions are usually Yes, No or Not Applicable. A few examples of checklist instructions are given hereunder:
 - a) Are tenders called before placing orders?
 - b) Are the purchases made on the basis of a written order?
 - c) Are purchase order forms pre-numbered?
 - d) Are the stock control accounts maintained by persons who have nothing to do with: Custody of work, Receipt of stock, Inspection of stock, Purchase of stock.
3. **Questionnaire:** (PM, M16 2M)
 - a) It refers to a list of questions prepared by the auditor in respect of which the answers are to be provided by the client. ICQ can be prepared for the following areas. Cash and bank balances, Purchases, Sales, Payroll, Inventory, Fixed assets, Investment.

- b) ICQ contains questions which are arranged in logical and sequential manner in order to know about the working of internal control system. It consists of 3 vertical columns: Column 1 - Questions, Column 2 - Space for answers, Column 3 - Remarks.
- c) Usually the answers are provided by the client in the form of 'yes' 'no' or 'not applicable'
- d) Where the system has inherent defect the same is described in detail in the remarks column.
- e) Basically, ICQ is narrative in nature. The auditor should be careful while framing the questions because if they are not properly related to each other they may not bring out the defects existing therein thereby defeating the purpose of ICQ itself.
- f) The main advantage of ICQ is that it can be prepared for any system whether simple or complicated.
- g) The main disadvantage is that it is highly narrative in nature.
- h) Finally, the auditor has to report to the management the weakness observed by him through ICQ.

An e.g. - ICQ for purchases:

- a) *Is there any purchasing department within the organisation.*
- b) *Whether purchase manual is in existence or not?*
- c) *Are the purchase orders determined on the basis of internal indents from the production department?*
- d) *Whether there is an approved list of suppliers and it is updated periodically.*
- e) *Whether Tender procedure is adopted?*

4. Flow chart:

(PM ,M16-4M)

- a) A flow chart is a symbolic representation of flow of a transaction i.e. this refers to the pictorial description of an existing system. It is one of the methods of evaluation of IC system of the client.
- b) It is giving more emphasis on diagrammatic representation rather than narrative description
- c) It involves the range of various symbols and signs. It discloses the document and information flow. For eg. In the case of flow chart for purchases it shows how the various documents such as purchase orders, GRN are generated, recorded, followed up and disposed of. It shows the origin of the document and the ultimate disposal thereof.
- d) The main advantages of IC flow chart are diagrammatic in nature.
- e) However, it has a defect also that everyone cannot understand it as it involves usage of symbols. Moreover, it cannot be applied in the case of simple systems.

Advantages:

(N13 – 4M)

1. It is the most concise way of recording the auditor's review of the system.
2. It helps in minimizing the amount of narrative explanation and there by achieves a consideration or presentation not possible in any other form.
3. It gives bird's eye view of the system and the flow of transactions and integration & documentation can be easily spotted and improvements can be suggested.

Similar Questions: Evaluation of client's internal control system is significant. Why?

Ans: Same as above

Q.No.5. Distinguish between the following: Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE). (B) (M 07 - 5M, PM)

The Internal control questionnaires show the area where weakness occurs or likely to occur. They do not give any idea of the importance of those weaknesses. The internal control evaluation brings to light importance of those weaknesses disclosed by ICQ.

1. ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation materially. ICE isolates the main control objectives within the area of review.
2. Weaknesses are highlighted by answer "Yes" on ICE compared with 'No' on ICQ.
3. Answer 'no' in ICQ indicates a weakness real or potential, but its significance is not revealed. Whereas ICE requires audit personnel to state whether, an apparent weakness may prove to be material in relation to the accounts as a whole.
4. The 'Control Checklist' in ICE is more than a Summary of key control factors, and is not substituted for ICQ.

Q.No.6. Write about internal check? (B) (N 06 - 6M, M 12 - 8M)

Essential elements of a good system of internal check are:

- a) Existence of checks on the day-to-day transaction,
- b) Which operate continuously as a part of the routine system,
- c) Whereby the work of each person is made complementary to the work of another.

Example: Internal check system with regard to credit sales will comprise of allocation of functions among various credit department (for credit approval); dispatch department (for dispatching goods) and finance or billing department (for billing customers).

Importance/usefulness: The scope of the statutory or professional audit is limited by both the cost and the time factors. Therefore, it is increasingly being recognised that for an audit to be effective, especially when the size of a concern is large, the existence of a system of internal check is essential. The auditor can rely on it and on that consideration, reduce the extent of detailed checking to be carried out by him.

Objects / Characteristics of internal check system:

- a) An internal check system helps in fixing up responsibility for particular acts or omission by segregating the duties.
- b) The work done by one person is automatically checked by another.
- c) Every staff gets the workload according to his capacity and qualification and the duties are rotated to break the monotony. It results in improving his efficiency.
- d) The internal check system divides the work among staff in such a way that each aspect of a transaction is recorded by a different person. This helps in minimising and preventing errors.

Advantages of internal check:

- a) **Fixation of responsibility:** Internal check entails a proper segregation of duties among the staff of a business. As duties are well defined, it becomes easier to fix responsibility in case of errors and frauds. For example, in case goods are stolen from the stores, storekeeper can be held responsible.
- b) **Increases efficiency of clerks:** Work is distributed according to qualification and experience of the staff. Proper division of work leads to specialisation and increases efficiency of staff.

- c) **Prevention of errors and frauds:** No person is allowed to record more than one aspect of a single transaction and work of each worker in the ordinary course is checked by other. This helps in preventing errors and frauds.
- d) **Reliability of information:** The financial information generated is reliable and accurate.
- e) **Reduces the workload of auditor:** A reliable internal check reduces the extent of audit procedures and, hence, the workload of the auditor.
- f) **Increases the profitability of the business:** By preventing errors and frauds and increasing efficiency of clerks, a good internal check system increases the profitability of business.

General considerations in framing a system of internal check: (M 01 - 8M, M15 RTP)

- a) No single person should have an independent control over any important aspect of the business.
- b) The duties of members of the staff should be changed from time to time without any previous notice.
- c) Every member of the staff should be encouraged to go on leave at least once in a year.
- d) Persons having physical custody of assets must not be permitted to have custody of the books
- e) To prevent misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.
- f) Preparing budgets and if big differences are observed, these should be reconciled.
- g) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.
- h) Accounting procedures should be reviewed periodically, for, even well-designed and carefully installed procedures in course of time, cease to be effective.
- i) Checking of the staff functions to see that functions are performed as per job description.

Q.No.7. How far is the internal audit useful to the statutory auditor? (C)

1. Generally the internal audit work carried out in the organisation is quite useful to the statutory auditor because there are substantial similarities in the area of operations.
2. The Statutory Auditor may be able to rely to a great extent on the Internal Auditor after ascertaining as to whether the system of internal audit is operating satisfactorily.
3. The degree of reliance that can be placed on accounting records and the system of internal check would depend on the individual judgement of the Statutory Auditor from organisation to organisation.
4. In this process the statutory auditor can reduce his time in the routine checking and concentrate on the issues of vital importance.
5. Therefore, the statutory auditor can take into account the work of internal auditor in determining the audit programme.

Q.No.8. Write a short note on independence of internal auditor. (B) (M 05 - 4M, PM)

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

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

Q.No.9. Write about the internal relationship between the statutory and internal auditor? (B) (M 07 - 5M, PM)

Ans.: Q.No.7 + Q.No.6 (With regard to statutory auditor).

Q.No.10. Internal audit vs. statutory audit. (A) (PM)

Internal Audit	Statutory Audit
It is required for some companies as per Sec 138.	In the case of Co., it is compulsory.
The scope is determined by management	Sec.143 of the Companies Act, 2013, determines the scope.
Eligibility as per Sec 138.	He should possess the qualification as per Sec.141.
Appointment is by Directors/management.	Appointment is generally by shareholders.
The approach of the auditor is from the Management's point of view.	The approach is from the angle of compliance of the statute.
It is not that much independent as Statutory Audit.	It is independent
<i>The remuneration is fixed by management and there is no special requirement as per Sch. III part II for the disclosure.</i>	<i>Remuneration is fixed by the respective appointing authority and the Sch.III part II prescribes special manner of disclosure</i>
<i>The casual vacancy in the office can be filled by management.</i>	<i>In the case of vacancy due to resignation it can be filled only by the share holders whereas in other cases it can be filled by directors.</i>
<i>The report has to be submitted to the chief executive.</i>	<i>Report has to be submitted to the shareholders.</i>
<i>There is no statutory requirement regarding the contents of internal audit report.</i>	<i>The contents of the auditor's report shall be as per Sec 143.</i>

Q.No.11. Internal audit vs. internal check. (B)

Distinction	Internal Check	Internal Audit
Nature of work	The work of recording and checking of entries is carried on simultaneously by proper allocation of duties among staff.	Only checking of the entries recorded is carried out ensuring at the same time effective operation of internal check.
Scope of work	Limited	Unlimited
Purpose	To prevent fraud and errors.	To detect fraud and errors.
Starting & ending	It starts the moment a transaction is carried on and run till it is recorded in the books.	It starts when internal check ends after all the transactions are recorded in the books.
Appointment of staff	No special staff is provided and every staff is involved in and forming part of internal check.	It is carried out by specially assigned staff.
Reporting	There is no separate reporting by staff.	The internal auditor has to submit a report to management.
Discovery	The frauds or errors are discovered while they take place.	The frauds/errors are discovered after they have taken place.

Q.No.12. Write about letter of weakness / letter of management. (A)

(J 09 - 5M, M15 – 2M, PM)

1. This letter also known as letter on internal control refers to the communication by the auditor to the client disclosing the weaknesses observed in the IC system and the related accounting system.
2. ICAI has recommended through SA 200 that an auditor shall review the clients IC system prior to commencement of audit.
3. The auditor carries out the evaluation by adopting the flow chart and questionnaire techniques and finally arrives at his conclusions on the weaknesses observed.
4. When he advises the client regarding such weaknesses it takes the shape of letter of weakness.
5. Lapses in the operation of internal control too are reported in the letter of weakness.

The contents of this letter are as follows:

- a) A statement saying that the client is responsible for the introduction of IC system in the entity.
- b) A statement that auditor's observations are not based on exhaustive checking but on test check.
- c) The list of weakness observed.
- d) Suggestions and recommendations to overcome the above weaknesses.

Objective:

1. *The object of issuing such a letter is to ensure that the management takes the necessary corrective measures so that frauds and errors may not be committed.*
2. *It may also help the management for the purpose of revising the system and insisting on its strict implementation.*
3. The letter may also serve to minimise the loss resulting from a weakness in internal control.

Time of issue: *This letter may be issued either before the commencement of audit or after signing the audit report at the end.*

Q.No.13. Write about internal audit? (A)

(M15 – 2M, M16 – 2M)

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process."

The main thrust of the revised definition is to remphasise the increasing scope of internal audit with a view to achieving maximum organisational effectiveness. It is felt that if such an activity is an integral part of the organisation, it shall go a long way to maximise the organizational goals. As students, if you trace the emergence of internal auditing over a period of time since early forties in the twentieth century, the scope of internal auditing increased considerably from financial to non financial activities. With the passage of time, the internal audit came to be recognised as a valuable resource to achieve overall growth objectives of the organisation.

"Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's risk management and internal control system."

The objects of internal audit can be stated as follows:

- a) To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.
- b) To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.
- c) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
- d) To confirm that liabilities have been incurred only for the legitimate activities of the organisation.
- e) To analyse and improve the system of internal check; in particular to see (i) that it is working; (ii) that it is sound; and (iii) that it is economical.
- f) To facilitate the prevention and detection of frauds.
- g) To examine the protection afforded to assets and the uses to which they are put.
- h) To make special investigations for management.
- i) To provide a channel whereby new ideas can be brought to the attention of management.
- j) To review the operation of the overall internal control system and to bring material

Departures and non-compliances to the notice of the appropriate level of management; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The activities of the internal audit function may include one or more of the following:

1. **Monitoring of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, monitoring their operation and recommending improvements thereto.
2. **Examination of financial and operating information:** The internal audit function may be assigned to review the means used to identify, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

3. **Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non- financial activities of an entity.
4. **Review of compliance with laws and regulations:** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
5. **Risk management:** The internal audit function may assist the organization by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.
6. **Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

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

(M16 – 4M)

1. **Every listed company;**
2. **Every unlisted public company having-**
 - a) Paid up share capital of 50 crore rupees or more during the preceding financial year; or
 - b) Turnover of 200 crore rupees or more during the preceding financial year; or
 - c) Outstanding loans or borrowings from banks or public financial institutions exceeding 100 crores rupees or more at any point of time during the Preceding financial year; or outstanding deposits of 25 crores rupees or more at any point of time during the preceding financial year; and
3. **Every private company having-**
 - a) Turnover of 200 crores rupees or more during the preceding financial year; or
 - b) Outstanding loans or borrowings from banks or public financial institutions exceeding 100 crores rupees or more at any point of time during the preceding financial year: Provided that an existing company covered under any of the above criteria shall comply with the requirements within six months of commencement of such section.

Q .NO. 14. Who can be appointed as Internal Auditor? (B)

As per section 138 the internal auditor, who shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company.

In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

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

Q.No.15. Write short note on the Internal control in small business. (B)
(FOR STUDENTS SELF STUDY) (M11 – 4M, PM)

Internal control in small business: The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However, many controls which would be relevant to large entities are not practical in the small business e.g. in small business accounting work may be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severally limited.

Inadequate segregation of duties may, in some cases, be off set by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditors' opinion on the financial information may have to be obtained largely through the performance of substantive procedure.

QUESTIONS FOR ACADEMIC INTEREST ONLY

Q.No.16. Briefly discuss the concept of internal control. What are its objectives? State the features of a good internal control system? (C)

1. **Concept of internal control - General:** In simple a control procedure is an action plan for the purpose of preventing and detecting errors and frauds. For example, segregation of duties of recording and custody of cash receipts is a type of control procedure.
2. **Internal control system consists of all the policies and procedures adopted by the management of an entity to assist in achieving the following objectives:**
 - a) The orderly and efficient conduct of business.
 - b) Adherence to management policies.
 - c) Segregation of accounting and custodial functions.
 - d) Securing proper documentation at each stage.
 - e) Specifying authority to enter into the various transactions.
 - f) The safeguarding of assets.
 - g) The prevention and detection of fraud and errors.
 - h) Accurate and complete accounting records.
 - i) The timely preparation of financial information.
3. **Features of good internal control:**
 - a) **Proper Organisation Structure:** An organizational structure that provides for clearly lines of responsibility and authority and segregation of functions enhances control by providing a basis for fixing accountability for actions. Management must clearly communicate lines of authority and responsibility to the staff.
 - b) **Internal Check:** A good internal control system will possess an important feature that no single individual person has an exclusive control over a transaction.
 - c) **Management attitude:** Management of an entity is responsible for designing and maintaining the system of internal control. Management's attitude towards internal controls has a significant impact on control effectiveness. An internal control system which is well supported by the management is good ICS (Internal control system).

- d) **Suitable Personnel:** The effectiveness of any control system would depend upon the persons who are operating it. Therefore, it is vital that only competent and honest persons are employed in the organisation so far the system operates effectively.
- e) **Internal Audit System:** Primarily the management is responsible for devising and maintaining the system of internal control. To achieve this, the management may establish an internal audit department and delegate some of its supervisory functions especially with respect to the review of internal control.
- f) **Reporting:** The person incharge of the system (internal audit chief) is submitting periodical activity reports to management annually or more frequently as necessary. Activity reports should highlight significant audit findings and recommendations and should inform management of any significant deviations.
- g) **Communication:** The person incharge of the system (internal audit chief) is having the direct communication with the top management and respect is given for his suggestions.

PRACTICAL QUESTIONS

Q.NO.1. INTERNAL AUDITOR OF THE COMPANY CANNOT ALSO BE ITS COST AUDITOR.

True: Internal auditor cannot be appointed as cost auditor as per Sec. 233B, as he would not be able to discharge his duties properly.

Q.NO.2. DIRECTOR (FINANCE) OF KK LTD. INFORMED THEIR NEWLY APPOINTED STATUTORY AUDITOR THAT THEY HAVE SOUND INTERNAL CONTROL SYSTEM IMPLEMENTED BY A RENOWNED PROFESSIONAL FIRM AND HE IS SATISFIED WITH ITS EFFECTIVENESS AND FUNCTIONING AND THEREFORE, THE STATUTORY AUDITOR SHOULD CONCENTRATE ON VERIFYING ONLY THE ROUTINE BOOKS AND FINANCIAL STATEMENTS.

As per the requirement of SA 200 Auditor should study and evaluate the internal control system and accounting system and should decide how much degree of reliance could be placed on internal control by applying his compliance procedure to ultimately decide the nature, timing and extent of his substantive procedure.

Further SA 315 Risk Assessment and Internal control emphasizes that Auditor should assess the inherent risk and control risk at high unless he has convincing evidence in its support to assess these risks at less than high. Further all the reasons why the risk is assessed at less than high should be documented. On the other hand if auditor assumes that the inherent and control risks are high he should extend his audit procedure to that extent from where he can assess his detection risk at lowest.

As in the given case director finance of the client is of opinion that auditor must not study and evaluate the internal control system as it is designed by the most reknowned firm and he is satisfied with such controls.

Conclusion: It is quite clear that mere implementing an internal control is not sufficient. It's existence, effectiveness and continuity shall be verified by the auditor by applying compliance procedures as defined in SA 500 Audit Evidences. Hence we can conclude that the view of director finance is not in support with the requirements of the SA.

Q.NO.3. PP LTD., A GARMENT EXPORTER, ASKED THEIR INTERNAL AUDITOR, A PRACTICING CHARTERED ACCOUNTANT, TO CONDUCT PHYSICAL VERIFICATION OF THE YEAR END INVENTORY AND THE REPORT OF SUCH VERIFICATION WAS HANDED OVER TO THE STATUTORY AUDITOR FOR THEIR VIEW AND USE. CAN STATUTORY AUDITOR RELY ON SUCH REPORT?

In SA 600 (Using the work of Another Auditor) when the “principal auditor” uses the work of another auditor, then the principal auditor should determine how the work of other auditor will effect the audit. The auditor should consider whether his own participation is needed for giving his opinion.

When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment.

The principal auditor should apply reasonable care and skill and should perform procedures as to obtain sufficient & appropriate audit evidence, that the work of other auditor is adequate for the principal auditor’s purposes, in the context of specific assignment.

Conclusion: Thus in the above case of PP Ltd. Statutory auditor can rely upon the report of internal auditor regarding verification of stock, but he has to apply reasonable care and skill in assessing the verification of stock and reports presented by the internal auditors.

Q.NO.4. IN A MEDIUM SIZE TRADING ORGANIZATION THE ACCOUNTANT WAS GIVEN ADDITIONAL RESPONSIBILITY OF MAKING RECOVERIES FROM THE DEBTORS. ON ONE OCCASION, WHEN AN INSURANCE CLAIM OF RS.25,000 WAS RECEIVED, HE CREDITED THE SAME TO THE ACCOUNT OF A DEBTOR AND MISAPPROPRIATED THE CASH WHICH HE HAD RECOVERED FROM THE SAID DEBTOR. PINPOINT WEAKNESSES IN THE INTERNAL CONTROL SYSTEM WHICH LED TO THIS SITUATION. (M 07 - 4M)

Following two essential features of internal control are relevant here:

1. Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end and
2. Segregation of accounting and custodial functions.

Weakness in internal control system in the instant case:

1. The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.
2. It also appears that system for issuing receipts for amount received – whether cash or cheque is also lacking.
3. In a small and to some extent medium size organisation, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking.

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

Q.NO.5. MWF (P) LTD. IS A PRIVATE COMPANY HAVING RS 50 LACS PAID UP CAPITAL DURING THE PRECEDING FINANCIAL YEAR. THE COMPANY HAD TURNOVER OF LAST THREE CONSECUTIVE FINANCIAL YEARS, IMMEDIATELY PRECEDING THE FINANCIAL YEAR UNDER AUDIT, BEING RS 210 CRORES, RS 205 CRORES AND RS 200 CRORES, BUT DOES NOT HAVE ANY INTERNAL AUDIT SYSTEM. IN VIEW OF THE MANAGEMENT, INTERNAL AUDIT SYSTEM IS NOT MANDATORY. YOU ARE REQUIRED TO STATE THE PROVISIONS RELATED TO APPLICABILITY OF INTERNAL AUDIT AS PER THE COMPANIES ACT, 2013 AND COMMENT UPON THE CONTENTION OF THE MANAGEMENT OF THE COMPANY. (N15 MTP1 - 4M)

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

- 1) Every listed company;
- 2) Every unlisted public company having-
 - a) Paid up share capital of 50 crore rupees or more during the preceding financial year; or
 - b) Turnover of 200 crore rupees or more during the preceding financial year; or
 - c) Outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year; or
 - d) Outstanding deposits of 25 crore rupees or more at any point of time during the preceding financial year; and
- 3) Every private company having-
 - a) Turnover of 200 crore rupees or more during the preceding financial year; or
 - b) Outstanding loans or borrowings from banks or public financial institutions exceeding 100 crore rupees or more at any point of time during the preceding financial year.

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

Q.NO.6. COMMENT ON THE FOLLOWING STATEMENTS:

(A) MAINTENANCE OF INTERNAL CONTROL SYSTEM IS RESPONSIBILITY OF AUDITOR.

(B) INTERNAL CONTROL IS PART OF INTERNAL CHECK SYSTEM.

(PM)

- a) **Maintenance of Internal Control System:** It is the responsibility of the management for the maintenance of internal control system rather than of the Auditor. Because, internal control is the process designed, implemented and maintained by those charged with governance, management to provide reasonable assurance about the achievement of entity's objectives.
- b) **Internal Check Being Part of Internal Control System:** Internal check has been defined as "checks on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. Therefore, the statement given in the question is not correct.

Q.NO.7. "THE DIVISION OF INTERNAL CONTROL INTO THE FIVE COMPONENTS PROVIDES A USEFUL FRAMEWORK FOR AUDITORS." COMMENT AND NAME THOSE COMPONENTS.

(RTP M14)

Division of internal control into components: The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

- a) The control environment;
- b) The entity's risk assessment process;
- c) The information system, including the related business processes, relevant to financial reporting, and communication;
- d) Control activities; and
- e) Monitoring of controls.

Q.NO.8. DISCUSS THE FACTORS TO BE CONSIDERED BY THE AUDITOR WHEN EVALUATING THE ADEQUACY OF THE INTERNAL AUDIT SYSTEM. **(RTP M14)**

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

- a) What is the size of the internal audit department?
- b) What are the qualifications of the persons who undertake the internal audit work?
- c) To whom does the internal auditor report?
- d) What are the areas covered by the internal audit?
- e) Has the internal auditor adequate technical assistance?
- f) What are the reports which are submitted by the internal auditor or what other evidence is there of his work?
- g) What is the follow-up?

THE END

18. CARO 2016

HISTORICAL BACK GROUND

In exercise of the powers conferred by sub-section (11) of section 143 of the Companies Act, 2013 (18 of 2013) and in supersession of the Companies (Auditor's Report) Order, 2015 published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section (ii), vide number S.O. 990 (E), dated the 10th April, 2015, except as respects things done or omitted to be done before such supersession, the Central Government, after consultation with the, committee constituted under proviso to sub-section (11) of section 143 of the Companies Act, 2013 hereby makes the following Order dated 29th March, 2016,

APPLICABILITY OF CARO, 2016

CARO - 2016 applies to every company including a foreign Company, except the following: (N15 MTP1 - 6M)

- a) A Banking company;
- b) An Insurance Company;
- c) A company licensed to operate under **section 8 of the Companies Act**;
- d) A **One Person Company** as defined under clause (62) of section 2 of the Companies Act and
- e) A **small company** as defined under clause (85) of section 2 of the Companies Act; and
- f) A **private limited company** which satisfies all the following 4 conditions:
 - i) Not being a subsidiary or holding company of a public company
 - ii) Paid up capital and reserves and surplus not more than rupees **1 crore** as on the balance sheet date
 - iii) Total borrowings does not exceeding rupees **1 crore** from any bank or financial institution at any point of time during the financial year
 - iv) Total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) does not exceeding rupees **10 crore** during the financial year as per the financial statements.

Points to be kept in mind for CARO 2016 applicability w.r.t the private Companies:

- 1. Paid up share capital includes both equity share capital as well as the preference share capital.
- 2. Both capital and the revenue reserves & surplus should be taken into account while computing the limit of Rs 1 Crore
- 3. Revaluation reserve, if any, should be taken into consideration while determining the applicability of CARO.
- 4. The debit balance of the profit and loss account, if any, should be reduced from the figures of Reserves & Surplus.
- 5. Loans from Banks or Financial Institutions shall include term loans, demand loans, working capital loans, cash credits, and overdraft, bills purchased and discounted.
- 6. Revenue means the aggregate amount of sales affected by the company.
- 7. Revenue includes sale of goods, services & any other operating revenues earned by the company.
- 8. The following amount shall be deducted from the Turnover
 - Excise duty, if credited separately to such account.

CARO, 2016 REPORTING REQUIREMENTS

Clause 3 (i) Fixed Assets

- a) Whether the company is maintaining **proper records** showing full particulars including quantitative details and situation of fixed asset.
- b) 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 accounts.
- c) Whether the **title of immovable properties** are held in the name of the company. If not provide the details of the same.

Clause 3(ii) Inventories

- a) Whether **physical verification of inventory** has been conducted at reasonable intervals by the management.
- b) Whether any **material discrepancies** if any, were noticed on physical verification and if so, whether the same have been properly dealt with in the books of accounts.

Clause 3(iii) Loans outstanding from parties Section 189 of Co.'s act, 2013.

- a) Has the company granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintains under section 189 of the Co.'s Act, 2013. If so, the number of parties and the amount involved in the transaction?
- b) Whether the **terms & conditions** of grant of such loans are not prejudicial to the company's interest.
- c) Whether the schedule of **repayment** of principal & payment of interest has been stipulated & Whether the same are **regular**?
- d) If amount is overdue, state the amount overdue for **more than 90 days**, whether **reasonable steps** have been taken by the company **for recovery** of the principal and interest.

Note: it should be noted that CARO 2016 only consider loan granted, not loan taken.

Clause 3(iv) Guarantee given by company for loans: In respect of loans, Investments, Guarantees, and securities provided by company, whether **provisions of section 185 & 186** have been complied with? If not, provide the details thereof.

Clause 3(v) Deposits: In case the company has accepted deposits from the public, whether the directives issued by the **RBI** and the provisions of **Sections 73 to 76** of the Co.'s Act, 2013 or any other relevant provision of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; if an **order has been passed by CLB or RBI** or any court or any other Tribunal whether the same has been complied with or not?

Clause 3(vi) Cost Records

Where **maintenance of cost records** has been prescribed by the Central Government under sub section (1) of section 148 of the Co.'s Act, 2013 whether such accounts and records have made and maintained.

Clause 3(vii) Statutory Dues

- a) Is the company **regular in depositing undisputed statutory dues** including provident fund, ESI, Income Tax, Sales Tax, Wealth Tax, Service Tax, Custom Duty, Excise duty, VAT, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the **arrears of outstanding** statutory dues as at the last day of the financial year concerned for a period of **more than six months** from the date they became payable, shall be indicated by the auditor.

- b) In case dues of Income Tax, Sales Tax, Wealth Tax, Service Tax, VAT, Custom duty, Excise Duty, Cess have not been deposited on account of any **dispute**, the **amounts involved and the forum where dispute is pending** shall be mentioned. (A mere representation to the concerned department shall not constitute a dispute.)

Clause 3(viii) Default in repayment of dues: Whether the company has defaulted in repayment of borrowings of loans to a financial institution or bank or debenture holders. If yes, the period and amount of default to be reported (in case of defaults to banks, financial institutions, & government lender wise details to be provided.)

Clause 3(ix) Application of funds: Whether the money raised by way of initial or further public offer (including debt instruments) & term loans were **utilized for the purposes for which those are raised**.

If not, the details along with the defaults, delays & subsequent rectifications, if any, to be reported.

Clause 3(x) Reporting of Frauds: Whether any fraud **by or on** the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Clause 3(xi) Managerial Remuneration

- a) Whether managerial remuneration has been paid or provided in accordance with the requisite approvals mandated under section 197 read with Schedule V?
- b) If not, state the amount involved & steps taken by company for refund of the same.

Clause 3(xii) Nidhi Company

1. Whether Nidhi company has complied with the net owned funds to deposits in the ratio of **1:20** to meet out the liability &
2. Whether Nidhi Company is maintaining 10% Unencumbered term deposits as specified in Nidhi Rules, 2014 to meet out the liability

Clause 3(xiii) Related Party Transaction: Whether all transaction with related parties are in compliance with section 177 & 188 where applicable, & details have been disclosed in the financial statements etc., as required by applicable accounting standards.

Clause 3(xiv) Preferential allotment:

- a) Whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review & if so, as to whether the requirement of section 42 have been complied with and the amount raised have been used for the purpose for which they are raised.
- b) If not provide the details in respect of the amount involved & nature of non-compliance

Clause 3(xv) Non-Cash Transaction: Whether Company has entered into any Non-Cash Transactions with directors or persons connected with him, & if so provisions of **section 192** have been complied with.

Clause 3(xvi) Non-Banking Financial Institution: Whether the company is required to be registered under section 45-IA of Reserve Bank Of India Act 1934, and if so, whether the registration has been obtained.

Reasons to be stated for Qualified or Unfavourable answers:

- a) Where in the Auditor's report, the answer to any of the questions referred above is Qualified or unfavorable, the report shall the reasons for such answers which are given as qualified or unfavorable.

Where the auditor is unable to express an opinion on a particular question, he shall report such fact along with the reasons thereof as to why it is not possible to give an answer to such clause.

THE END

19. MISCELLANEOUS TOPICS*(Off the Class Topics)*

NO	QUESTION	ABC
1.	<i>Distinguish between test check and internal check</i>	B
2.	<i>Write short notes on sample errors.</i>	C
3.	<i>Examples of situations where an auditor can employ the techniques of 'observations'.</i>	C
4.	<i>Write a short note on Compliance Audit.</i>	C
5.	<i>Outstanding assets.</i>	C
6.	<i>Outstanding liabilities.</i>	B
7.	<i>Intangible assets.</i>	B
8.	<i>Write a short note on Floating Assets.</i>	C
9.	<i>Write short notes on Contingent Assets</i>	B
10.	<i>Floating charge.</i>	B
11.	<i>Write short notes on Above the line and Below the line?</i>	C
12.	<i>Balance sheet audit.</i>	C
13.	<i>In case where audit sample selection has been done on a random basis, no statistical process for selection of samples need to be followed.</i>	C
14.	<i>"The duties of auditors are limited to the verification of the arithmetical accuracy of the books of accounts".</i>	B
15.	<i>Auditors report implies an expression of opinion by the auditor. Discuss the statement. Or Auditor is responsible for expressing opinion on financial statements in statutory Audit. Comment.</i>	B
16.	<i>The auditor is entitled to rely on work performed by others.</i>	B
17.	<i>The responsibility for properly determining the quantity and value of inventories rests with the management of the entity.</i>	B
18.	<i>"Doing a statutory audit is full of risk". Comment.</i>	B
19.	<i>"An opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted the affairs of the enterprise".</i>	B
20.	<i>In a system based audit, test checking approach provides a good base for the auditor to form his opinion on the financial statement. Give your comments.</i>	B
21.	<i>Discuss the factors relevant to the auditor's judgement, about whether a control individually or in combination with others, is relevant to the audit.</i>	B
22.	<i>Answer the following.</i>	B
23.	<i>Relationship between Materiality and Audit Risk</i>	B
24.	<i>Mention the disclosure requirement of current investments as per Schedule III of the Companies Act, 2013.</i>	B
25.	<i>Recognition of Interest on deposits</i>	B

Q.No.1. Distinguish between test check and internal check. (B)

1. The term 'test check' stands for the method of auditing when instead of a complete examination of all the transactions recorded in the books of account only some of the transactions are selected and verified. The term 'internal check' on the other hand refers to a system of book-keeping and arrangements of staff duties in the organization in such a manner that no single person can completely carry through transactions and record every aspect thereof.
2. Thus, both the concepts are entirely different as test check is an auditing procedure performed by the auditor while internal check system is instituted by the management.
3. Broadly, following points of distinction may be noted:

- a) *Test check is the checking carried out by the auditor in respect of only selected group of transactions whereas internal check is a set of procedures laid down by the management.*
- b) *Management has no control over the test checks carried out by the auditors whereas internal check is always subject to review, appraisal and change by the management.*
- c) *Test checks are helpful to the auditors to check and draw conclusions about the voluminous transactions whereas internal check facilitates management's functions.*
- d) *Test check helps the auditor to unearth frauds and errors without checking all the transactions whereas internal check is instituted to prevent frauds and errors.*

Q.No.2. Write short notes on sample errors. (C)

- a) *Even after a careful selection, a sample study may not show exact Position of the population. Sample errors are of two types, biased and unbiased.*
- b) *Biased errors arise from bias in selection estimation etc. For example, if in place of random sampling deliberate sampling is used in some particular case; there is likelihood of some bias introduced in the result. Such errors are known as biased sampling errors.*
- c) *Unbiased errors arise because of chance errors between the members of population included in the sample and those not included. Thus the total sampling error comprises of errors due to bias and the random sampling error.*

Q.No.3. List three examples of situations where an auditor can employ the techniques of 'observations'. (C)

Observations of an external auditor may be regarding:

- a) *Physical verification of fixed assets conducted by management.*
- b) *Physical verification of inventories.*
- c) *Observing the procedural aspects of payment of wages actually followed to determine compliance with laid down procedure.*

Q.No.4. Write a short note on compliance audit. (C)

It is common to us that all the business undertakings require some certified statement on various matters and the auditors certify such statements after carrying out audit which might be necessary under the particular cases. All such audits are called compliance audit. Suppose when a company applied to a bank for some loan, a certified statement showing the turnover of the company for the past two or three years along with the current year might be necessary, and for this purpose the certified statements are to be attached with the application, otherwise the application will be rejected. So these certified statements showing the turnover of the company fall under the category of compliance audit. Internal audit for compliance could be more broad based to include compliance with documented procedures/policies, compliance with statutory requirements in the relevant areas etc.

Q.No.5. Outstanding Assets. (C)

It is a well-accepted accounting principle that all expenditure pertaining to the year alone should be charged against year's revenue and all income whether received or not should be accrued for the year. Following this principle, one has to make certain year-end adjustments in the books of account and outstanding assets are brought to book in that process.

If expenditure has been made on certain revenue heads, the benefit off which is to be derived even after the year is over and adjustment is made to the original figure of expenditure so as to carry forward the sum that does not pertain to the year an outstanding asset is created. Similarly, if certain income has accrued for the year but has not been received, the amount that has so accrued is usually brought into books as year-end adjustment and thereby creating an outstanding asset account.

Generally, outstanding assets are those items for which amounts are yet to be received, though services etc. have been rendered, or items for which payments have been made in advance but for which benefit of service will be received later.

Some examples:

- a) **Insurance charges paid in advance:** Insurance premia are always paid in advance; and, in case of a large business, the amount paid, the benefit of which will arise in the succeeding period, may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated and included as on outstanding asset.
- b) **Advertisement:** Sometimes payments under advertising contracts are made in advance. In such a case, the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be adjusted as on outstanding asset.

Q.No.6. Outstanding Liabilities. (B)

- a) **Purchases:** In some instances, invoices relating to purchases of goods that have been taken into stock are received too late to be included in the Purchase Day Book of the closing month. As a result, those will be included in the accounts of the succeeding period. In such a case, a schedule of such invoices should be prepared and their total debited to Purchases Account and carried down as an outstanding liability. If the precise amount of liability on account of such purchases cannot be ascertained; an estimate made by a responsible official might be accepted.
- b) **Wages, Salaries, etc.:** The amounts debited to these accounts should represent the amount actually chargeable for the year. Thus, if the amount payable at the close of the year has been paid in the succeeding period, a provision there for should be made. While doing so, it should also be verified that the corresponding provision made at the end of the previous year has been brought in as a credit, for arriving at the amount chargeable for the year.
- c) **Rent and Taxes:** The amount charged towards the rent should be the annual rent as provided for in the lease. If any rent for the year was outstanding at the close of year or has been paid in advance, the amount outstanding or paid in advance should be adjusted as a liability or asset respectively. Municipal taxes usually are payable in advance. As a result a proportion of last payment is usually carried forward as unexpired to the next period.
- d) **Freight:** Carriage and freight account may not be rendered till some time after the period to which they relate. In such a case a provision for the amount outstanding may be made on an estimate and while doing so the amount provided in the earlier year may be taken into account.

Q.No.7. Intangible Assets. (B)

Such assets does not have any physical existence but their presence in the business is indicated with a value placed thereon. These assets confer rights and benefits to owners subject to their being useful. Examples of intangible assets are goodwill, patents, copyright, etc. Normally, intangible assets are valued at cost less the expired value of their utility to the business. The method of assessing the valuation of some of the intangible assets is discussed here under:

- a) **Goodwill:** Ordinarily, if goodwill has been purchased, the cost of purchase will be value of goodwill. There is no mandatory requirement to depreciate goodwill. However, it would be prudent to write-off goodwill over a reasonable period.
- b) **Patents:** It is to be seen that the patent is valued at cost less depreciation. Cost is the acquisition cost which may be purchase cost or development cost. The cost of registration of patent should be included in the valuation while the renewal fees should be charged off to revenue.
- c) **Trademarks and Copyrights:** The value has to be determined by capitalising the cost incurred for the purpose of obtaining the trademarks and copyrights. The cost of these assets are amortised having regard to appropriate legal and commercial considerations.

Q.No.8. Write a short note on floating assets. (C)

(M16 – 4M)

- a) **Meaning:** Floating asset means those current assets which are manufactured or purchased during the normal course of business.
Examples: Raw Materials, work in progress, finished goods, consumables, debtors, sundry receivables.
- b) They are held for a shorter period and may be converted into cash within a year.
- c) **Valuation:** The stock in trade shall be valued at cost or market price whichever is less. The sundry debtors and bills receivables are valued at net realizable value.

Q.No.9. Write short notes on contingent assets. (B)

- a) Contingent Assets may be defined as “an asset, the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.”
- b) Contingent assets are not accounted for in the financial statements as this may result in the recognition of revenue, which may never be realized.
- c) If contingent assets have a significant value, it is advisable to disclose such assets as a note to the balance sheet, at a proper valuation based on the related contract.
- d) Where full realization of such assets is doubtful even on the face of the contingencies occurring, it would be safer to value the assets on reliability basis e.g. the value of counter-guarantee given by the principal borrower may be taken as nil if the borrower has turned bankrupt.

Q.No.10. Floating Charge. (B)

Floating charge refers to a general charge on some or all the assets of an enterprise which is not attached to specific assets and are given as a security against a debt. It has the effect of creating an immediate charge on the property of the company leaving the company to deal with the same in its ordinary course of business, but subject to the limitations imposed in the instrument of creating the charge. The floating charge, however, becomes fixed or crystallized on happening of some events specified in the companies act and the creditor becomes entitled to proceed against instrument creating the charge. This charge is also required to be registered within 30 days of its creation under section 77 of the Companies Act, 2013.

Q.No.11. Write short notes on above the line and below the line? (C)

Above the Line	Below the Line
It is the segment of the P & L Account wherein the Net Profit or Loss is determined after (a) crediting all the revenues, gains and profits and (b) debiting all the expenses and working charges attributable to the period.	It is the segment of the P&L Account wherein the adjustments, appropriations, utilizations of profit are expressed, e.g. Transfer to Reserves, Excess provisions, Dividends etc.
The Manufacturing, Trading and Profit and Loss Account constitute the "above the line" segment.	The Profit and Loss Appropriation Account constitute the "below the line" segment.
<u>Provision</u> is a necessary charge against revenue and is hence shown "above the line".	<u>Reserve</u> is an appropriation of profit, hence shown "below the line".

Q.No.12. Balance Sheet Audit. (C)

Until recently, test checks were applied only for confirming balances in a few nominal accounts, those of stocks and stores, amount of sale and other similar records relevant to trading transactions, which were voluminous but of similar nature. Now a days on account of increase in the size of business units, but more so due to mechanization of accounting, the test checks are being applied widely for the verification of income and expense accounts as well as assets and liabilities. This has crystallised into a form of audit known as Balance Sheet audit.

A Balance Sheet audit consists of the verification of all includible Balance Sheet items, together with the examination of expense and income accounts, which are so closely related to these items that it cannot be properly verified without such analysis and test. Records, vouchers, books and accounts are examined; capital and revenue accounts are analysed.

In outline form, a Balance Sheet audit will include the following:

- An examination of partnership agreement, the memorandum and articles of association, minutes of the board of directors, and the system of accounting in force.
- The establishment of ownership of all assets included in the Balance Sheet.
- Proofs that all assets owned are included.
- The inclusion of the asset in the Balance Sheet in accordance with the accepted principles of accounting.
- Proof that all liabilities are included and at proved amounts.
- The examination of adjusting and closing entries or any other entries necessary to the preparation of the Balance Sheet.
- Evidence that the distinction has been made in recording transactions between capital and revenue; and that capital and revenue have been created on the basis of accepted accounting principles.
- Proof that the share capital issues have been made in compliance with the requirements of law and they are correctly recorded in the financial books.

Q.No.13. In case where audit sample selection has been done on a random basis, no statistical process for selection of samples need to be followed. (C) (PM)

Audit sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population. The audit sample selection on a random basis ensure that all items in the population have an equal change of selection, for example, by use of random number tables.

Thus, strictly speaking in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample. In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Hapazard Sampling and Block Sampling may result in selection of a sample which is not free from bias. Therefore, whenever audit sample selection has been done on a random basis i.e., selection of a representative sample, no statistical process of selection of sample need to be followed.

Q.No.14. "The duties of auditors are limited to the verification of the arithmetical accuracy of the books of accounts". (B)

The duties of auditors are not limited to the verification of the arithmetical accuracy of the books of accounts kept by his client. Simply because, the verification of arithmetical accuracy would amount to certification of accounts only which would not serve much purpose since the auditor is required to report on the manner of selection of accounting policies and to assess the judgement made by the enterprise on arriving at certain accounting estimates or how the final accounts have been ultimately prepared to portray the financial statements. The auditor must satisfy himself by performing substantive audit procedures to vouchers, invoices, minutes of meetings, correspondence and the documentary evidence must verify that there exists a proper authenticity of the transactions.

Furthermore, he must verify that there exists a proper authority in respect of each transaction and that they are properly recorded. An important aspect would involve valuation of different assets and liabilities shown in balance sheet. Finally, the auditor must verify that the form in which the final accounts have been drawn up is the one prescribed by law and as per professional pronouncements and exhibit a 'true and fair view'. In case of companies, Section 143 of the Companies Act, 2013, requires auditors to make a report to members of the companies on the accounts examined by him. Thus, the duty of the auditor is just not restricted to mere checking arithmetically accuracy of accounts but to report on the same.

Q.No.15. Auditors report implies an expression of opinion by the auditor. Discuss the statement. Or auditor is responsible for expressing opinion on financial statements in statutory audit. Comment. (B)

The audit report is the final outcome of the entire effort put in by the auditor to achieve the audit objectives. In fact, the auditor communicates his finding through the audit report. As per SA-200, "Overall objectives of the independent auditor and the conduct of an audit in accordance with standards on auditing", the objective of audit of financial statements is to express an opinion.

The objective of the audit of the financial statements is to enable an auditor to express an opinion on such financial statements.

As per the requirements of Sec.143 of the Companies Act, 2013, the auditor is required to express his opinion on:

- a) Whether books of account as required by law have been kept by the company so far as it appears from the examination of the books and proper returns adequate for the purpose of audit have been received from branches not visited by them.*
- b) Whether the accounts give the information required by the Act in the manner so required*
- c) Whether the accounts give a fair view in case of the balance sheet, the state of the companies affairs and in case of the profit and loss account of the profit and loss for the year.*

The auditor is responsible for forming and expressing his opinion on the financial statements. However, the responsibility for their preparation is that of the management of the enterprise. Management responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies and the safeguarding of the assets of the enterprise.

Q.No.16. The auditor is entitled to rely on work performed by others. Comment (B)

Work performed by others: The auditor should consider the following matters.

Work Done by	Auditors Duties
Assistants (SA-220)	The auditor should carefully direct, supervise and review work delegated to assistants. He will continue to be responsible for forming his independent opinion.
Experts (SA-620)	The auditor should seek reasonable assurance that the experts work constitutes appropriate audit evidence in support of the financial information. He should evaluate the work of an expert independently to conclude whether or not to rely upon the expert's certificate.
Another Auditors (SA-600)	The principal auditor should perform procedures to obtain sufficient & appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes in the context of the specific assignment. The principal auditor should consider the significant findings of the other auditor [AAS-10]
Internal Auditor (SA-610)	The means of achieving the objectives are very similar for the internal auditor and external auditor. Hence much of the work of the internal auditor may be useful for the external auditor in determining the nature, timing and extent of his procedures.
Joint Auditors (SA-299)	Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted auditing procedures. Each Joint Auditor is entitled to rely upon the other joint auditors for bringing to his notice, any department from Accounting Standards or material errors discovered during audit.

Q.No.17.The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. (B)

- The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. It is, therefore, the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity.
- The management satisfies this responsibility by carrying out appropriate procedures which will include verification of all items of inventory at least once in every financial year.
- The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity.
- He is also required to determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items are well-designed and operate properly.
- This responsibility of the management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence.
- The entities usually maintain detailed stock records in the form of Stores/Stock ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

Q.No.18. "Doing a statutory audit is full of risk". Narrate the factors that cause the risk. (B)

The process of auditing is based on the assessment of judgments made by the management of the entity as well as evaluation of internal controls. Hence, the audit suffers certain inherent risks, which arise due to the following factors:

- a) **Exercising judgement on the part of the auditor:** The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing reasonableness of the judgement and estimates made by the management in preparing financial statements.
- b) **Nature of audit evidence:** The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such evidence may far exceed the benefits.
- c) **Inherent limitations of internal control:** Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

An audit suffers from control risk on account of inherent limitations of internal control and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies. Statutory audit is not free from risks. The auditor takes a calculated risk in expressing his opinion on the financial statements. He should minimize the effect of risks on his opinion by exercising proper care and diligence. Various audit procedures are applied to obtain sufficient appropriate audit evidence towards the assertions in the financial statements.

Q.No.19. "An opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted the affairs of the enterprise". (or) generally an audit is not concerned with the propriety of business conduct. comment. (B)

The objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion, which helps determination of the true and fair view of the financial position and operating results of an enterprise. As per SA-200, "Overall objectives of the independent auditor and the conduct of an audit in accordance with standards on auditing", such an opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise. It must also be appreciated that the process of auditing suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. Thus, having regard to nature of opinion expressed by auditor in case of audit of financial statements, it is abundantly clear that the auditor's opinion is neither an assurance as to future viability of the enterprise or the efficiency or effectiveness with which management has conducted affairs of the enterprise.

It may however be noted that over a period of time, the scope of audit extended quite considerably by inclusion of certain matters of propriety nature in section 143 and CARO 2016 issued under section 143(11) of the Companies Act, 2013. Basically, the auditor has been primarily concerned with carrying out what may be termed as verifactory audit.

Thus, the auditor did not make judgement on management decisions, policies or the commercial prudence of transactions. However, with the introduction of aforesaid provisions, the auditor is required to express opinion on certain aspects of management decisions involving propriety aspects as well.

Q.No.20. In a system based audit, test checking approach provides a good base for the auditor to form his opinion on the financial statement. Give your comments. (B)

(N 08 - 8M, PM)

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

1. All the transactions and information have been recorded.
2. Fraud and errors, if any, in preparing the accounts will be identified,
3. All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts.
4. There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he resorts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking techniques. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and / or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability.

By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities we must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

Q.No.21. Discuss the factors relevant to the auditor's judgement, about whether a control individually or in combination with others, is relevant to the audit. (B)

(RTP M14)

Factors relevant to the auditor's judgment, about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

1. Materiality.
2. The significance of the related risk.
3. The size of the entity.
4. The nature of the entity's business, including its organisation and ownership characteristics.
5. The diversity and complexity of the entity's operations.
6. Applicable legal and regulatory requirements.
7. The circumstances and the applicable component of internal control.
8. The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
9. Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

Q.No.22. Answer the following- (B)

(RTP M14)

- a) KVT Limited could not recover an amount of Rs 8 lakhs from a debtor. The company is aware that the Trade receivable is in great financial difficulty. The accounts of the company for the year ended 31-3-2013 were finalized by making a provision @ 25% of the amount due from that Trade receivable. In May 2013, the Trade receivable became bankrupt and nothing is recoverable from him. Do you advise the company to provide for the entire loss of Rs 8 lakhs in books of account for the year ended 31-3-2013?
- b) M Co. Limited purchased goods at the cost of Rs40 lakhs in October, 2012. Till March, 2013, 75% of the stocks were sold. The company wants to disclose closing stock at Rs10 lakhs. he expected sale value is Rs 11 lakhs and a commission at 10% on sale is payable to the agent. Accountant has disclosed the value of Stock at Rs 990000. Give your views as an auditor.
- c) X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.2013 it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to Rs 20 lakhs being additional charge.

Decide how it must be disclosed in Profit and loss account. Also discuss when such changes in method of depreciation can be adopted by an enterprise as per AS 6.

- a) As per AS 4, 'Contingencies and Events Occurring after the Balance Sheet Date', adjustments to assets and liabilities are required for events occurring after the balance sheet date if such event provides/relates to additional information to the conditions existing at the balance sheet date and is also materially affecting the valuation of assets and liabilities on the balance sheet date.

As per the information given in the question, the Trade receivable was already in a great financial difficulty at the time of closing of accounts. Bankruptcy of the Trade receivable in May 2013 is only an additional information to the condition existing on the balance sheet date. Also the effect of a Trade receivable becoming bankrupt is material as total amount of Rs 8 lakhs will be a loss to the company. Therefore, the company is advised to provide for the entire amount of ₹ 8 lakhs in the books of account for the year ended 31st March, 2013.

- b) As per AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost and net realizable value. In this case, the cost of inventory is Rs10 lakhs. The net realizable value is $11,00,000 \times 90\% = \text{Rs } 9,90,000$. So, the stock should be valued at Rs 9,90,000.
- c) The company should disclose the change in method of depreciation adopted for the accounting year. The impact on depreciation charge due to change in method must be quantified and reported by the enterprise. Following aspects may be noted in this regard as per AS 6 on Depreciation Accounting.
 - i) The depreciation method selected should be applied consistently from period to period.
 - ii) A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.
 - iii) When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed.
 - iv) In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss.
 - v) In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Q.No.23.What is the relationship between Materiality and Audit Risk. (B) (N14 – 4M, PM)

Materiality and Audit Risk: SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an **inverse relationship** between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

Q.No.24. Disclosure requirements of current investment: In Schedule III Part I of the Mention the disclosure requirement of current investments as per Schedule III of the Companies Act, 2013. (M16 - 4M)

Companies Act, 2013, Current Investments are shown under the head Current Assets.

Further, Schedule III requires that company shall disclose "Current Investments" in notes to accounts as follows-

a) Current Investments shall be classified as:

i) Investments in equity instruments;	iv) Investments in debentures or bonds;
ii) Investments in preference shares;	v) Investment in mutual funds;
iii) Investments in government or trust securities;	vi) Investments in partnership firms;
	vii) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether bodies are subsidiaries, associates, joint ventures or controlled special purpose entities) in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly paid). In regards to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

b) The following shall also be disclosed:

- i)** The basis of valuation of individual investments.
- ii)** Aggregate amount of quoted investments and market value thereof.
- iii)** Aggregate amount of unquoted investments.
- iv)** Aggregate provision made for diminution in value of investments

Q.No.25. Write short notes on Recognition of Interest on deposits (M16 – 4M)

Recognition of Interest on deposits:

1. AS - 9 on "Revenue Recognition" requires that the revenue arising from interest should be recognized on a time proportion basis taking into account the amount outstanding and the rate applicable. Such revenue should only be recognized when no significant uncertainty as to measurability or collectability exists.

2. Further, according to section 128 of the Companies Act, 2013 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.
3. Interest accrued but not due should be shown under current assets in the balance sheet.
4. If interest on deposits is not recognized on accrual basis, the profits and current assets will be understated and true and fair views of the accounts, thus vitiated.
5. On considerations of materiality of the item, the auditor may appropriately qualify the report.

THE END

STANDARDS ON AUDITING**TOPIC WISE ANALYSIS OF PAST EXAM PAPERS OF IPCC IN THE CHAPTER OF STANDARDS ON AUDITING**

No.	Chapter / Topic Name	M - 06	N - 06	M - 07	N - 07	M - 08	N - 08	M - 09	N - 09	M - 10	N - 10	M - 11	N - 11	M - 12	N - 12	M - 13	N - 13	M - 14	N - 14	M - 15	N - 15	M - 16
1.	Intro.	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-
2.	SA 200	8	-	10	-	8	-	-	-	-	-	5	-	-	-	8	-	-	-	-	-	2
3.	SA 210	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	5	-	-	-
4.	SA 220	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-	-	5	-	-
5.	SA 230	-	-	-	-	4	6	-	-	-	-	5	-	-	-	5	-	-	-	-	-	-
6.	SA 240	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	6	-	-	4	-
7.	SA 250	-	-	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-
8.	SA 260	-	-	-	-	-	-	-	-	-	4	-	-	-	-	5	-	-	-	6	-	-
9.	SA 265	-	-	-	-	-	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-
10.	SA 299	-	-	-	-	-	5	7	-	5	5	-	-	-	-	-	-	-	-	-	6	-
11.	SA 300	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
12.	SA 315	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	6	-	-
13.	SA 320	-	-	5	-	-	-	-	6	-	-	-	-	-	-	4	-	-	2	-	5	-
14.	SA 330	-	-	-	-	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	2
15.	SA 402	-	-	6	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
16.	SA 450	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
17.	SA 500	-	-	-	-	-	5	-	-	-	-	-	-	-	-	5	-	-	-	-	-	-
18.	SA 501	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
19.	SA 505	-	6	-	-	-	-	-	-	-	4	-	8	-	8	-	-	-	-	-	-	-
20.	SA 510	4	-	6	-	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-	-
21.	SA 520	-	-	-	-	-	-	-	2	-	8	-	-	-	-	-	-	8	-	-	-	-
22.	SA 530	8	-	-	-	-	-	-	-	-	8	-	-	-	-	-	-	12	-	-	-	5
23.	SA 540	-	4	6	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	-
24.	SA 550	-	-	-	-	-	-	-	-	-	-	-	-	-	-	2	-	-	-	-	-	5
25.	SA 560	-	-	-	-	-	-	6	-	-	-	-	-	8	-	-	-	-	5	-	-	-
26.	SA 570	-	-	-	-	6	-	-	2	-	4	-	-	8	-	-	-	5	-	-	-	-
27.	SA 580	-	-	5	-	-	2	-	-	-	-	-	-	-	-	-	-	5	-	2	-	-
28.	SA 600	-	-	-	-	2	5	2	-	-	-	-	-	-	-	-	-	-	8	-	-	-
29.	SA 610	-	-	-	-	6	-	-	-	-	-	5	-	-	-	-	-	-	8	-	-	-
30.	SA 620	-	8	-	2	2	-	-	2	-	-	-	-	-	-	-	-	-	-	-	-	-
31.	SA 700	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	9	-	-	-	-
32.	SA 705	-	-	-	-	-	-	-	-	-	-	-	-	-	-	8	-	-	-	7	-	-
33.	SA 706	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
34.	SA 710	-	-	-	-	-	-	2	-	5	-	-	-	-	-	-	-	-	-	-	-	-
35.	SA 720	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

COMPLIANCE WITH PRONOUNCEMENTS ISSUED BY ICAI

The pronouncements of the ICAI and the duties of Members in relation thereto are summarized as under -

1. Statements on Accounting Matters (Accounting Standards):

- a) Members should examine whether 'Statements' relating to accounting matters are complied with in the presentation of Financial Statements covered by their audit.
- b) In the event of any deviation from the 'Statements', it will be their duty to make adequate disclosures in their Audit Reports so that the users of Financial Statements may be aware of such deviations. Further he is required to document how alternative procedure performed achieve the purpose of the procedure, and, unless otherwise clear, the reasons for the departure.

2. Statement on Auditing Matters:

- a) Members should ensure that the 'statements' relating to auditing matters are followed in the audit of financial information covered by their Audit Reports.
- b) If, for any reason, a Member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.

3. Guidance Notes:

- a) These are designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues that may pose difficulty.
- b) They are recommendatory in nature. A Member should ordinarily follow an Auditing related Guidance Note except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.
- c) Similarly while discharging his attest function, a Member should examine whether an accounting related Guidance Note has been followed or not. If not, the Member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

4. Technical Guides, Practice Manuals, Studies and Other Papers Published by the AASB:

- a) AASB may also publish Technical Guides, Practice Manuals, Studies and Other Papers.
- b) Technical Guides are ordinarily aimed at imparting broad knowledge about a particular aspect or of an industry to the Professional Accountants.
- c) Practice Manuals are aimed at providing additional guidance to Professional Accountants in performing audit and other related assignments.
- d) Studies and other papers are aimed at promoting discussion or debate or creating awareness on issue relating to Quality Control, Auditing, Assurance and Related Service, affecting the profession.
- e) Such publications of the Board do not establish any basic principles or essential procedures to be followed in Audit, Review, Other Assurance or Related Services Engagements, and accordingly, have no authority of the Council attached to them.

5. General Clarification: General Clarifications are issued by AASB under the authority of the Council of the Institute with a view to clarify any issues from the Standards. General Clarifications are mandatory in nature.

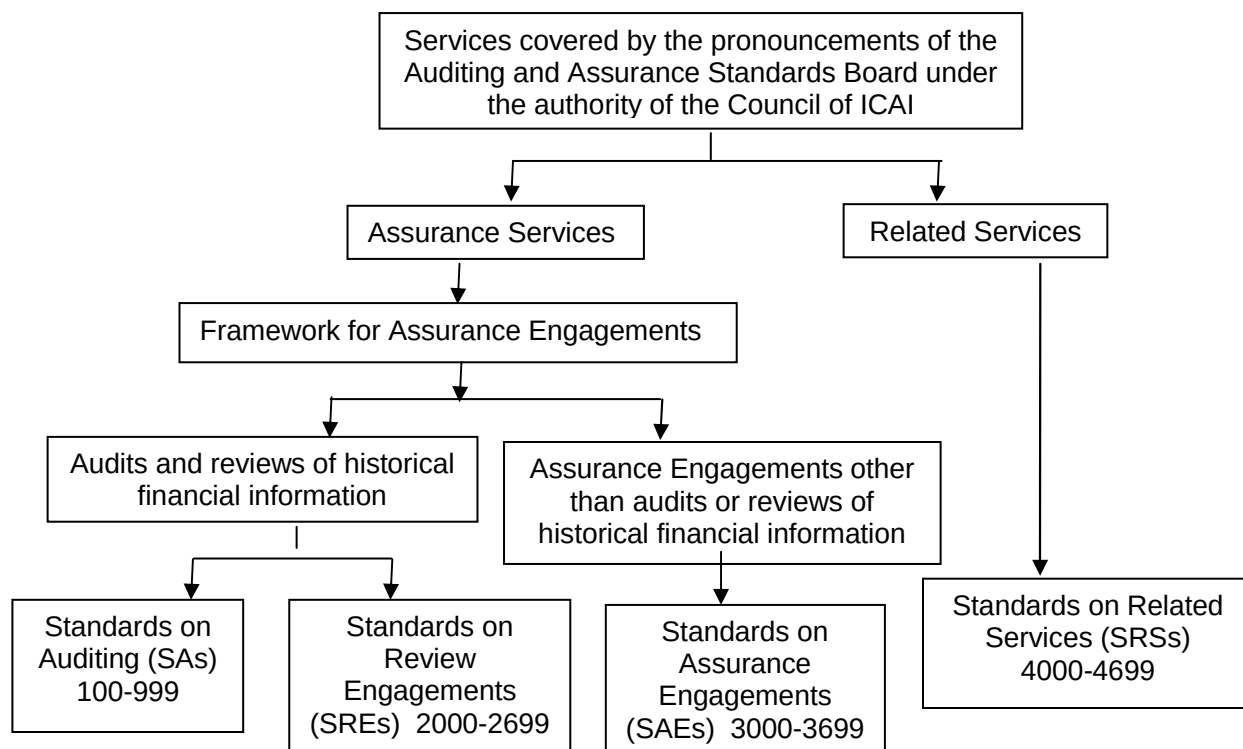
Q.No.1 Discuss the following:

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

(M14 – 5M, PM)

Ans: Refer Para 1, 2 & 3 above.

STRUCTURE OF STANDARDS ISSUED BY A.A.S.B. UNDER THE AUTHORITY OF THE COUNCIL OF ICAI



SERIES	CONTENT
1-99	Standards on Quality Control (SQCs)
100-199	Introductory matters
200-299	General Principles & Responsibility
300-499	Risk Assessment and response to assessed risks
500-599	Audit Evidence
600-699	Using works of others
700-799	Audit conclusions and reporting
800-899	Specialised areas
2000-2699	Standards on Review Engagements (SREs)
3000-3699	Standards on Assurance Engagements (SAEs)
4000-4699	Standards on Related Services (SRSS)

AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION

200-299	General Principles and Responsibilities		
	SA 200	Overall objectives of the independent Auditor and the conduct of an Audit in accordance with standards on Auditing (Revised).	1-4-2010

	SA 210	<i>Agreeing the Terms of Audit Engagements (Revised).</i>	1-4-2010
	SA 220	<i>Quality Control for Audit of Financial Statements (Revised).</i>	1-4-2010
	SA 230	<i>Audit Documentation (Revised).</i>	1-4-2009
	SA 240	<i>The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements (Revised).</i>	1-4-2009
	SA 250	<i>Consideration of Laws and Regulations in an Audit of Financial Statements (Revised).</i>	1-4-2009
	SA 260	<i>Communications with those Charged with Governance (Revised).</i>	1-4-2009
	SA 265	<i>Communicating Deficiencies in Internal Control to those charged with Governance and Management.</i>	1-4-2010
	SA 299	<i>Responsibility of Joint Auditors.</i>	1-4-2008
300-499	<i>Risk Assessment and Response to Assessed Risks</i>		
	SA 300	<i>Planning an Audit of Financial Statements (Revised).</i>	1-4-2008
	SA 315	<i>Identifying and Assessing the Risk of Material Misstatements through Understanding the Entity and Its Environment.</i>	1-4-2008
	SA 320	<i>Materiality in Planning and Performing an Audit (Revised).</i>	1-4-2010
	SA 330	<i>The Auditor's Responses to Assessed Risks.</i>	1-4-2008
	SA 402	<i>Audit Considerations Relating to Entities Using Service Organisations (Revised).</i>	1-4-2010
	SA 450	<i>Evaluation of misstatements identified during the audit.</i>	1-4-2010
500-599	<i>Audit Evidence</i>		
	SA 500	<i>Audit Evidence (Revised).</i>	1-4-2009
	SA 501	<i>Audit Evidence-Additional Considerations for Specific Items (Revised).</i>	1-4-2005
	SA 505	<i>External Confirmations (Revised).</i>	1-4-2010
	SA 510	<i>Initial Audit Engagements –Opening Balances (Revised).</i>	1-4-2010
	SA 520	<i>Analytical Procedures (Revised).</i>	1-4-2010
	SA 530	<i>Audit Sampling (Revised).</i>	1-4-2009
	SA 540	<i>Auditing Accounting Estimates, including fair value accounting estimates, and related disclosures (Revised).</i>	1-4-2009
	SA 550	<i>Related Parties (Revised).</i>	1-4-2009
	SA 560	<i>Subsequent Events (Revised).</i>	1-4-2009
	SA 570	<i>Going Concern (Revised).</i>	1-4-2009
	SA 580	<i>Written Representations (Revised).</i>	1-4-2009
600-699	<i>Using work of Others</i>		
	SA 600	<i>Using the Work of Another Auditor.</i>	1-4-1995
	SA 610	<i>Using the work of an Internal Auditor (Revised).</i>	1-4-2011
	SA 620	<i>Using the work of an Auditor's Expert (Revised).</i>	1-4-2011

Audit Conclusions and Reporting			
700-799	SA 700	<i>Forming an opinion and Reporting on Financial Statements (Revised).</i>	1-4-2011
	SA 705	<i>Modifications to the opinion in the independent Auditor's Report</i>	1-4-2011
	SA 706	<i>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the independent Auditor's Report</i>	1-4-2011
	SA 710	<i>Comparative information – Corresponding figures and comparative financial statements (Revised).</i>	1-4-2011
	SA 720	<i>The Auditor's responsibilities in relation to other information in documents containing audited financial statements.</i>	1-4-2011

Q.No.2. Mention any twelve title of Statements on Standards on Auditing and the date from which it comes into force. **(PM)**

Ans: Write any of the 12 SA'S from above table.

SA 200 (Revised) OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH STANDARDS ON AUDITING (on or after April 1, 2010)

1. Overall objectives of the Auditor:

- a) While auditing the financial statements, the auditor has following objectives:
 - i) To obtain reasonable assurance about whether the financial statements are free from material misstatements thereby enabling the auditor to express an opinion on whether financial statement are prepared as per applicable Financial Reporting Framework and
 - ii) To report on financial statements and communicate as per SAs.
- b) If reasonable assurance can not be obtained and qualified opinion is insufficient then he should either disclaim the opinion or withdraw from engagement.

2. Definitions:

a) Applicable Financial Reporting Framework:

- i) *Financial Reporting Framework adopted by the management and TCWG*
- ii) *In preparation and presentation of financial statements that is*
 - *Acceptable as per the circumstances or*
 - *Required by law*

b) Audit Evidence:

- i) *Information used by the auditor*
- ii) *In arriving at the conclusions*
- iii) *On which the auditor's opinion is based.*

c) Financial Statements:

- i) *A structured representation*
- ii) *of historical financial information*
- iii) *Including related notes*
- iv) *intended to show entity's economic results & position*
- v) *As per applicable Financial Reporting Framework.*

d) Professional Judgment:

- i) Application of relevant training, knowledge and experience
- ii) In making appropriate decisions
- iii) During audit engagement

e) Professional skepticism:

(PM)

- i) An attitude
- ii) That includes a questioning mind
- iii) Being alert to conditions
- iv) Indicating possible misstatement.

f) Reasonable Assurance:

- i) A high
- ii) But not absolute
- iii) Level of assurance

g) Risk of material misstatement:

- i) Risk that
- ii) Financial statement are misstated
- iii) Prior to audit

Note: It consists of two components: Inherent risk and control Risk.

h) Audit Risk:

- i) Risk that auditor expresses
- ii) Inappropriate audit opinion
- iii) When financial statement are materially misstated.

Note: It consists of Risk of material misstatements & detection Risk

3. Overall objectives of Audit of financial statement:

a) Preparation of financial statement:

- i) Primary responsibility lies with management.
- ii) Audit of the financial statements does not relieve them of their responsibilities.

b) Scope of Audit:

- i) The purpose of audit is to enhance the confidence of users of financial statements.
- ii) Thus, his opinion is on whether the financial statement are presented fairly or give a true & fair view as per applicable Financial Reporting Framework.
- iii) His opinion does not assure (i) future viability of entity or (ii) efficiency or effectiveness, with which the management has conducted the affairs of the entity
- iv) However, in some cases auditor may be required to express his opinion on some specific matters as per applicable laws & regulations.

c) Reasonable Assurance w.r.t. misstatements:

- i) Auditor is required to obtain reasonable assurance as to whether the financial statements are free from material misstatements
- ii) He obtains sufficient & appropriate audit evidence to reduce the risk to an acceptable low level.
- iii) However, reasonable assurance is not absolute assurance. This is due to inherent limitations of an audit.

d) **Inherent limitations of an audit:**

Refer: Chapter 1- Q.No.4

e) **Consideration of SA:**

i) Auditor should consider SA while performing audit.

ii) SA require the auditor to :

- Maintain Professional judgment & professional skepticism.
- Identify and assess risk of material misstatement.
- Obtain sufficient & appropriate audit evidences about misstatements.
- Form an opinion on financial statements based on conclusions drawn from evidences.

f) **Form of opinion:**

i) It depends upon applicable Financial Reporting Framework & any law or regulations.

ii) Moreover, auditor may have certain reporting responsibilities to users, management, TCWG or outside parties (as per SA or law)

4. Requirements / Responsibilities of the auditor:

Refer: Chapter 1- Q.No.11

PRACTICAL QUESTIONS

Q.No.1. Discuss the basic principles governing an audit. (or) what are the basic principles governing an audit as laid down in SA-200? (OR) Responsibilities of an auditor as per SA 200.

Ans: Write Para – 4

Q.No.2. What are the objectives of audit?

Ans: Write Para – 1

Q.No.3. “Some material mis-statements remain unreported by auditors”. Comment

Ans: Write Para – 3 (b, c) & also LONDON GENERAL BANK CASE.

Q.No.4. Audit opinion is not an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise. Comment. (M16 – 2M)

Ans: Write Para – 3 (b, c & d) & also LONDON GENERAL BANK CASE.

Q.No.5. WHAT ARE THE RESPONSIBILITIES OF AUDITOR AS PER SA: 200

Ans: Write Para – 4

Q.No.6. Mr. K auditor of ABC Ltd, is of the opinion that standards on auditing are meant only for references and it is not necessary to follow such standards.

Ans: Write Para – 4

Q.No.7. "Professional judgement is essential to the proper conduct of an audit." Discuss the statement in terms of Standard on auditing 200. **(NOV15RTP)**

Ans: Refer Para – 4

Q.No.7. The Auditor is responsible for maintaining an attitude of professional skepticism throughout the Audit. Do you agree with the statement? **(M14 – 6M)**

Ans: Refer Para – 4

SA 210 (Revised) AGREEING THE TERMS OF AUDIT ENGAGEMENTS (on or after April 1, 2010)

1. *This SA deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and TCWG and Confirming that there is a common understanding between the auditor and management regarding the terms of the audit engagement.*
2. **Applicability:** *This SA is applicable to engagement relating to Audit of Financial Statements only.*
3. **Preconditions for an Audit:** In order to establish whether the preconditions for an audit are present, the auditor shall:
 - a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable with reference to the following—
 - i) Nature of the entity (for e.g. whether it is a business enterprise, or a not for profit organization),
 - ii) Purpose of the Financial Statements (for e.g. whether they are prepared to meet the common financial information needs of a wide range of users or for specific users),
 - iii) Nature of the Financial Statements (for e.g. whether the Financial Statements are a complete set of Financial Statements or a single Financial Statement), and
 - iv) Whether law or regulation prescribes the applicable Financial Reporting Framework.
 - b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including their fair presentation;
 - ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - iii) To provide the auditor with:
 - Access to all information such as records, documentation and other matters;
 - Additional information that the auditor may request from management for the purpose of the audit; and
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.
4. **Audit of Components (e.g. Subsidiary, Branch, Division, etc):** *When the auditor of parent company is also the auditor of its subsidiary, branch or division, he should consider certain factors like legal requirements, independence of management, degree of ownership by parent, extent of work performed by other auditors, etc. in decide whether to issue separate engagement letters.*

5. **Contents of letter of engagement, Issue of letter of engagement in case of Recurring audit, Acceptance of changes in terms of engagement:**

Refer: Chapter 1- Q.No.12

ADVANCED

6. **Attributes of Financial Reporting Framework:** Financial Reporting Frameworks normally exhibit the following attributes–

- a) **Relevance:** The information provided in the Financial Statements is relevant to the nature of the entity and the purpose of the Financial Statements.
- b) **Completeness:** Transactions and events, account balances and disclosures are not omitted.
- c) **Reliability:** The information provided in the Financial Statements –
 - i) Reflects the economic substance of events & transactions and not merely their legal form.
 - ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.
- d) **Neutrality:** Information in the Financial Statements is free from bias.
- e) **Understandability:** Information provided in the Financial Statements is clear and comprehensive, and not subject to significantly different interpretation.

FORMAT OF AN AUDIT ENGAGEMENT LETTER

To the Board of Directors of ABC Company Limited

You have requested that we audit the financial statements of ABC Company Limited, which comprise the balance Sheet as at March 31, 20XX, and the Statement of Profit & Loss, and Cash Flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

- a) *For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards. This includes the responsibility for:*

- i) Preparation of financial statements on a going concern basis
 - ii) Selection and consistent application of appropriate accounting policies
 - iii) Making judgments and estimates that are reasonable and prudent
 - iv) Maintenance of adequate records and internal controls
 - v) Written representation by the management
- b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- c) To provide us with;
- i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - ii) Additional information that we may request from [management] for the purpose of the audit; and
 - iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the chartered accountants Act, 1949 to be conducted by an independent reviewer. The reviewer may inspect examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ & Co.,
Chartered Accountants

Date:

Place:

(Signature)
(Name of the Member)
Partner

Acknowledged on behalf of ABC Company by

(Signature)

Name and Designation

Date

PRACTICAL QUESTIONS

Q.No.1. "It is not mandatory to send a new engagement letter in recurring audit but sometimes it becomes mandatory to send new letter" comment. (PM)

Ans: Write Para – 5.

Q.No.2. R&M Co, a firm of chartered accountants, was appointed as statutory auditors of XYZ Company Ltd. Draft an engagement letter accepting the appointment as auditors.

Ans: Refer format given above.

Q.No.3. What are management's responsibilities.(or) Describe a set of instructions, which an auditor has to give to his client before the start of actual audit. **(PM, N14RTP)**

Ans: Write Para – 3

Q.No.4. Mr. X, a CA was engaged by PQR Ltd for auditing their accounts. He sent his letter of engagement to the board of director, which was accepted by the company. In the course of audit, the auditor was unable to obtain sufficient audit evidence regarding receivables. The client requested for change in terms of engagement. Offer your comments in this regard.

Ans: Write Para – 5

SA 220 (Revised) QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS
(on or after April 1, 2010)

1. Definitions:

- a) **Engagement Documentation:** Record of work performed, its result & conclusions. It is assembled in an engagement file.
- b) **Engagement Partner:** Partners other person in firm (C.A full time in practice) responsible for engagement & report thereon.
- c) **Engagement Quality Control Review:** Process to evaluate the judgment & conclusions of Engagement Team before report is issued.
- d) **Engagement Q.C. Reviewer:** Partner/ other person in firm /external person or a team to conduct Review.
- e) **Engagement team:** All persons performing an engagement including any expert.
- f) **Firm:** Sole Practitioner/ Proprietorship firm/ partnership firm.
- g) **Inspection:** Procedures to check compliance by engagement team with firm's Q.C policies w.r.t. completed engagements.
- h) **Monitoring:** Evaluation of firm's system of Q.C. to check its operational effectiveness. (It includes inspection)
- i) **Network firm:** Entity under common control ownership or management with firm (Nationally / Internationally).
- j) **Staff:** Professionals other than partners.

2. Leadership Responsibilities for Quality on Audits / Responsibility of engagement partner: The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

3. Relevant ethical requirements: Throughout the audit engagement, the engagement partner shall remain alert, for noncompliance with relevant ethical requirements by members of the engagement team.

Independence: The engagement partner shall form a conclusion on compliance with independence requirements. In doing so, the engagement partner shall:

- a) Obtain relevant information to identify circumstances and relationship that create threats to independence;
 - b) Take appropriate action to eliminate such threats or reduce them to an acceptable level or to withdraw from the audit engagement.
4. **Acceptance and continuance of Engagement Teams:** The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationship and audit engagements have been followed. If not, necessary action will be taken by engagement partner.
- a) The integrity of the principal owners, key management and those charged with governance of the entity;
 - b) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
 - c) Whether the firm and the engagement team can comply with relevant ethical requirements; and
 - d) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship
5. **Assignment of Engagement teams:** The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:
- a) Perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and
 - b) Enable an auditor's report that is appropriate in the circumstances to be issued.
6. **Engagement Performance - The Direction, Supervision and performance:** The Engagement partner shall take responsibility for:
- a) The direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and
 - b) The auditor's report being appropriate in the circumstances.

Direction of the engagement team involves informing the members of the engagement team of matters such as:

- a) Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by SA 200 (Revised).
- b) Responsibilities of respective partners where more than one partner is involved.
- c) The objectives of the work to be performed.
- d) Risk-related issues.
- e) Problems that may arise.
- f) The detailed approach to the performance of the engagement.

Supervision includes matters such as:

- a) Tracking the progress of the audit engagement.
- b) Considering the competence and capabilities of individual members of the engagement team.
- c) Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- d) Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

7. Reviews:

- a) The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.
- b) On or before the date of the auditor's report, the engagement partner shall, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions and the auditors report.

8. Consultation: The engagement partner shall:

- a) Take responsibility for the engagement team undertaking appropriate consultation of difficult matters;
- b) Be satisfied that engagement team have undertaken consultation both within the engagement team and between the engagement team and others;
- c) Determine that conclusions resulting from such consultations have been implemented.

9. Engagement Quality Control Review:

a) For audits of financial statements of listed entities and those other audit engagement quality control reviews is required, the engagement partner shall:

- i) Determine that an engagement quality control reviewer has been appointed,
- ii) Discuss significant matters with the engagement quality control reviewer, and
- iii) Not date the auditor report until the completion of the engagement quality control review.

b) The engagement quality control reviewer shall evaluate the following:

- i) Discussion of significant matters with the engagement partner
- ii) Review of the financial statements and the proposed auditors report
- iii) Review of selected audit documentation and
- iv) Conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

c) For audits of financial statements of listed entities, the engagement quality control reviewer shall also consider the following:

- i) The engagement team's evaluation of the firms independence
- ii) Whether appropriate consultations has taken place and the conclusions arising from those consultations
- iii) Whether audit documentation selected for reviews reflects the work performed and supports the conclusions reached.

10. Monitoring: A monitoring process is designed to provide the firm with reasonable assurance that its policies and procedures relating to quality control are relevant adequate and operating effectively. The engagement partner shall consider the result of the firms monitoring process.

PRACTICAL QUESTIONS

Q.No.1. Write short notes on Supervision of audit work.

(M 07)

According to SA – 220, the person who is responsible for supervision of audit work should perform the following:

- a) Check the audit work in progress to find out whether the assistants are discharging their duty well.
- b) Monitor the audit direction.
- c) Modify the audit plan and Programme according to the need.
- d) Check the differences that arise due to professional judgement.

Q.No.2. Quality control for audit work at firm level.

(N 07, PM)

Refer: Para- 2, 3, 4, 5, 6, 7, 8, 10

Q.No.3. Mention any four special points which assists the auditor in accepting and continuing of relationship with the client as per SA 220.

(M 15 - 5M)

Refer: Para - 4

Q.No.4. Explain the concept and procedures of Engagement Quality Control Review under SA- 220.

Refer: Para- 9

SA 230 (Revised) AUDIT DOCUMENTATION (w.e.f. 1st April' 2009)

1. **Objective, Nature & purposes of Audit documentation:** Audit documentation provides:

- a) *Evidence of the auditor's basis for audit report; and*
- b) *Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.*

2. **Audit documentation serves a number of additional purposes, including the following:**

Refer: Chapter 4 - Q.No.3

3. However, this standard does not any way limit the specific documentation requirements of other SAs.

4. **Definitions:**

- a) **Audit documentation:** The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (working papers).
- b) **Audit file:** One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

5. **Form, Content and Extent of Audit Documentation:**

Refer: Chapter 4 - Q.No.3

6. **Preparation of working papers:**

- a) *Working papers should be designed and properly organized to meet the circumstances of each audit and the auditor's needs.*
- b) *They should be standardized to facilitate delegation and control of work.*
- c) *They should be adequately complete and detailed so as to enable the auditor to have an overall understanding of the audit.*
- d) *All significant matters, which require the exercise of judgement and the auditor's conclusion as regards them, should be included in working papers.*
- e) *The auditor should ensure that the schedules, analysis and other working papers prepared by the client and utilized in the course of the audit have been properly prepared.*
- f) *In case of recurring audits, some working paper files may be classified as permanent audit files and current audit files.*

7. Audit completion memorandum:

- a) The auditor may consider it helpful to prepare and retain as part of audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross references to other relevant supporting audit documentation that provides such information.
- b) Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits.
- c) Further, the preparation of such a summary may assist the auditor's consideration of the significant matters.
- d) It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective.

8. If, in exceptional circumstances, the auditor departs from SA, the auditor shall document the reasons for the departure and alternative procedures performed.

9. **Matters Arising after the Date of the Auditor's Report:** If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

- a) The circumstances encountered;
- b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- c) When and by whom the changes to audit documentation were made and reviewed.

10. The auditor shall complete the process of assembling the audit documentation in an audit file.

11. Ownership and custody of working papers:

Refer: Chapter 4 - Q.No.3

12. **Auditor's duties – Documentation of Audit procedures:** The Auditor shall prepare Audit Documentation that is sufficient to enable an experienced Auditor, having **no previous connection with the audit**, to understand –

- a) The nature, timing, and extent of the audit **procedures** performed to comply with the SAs and applicable legal and regulatory requirements,
- b) The **results** of the audit procedures performed and the audit evidence obtained, and
- c) **Significant** matters arising during the audit, conclusions reached thereon, and significant professional judgments made in reaching those conclusions, e.g.
 - i) Matters that give rise to significant risks.
 - ii) Results of Audit procedures indicating
 - That the Financial Statements could be materially mis-stated, or
 - A need to revise the Auditor's previous assessment of the risks of material mis-statement and the Auditor's responses to those risks.
 - iii) Circumstances that cause the Auditor significant difficulty in applying necessary audit procedures.
 - iv) Findings that could result in a modification to the audit opinion, or the inclusion of an Emphasis of Matter Paragraph in the Auditor's Report.

ADVANCED

13. Assembly of Final Audit File:

- a) The Auditor shall assemble the audit documentation in an **Audit File**, and complete the administrative process of assembling the Final Audit File on a timely basis after the date of the Auditor's Report. (i.e., not more than 60 days after the date of Auditor's Report)
- b) The completion of the assembly of the Final Audit File after the date of the Auditor's Report is an **administrative process** that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature, Examples of such changes include –
 - i) Deleting or discarding superseded documentation.
 - ii) Sorting, collating and cross referencing working papers.
 - iii) Signing off on completion checklists relating to the file assembly process.
- c) Documenting audit evidence that the Auditor has obtained, discussed and agreed with the relevant members of the Engagement Team before the date of the Auditor's Report.
- d) After the assembly of the Final Audit File has been completed, the Auditor shall **not** delete or discard audit documentation of any nature before the end of the **retention period** [i.e. **minimum 7 years** from the date of Auditor's Report.]
- e) In circumstances other than those envisaged in Para 13 where the Auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the Final Audit File has been completed, the Auditor shall, regardless of the nature of the modifications or additions document –
 - i) To specific reasons for making them, and
 - ii) When and by whom they were made and reviewed.

PRACTICAL QUESTIONS

Q.No.1. What are audit working papers? Why should they be carefully preserved by the auditor?
(PM, N14RTP)

Ans: Write Para – 2, 4.

Q.No.2. A CA firm, established in 1958 were the auditors of a PSU for the years 1984-85, 1985-86 and 1986-87. They were also auditors of a few nationalized bank branches and insurance offices. They are still keeping audit working papers/files for all these years. Suggest whether there is any guideline/law or rules regarding the period for which the audit working files should be kept? Is it also relevant for other audits (i.e. Private limited companies, partnership firms, trusts etc.)

Ans: Write Para – 5

Q.No.3. What points in relevance to SA-230 should be kept in view while preparing an audit programme? **(N 08)**

Ans: SA-230 on "documentation" lays down the preparation of an audit programme for documenting the steps taken while conducting an audit.

The following points shall be kept in mind while preparing an audit programme as per SA-230:

- a) Audit programme shall consider the nature, timing and extent (NTE) of audit procedures to be performed which should be documented.
- b) The programme shall include the complexities of clients business, condition of his record and degree of reliance on internal control should be recorded.
- c) Audit programme should be designed in a manner so as to obtain an overall understanding of an audit.
- d) Audit programme shall be such so as to use the schedules and other working papers in order to improve the audit efficiency.
- e) Audit programme shall be such so as to improve the efficiency of the audit conducted by the auditor.

Therefore, audit programme is an important tool of documentation.

Q.No.4. M/s health zone, a partnership firm running a nursing home, has decided to discontinue you as an auditor for the next year, and requests you to handover all the relevant working papers of the previous years. Comment. (or) discuss the concept of "lien on working papers".

Owner ship & custody of working papers:-

- a) Working papers are the property of the auditor.
- b) At his discretion, may make any portions or extracts from working papers available to the client.
- c) The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of records retention.

SA 240 (Revised) THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS (w.e.f. 1st April 2009)

1. **Scope of this SA:** Specifically, it expands on how SA 315 and SA 330 are to be applied in relation to risks of material misstatement due to fraud
2. **Objective of the Auditor:**
 - a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
 - b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud;
 - c) To respond appropriately to identified or suspected fraud
3. **Definitions:**
 - a) **Fraud:** An intentional act by one or more individuals among management, TCWG, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
 - b) **Fraud risk factors:** Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

4. Characteristics of Fraud:

- a) Misstatements in the financial statements can arise from either fraud (intentional) or error (unintentional).
- b) The auditor is concerned with fraud that causes a material misstatement in the financial statements.
- c) Fraud may be of two types:

Refer:

5. Responsibility for the Prevention and Detection of Fraud: The primary responsibility for the prevention and detection of fraud rests with both TCWG and management. This involves a commitment to creating a culture of honesty and ethical behavior.

6. Responsibilities of the Auditor:

- a) An auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement
- b) As described in SA 200, due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected even though the audit is properly planned and performed in accordance with the SAs.
- c) The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.
- d) The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud as management can manipulate accounting records.
- e) It is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.
- f) Auditor is responsible for maintaining an attitude of professional skepticism throughout the audit.

REQUIREMENTS

1. Professional Skepticism:

- a) *The auditor shall maintain an attitude of professional skepticism throughout the audit.*
- b) *He should recognize the possibility that a material misstatement due to fraud could exist.*
- c) *Unless doubtful situations are present, the auditor may accept records and documents as genuine.*
- d) *If conditions cause the auditor to believe that a document may not be authentic or that terms in a document have been modified, the auditor shall investigate further.*
- e) *Where responses to inquiries of management or TCWG are inconsistent, the auditor shall investigate the inconsistencies.*

2. *Engagement team should discuss how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.*

3. Risk Assessment Procedures and Related Activities:

- a) ***Enquiring Management and Others within the entity:*** The auditor shall make inquiries of management regarding:
 - i) *Management's assessment of the risk of material misstatement due to fraud;*
 - ii) *Management's process for identifying & responding to the risks of fraud in the entity.*
 - iii) *Management's communication, if any, to those charged with governance; and*

- iv) Management's communication, if any, to employees on business practices & ethical behavior.*

For those entities that have an internal audit function, the auditor shall make inquiries of internal auditor.

b) Enquiring Those Charged with Governance:

- i) He shall obtain an understanding of how TCWG supervise management's processes.*
 - ii) The auditor shall ask TCWG whether they have knowledge of any fraud affecting the entity*
- c) The auditor shall evaluate whether unusual or unexpected relationships identified in performing analytical procedures, may indicate risks of material misstatement due to fraud.**
- d) Other Information:** *The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.*
- e) Evaluation of Fraud Risk Factors:**
- i) The auditor shall evaluate whether the information obtained, indicates that one or more fraud risk factors are present*
 - ii) However, fraud risk factors may not necessarily indicate the existence of fraud.*

4. Audit Risk:

Refer: Chapter 3 - Q.No.8

- 5. Assessment of Audit Risk:** *When the auditor assesses the inherent risk and control risk, he should particularly assess the possible material misstatement due to error or fraud. The possibility of misstatement due to fraud will depend on the presence of "FRAUD RISK FACTORS"; these fraud risk factors may be classified into two categories:*

- a) Relating to fraudulent financial reporting.*
- b) Relating to misappropriation of assets.*

- 6. In accordance with SA315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures by understanding of the entity's related controls, including control activities, relevant to such risks.**

- 7. In accordance with SA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. For this auditor shall:**

- a) Assign and supervise personnel as per their capability;*
- b) Evaluate whether accounting policies adopted by the entity indicate fraudulent financial reporting resulting from management's effort to manage earnings; and*
- c) Incorporate surprise element in the selection of the Nature, Timing, Extent of audit procedures.*
- d) Design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.*
- e) Need to perform extra audit procedures incase management perpetrate fraud by overriding controls.*

8. Evaluation of Audit Evidence:

- a) The auditor shall evaluate whether analytical procedures are consistent with the auditor's understanding of the entity and its environment*
- b) When the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud.*
- c) If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.*

- d) *If the auditor identifies a misstatement, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures.*
- e) *When the auditor confirms that the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implication for the audit.*

9. Auditor Unable to Continue the Engagement:

- a) Determine the Professional and legal responsibilities applicable in the circumstances.
- b) Consider whether it is appropriate to withdraw from the engagement; and
- c) If he withdraws, discuss with management and TCWG along with the reasons for withdrawal; and
- d) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities.

10. Management Representations:

- a) Its responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- b) It has disclosed to the auditor the results of its assessment of the risk of fraud;
- c) It has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements.

11. If the auditor has identified a fraud or has indication of fraud, the auditor shall communicate these matters on a timely basis to the appropriate level of management and TCWG.

12. Communication with Regulatory and Enforcement Authorities: The disclosure of fraud or error to parties other than the client's senior management and TCWG ordinarily is not part of auditor's responsibility and is ordinarily excluded by the auditor's ethical or legal obligations of confidentiality. However, in the following circumstances a duty to discuss outside the entity may exist-

- a) To comply with legal or regulatory requirement as per law in force.
- b) A successor auditor as per clause 8 of part I of the first schedule of CA Act, 1949.
- c) To a funding agency in accordance with the requirement of the audit engagements.

Example: As per Companies Act, 2013, LFAR for banks as per RBI Guidelines

PRACTICAL QUESTIONS

Q.No.1. Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from management fraud. **(N 09 - 6M)** (OR)
'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defence as an auditor? **(PM)** (OR)
What are the auditor's responsibilities for detection of Frauds and Errors?

As per SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

Fraud involving one or more members of management or those charged with the governance is referred to as "management fraud". The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

SA 200, "Objective and General Principles Governing an Audit of Financial Statements," indicates that an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit; the auditor does not guarantee that material misstatements will be detected.

Q.No.2. While conducting statutory audit of ABC Ltd., you come across cash balance shown in books of Rs.2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of Rs.50,000 are withdrawn from the bank to meet day-to-day expenses. **(5M)**

According to SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

Q.No.3. While auditing accounts of a public limited company for the year ended 31st march 2003, an auditor found out an error in the valuation of inventory, which affects the financial statement materially. **(5M)**

Errors in Valuation of Inventories and Auditor's Responsibilities: SA-240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information.

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. SA-240 also requires that the auditor should consider the implications of the misstatement in relation to other aspects of the audit, particularly, the reliability of management representations.

Further, SA- 320 also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

Q.NO.4. As a statutory auditor, how would you deal with the following? The managing director of the company has committed a “teeming and lading” fraud. The amount involved has been however subsequently after the year end deposited in the company. **(4M)**

Fraud Committed by Managing Director: The Managing Director of the company has committed a “Teeming and Lading” fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA-240, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements”. First of all, as per SA - 240, the auditor need to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor need to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management. Finally, the auditor shall have to report under CARO, 2016 indicating the nature and amount involved in respect of fraud noticed during the year.

Q.No.5. As a statutory auditor, how would you deal with the following? You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. **(5M)**

Impossibility to continue the performance of audit: If an auditor concludes that it is not possible to continue the performance of auditing because of misstatement resulting from fraud or suspected fraud, he should take action in accordance with the requirement of SA-240 “The Auditor’s Responsibility to consider Fraud and Error”.

- a) He should consider the professional and legal responsibilities applicable in the circumstances including whether there is a requirement for the auditor to report to the person(s) who made the audit appointment
- b) He should consider whether he has to report to the regulatory authorities.
- c) If the auditor withdraws, he should discuss with the appropriate level of management and those who charged with the governance about the reasons for the withdrawal.

In view of the exceptional nature of circumstances and the need to consider the legal requirement, he may also seek legal advice for determining the appropriate course of action.

TRUE OR FALSE QUESTIONS (FOR STUDENT SELF STUDY)

1. When an auditor identifies a Misstatement resulting from fraud, it is his responsibility to communicate it to the regulatory and enforcement authorities apart, from those charged with governance.

True: As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” an auditor identifies a misstatement resulting from fraud or error it is his responsibility to communicate the matter with those charged with the governance and, in some circumstances, when so required by laws or regulations, to regulatory and enforcement authorities also.

**SA 250 (Revised) THE AUDITOR'S RESPONSIBILITIES RELATING TO LAWS AND REGULATIONS
IN AN AUDIT OF FINANCIAL STATEMENTS (w.e.f.1st April 2009)**

1. **Definition:** *Non-compliance*—Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.
2. **Effect of Laws and Regulations:**
 - a) The Provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements.
 - b) Other laws or regulations are to be complied with by management but do not have a direct effect on an entity's financial statements.
 - c) Some entities operate in heavily regulated industries (such as banks and chemical companies).
 - d) Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements
3. It is the responsibility of management, TCWG to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations.
4. **Responsibility of the Auditor:**
 - a) The requirements in this SA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations.
 - b) However, the auditor is not responsible for preventing non compliance and cannot be expected to detect non-compliance with all laws and regulations.
 - c) This SA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:
 - i) The provisions of those laws and regulations having a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws; and
 - ii) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business.
5. **Indicators of non-compliance:**
 - a) Investigations by regulatory organisations & government departments or payment of fines or penalties.
 - b) Payments for unspecified services or loans to consultants, related parties, employees or government employees.
 - c) Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
 - d) Purchasing at prices significantly above or below market price.
 - e) Unusual payments towards legal and retainer ship fees.
 - f) Unusual transactions with companies registered in tax havens.
 - g) Payments without proper exchange control documentation.
 - h) Existence of an information system which fails to provide adequate audit trail or sufficient evidence
 - i) Unauthorised transactions or improperly recorded transactions.
 - j) Adverse media comment.

6. The Auditor's Consideration of Compliance with Laws and Regulations:

- a) The auditor shall obtain a general understanding of:
 - i) The legal and regulatory framework applicable, to the entity and the industry or sector in which the entity operates; and
 - ii) How the entity is complying with that framework.
- b) The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.
- c) The auditor shall perform the following audit procedures to identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:
 - i) Inquiring of management; and
 - ii) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.
- d) During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.
- e) Obtain written representation that all known instances of non-compliance or suspected non-compliance with laws and regulations have been disclosed to the auditor.

7. Audit Procedures When non-compliance is identified or suspected:

- a) If the auditor becomes aware of information concerning an instance of non compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:
 - i) An understanding of the nature of the act and the circumstances in which it has occurred; &
 - ii) Further information to evaluate the possible effect on the financial statements.
- b) If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and those charged with governance.
- c) If management or those charged with governance do not provide sufficient information the auditor shall consider the need to obtain legal advice.
- d) If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

8. Reporting of Identified or Suspected Non – Compliance

a) Reporting Non – Compliance to Those Charged with Governance:

- i) Unless all of those charged with governance are involved in management of the entity, the auditor shall communicate with those charged with governance matters involving non compliance with laws and regulations that come to the auditor's attention.
- ii) If, in the auditor's judgment, the non-compliance is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.
- iii) If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon, the auditor shall consider the need to obtain legal advice.

b) Reporting Non-Compliance in the Auditor's Report on the Financial Statements:

- i) If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, express a qualified or adverse opinion on the financial statements.
- ii) If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion.
- iii) If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion.

c) Reporting Non-Compliance to Regulatory and Enforcement Authorities: If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

9. Withdrawal from the engagement:

- a) *In exceptional cases, the auditor may consider withdrawal from the engagement is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice.*
- b) *If withdrawal from the engagement is prohibited, the auditor may consider alternative actions*

10. Documentation: The Auditor shall document identified or suspected non-compliance with laws and regulations, and the results of discussion with Management & Governance Team and other external parties. It includes:

- a) Copies of records or documents,
- b) Minutes or discussions held with Mgmt. Governance Team or Other Parties.

PRACTICAL QUESTIONS

Q.No.1. List the auditor's duties under SA-250 in consideration of laws and regulations in his audit. (OR) Explain what the auditor may perform to obtain such general understanding of the legal and regulatory framework applicable to the entity. **(N15RTP)**

Ans: Refer Para: 6

Q. No.2. Discuss briefly the role of a statutory auditor in relation to unlawful acts or defaults by the clients. What should the auditor do when non-compliance is discovered?

Ans: Refer Para: 7 & 8

Q. No.3. State the reporting responsibility of an auditor in the context of non-compliance of law and regulation in an audit of financial statement. **(8M)**

Ans: Refer Para: 7 & 8

Q.No.4. "Management is responsible for compliance with laws and regulations" - Comment.

Ans: Refer Para: 3 & 4

Q.No.5. Discuss the following:

With reference of SA 250 give some examples or matters indicating to the auditor about non compliance of laws & regulations by management. **(N13, PM, M15 MTP2 - 5M)**

Ans: Refer Para: 5.

SA 260 (Revised) COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE (w.e.f. 1st April 2009)

1. Definitions:

- a) **Those charged with governance:** *The Person(s) or organization(s) (e.g. a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.*
- b) **Management:** *The person(s) with executive responsibility for the conduct of the entity's operations.*

2. Matters to be Communicated:

- a) **The Auditor's Responsibilities in Relation to the Financial Statement Audit:** The Auditor shall communicate with TCWG the responsibilities of the auditor in relation to audit, including that:
- i) The auditor is responsible for forming and expressing an opinion on the financial statements;
 - ii) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities
- b) **Planned Scope and Timing of the Audit:** The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit.
- c) **Significant findings from the audit:** The auditor shall communicate with TCWG:
- i) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
 - ii) Significant difficulties, if any, encountered during the audit;
 - Significant delays in management providing required information.
 - An unnecessarily brief time within which to complete the audit.
 - Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
 - The unavailability of expected information.
 - Restrictions imposed on the auditor by management.
 - Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.
 - iii) Material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management;
 - iv) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
 - v) Written representations the auditor is requesting; and
 - vi) Other matters, if any, arising from the audit that, in the auditor's professional judgment are significant to the oversight of the financial reporting process.
- d) **Auditor Independence:** In the case of listed entities, auditor shall communicate with TCWG:

- i) A Statement that the engagement team and others in the firm have complied with relevant ethical requirements regarding independence; and
 - All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence;
 - The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.
 - This shall include Total Fees charged during the period covered by the Financial Statements for audit and non-audit services provided by the Firm and Network Firms to the Entity and components controlled by the Entity.

3. The Communication Process: (N15, PM, N15 MTP2-5M, N14RTP)

- a) **Establishing the Communication Process:** *The Auditor shall communicate with those charged with governance the form, timing and expected general content of communications.*
- b) **Forms of Communication:** *The auditor shall communicate in writing with those charged with governance regarding significant matters and Auditors Independence.*
- c) **Timing of Communications:** *The auditor shall communicate on a timely basis to TCWG.*
- d) **Adequacy of the communication process:** *The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect on the auditor's assessment of the risks of material misstatement.*

ADVANCED

4. Forms of Communication:

The form of communication (e.g. whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a structured or unstructured manner) may be affected by factors like –

- a) Whether the matter has been satisfactorily resolved.
- b) Whether Management has previously communicated the matter.
- c) Size, operating structure, control environment, and legal structure of the Entity.
- d) In the case of an audit of Special Purpose Financial Statements, whether the Auditor also audits the Entity's General Purpose Financial Statements.
- e) Legal requirements (In some cases, a written communication with Those Charged with Governance is required in a prescribed form by local law).
- f) Expectations of Those Charged with Governance, including arrangements made for periodic meetings or communications with the auditor.
- g) The amount of ongoing contact and dialogue the Auditor has with Those Charged with Governance.
- h) Whether there have been significant changes in the Membership of a Governing Body.

5. Communication with Third Parties

- a) In some cases, disclosure to third parties may be illegal or otherwise inappropriate,
- b) Communication to Third Parties may be appropriate, where the Governance Team itself may wish to provide Third Parties (e.g. Bankers or Regulatory Authorities), with copies of a written communication from the Auditor.
- c) In such cases, the Third Parties must be informed that the communication was not prepared with them in mind. This may be done, by stating in written communications-
 - i) That the communication has been prepared for the sole use of Those Charged with Governance (where applicable, the Group Management & the Group Auditor), and should not be relied upon by Third Parties.

- ii) That no responsibility is assumed by the Auditor to Third Parties and
- iii) Any restrictions on disclosure or distribution to Third Parties.
- d) An Auditor may also be required by Laws or Regulations to, for example –
 - i) Notify a Regulatory or Enforcement Body, of certain matters communicated with Those Charged with Governance. In such cases, the Auditor has a duty to report mis-statements to authorities where Management and Those Charged with Governance fail to take corrective action.
 - ii) Submit copies of certain reports prepared to relevant Regulatory or Funding Bodies, or other bodies (such as Central Government in the case of some Public Sector Undertakings) or
- e) Make reports prepared for Those Charged with Governance publicly available.

PRACTICAL QUESTIONS

Q.No.1. “The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity”. Briefly state the matters to be included in such communication. **(M15MTP1-5M)**

Ans: Refer Para: 2.

Q.No.2. Discuss with reference to SAs:
The auditor shall communicate all significant findings with those charged with Governance. **(N15, PM, N14 MTP1-4M)**

Ans: Refer Para: 2(c).

Q.No.3. State the significant difficulties encountered during the Audit with reference to SA 260. **(M15 - 6M, N15RTP)**

Ans: Refer Para: 2(c)(ii).

Q.No.4. What are the factors affecting the form of communication under SA – 260.

Ans: Refer Para: 4.

SA 265 COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT (on or after April 1, 2010)

1. Definitions:

- a) **Deficiency in internal control:** This exists when:
 - i) A Control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or
 - ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
- b) **Significant deficiency in internal control:** A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

2. Auditor's obligation Requirements: The auditor is not obliged to search specifically for deficiency in internal control to be reported, however auditor has responsibility under this SA to follow the following auditing procedures:

- a) Identify the deficiencies
- b) Whether the deficiencies identified are significant

Matters to be considered in determining whether deficiency(ies) is a Significant Deficiency

- i) Likelihood of the deficiencies leading to material mis-statements in the Financial Statements in the future.
 - ii) Susceptibility to loss or fraud of the related asset or liability.
 - iii) Subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
 - iv) Financial Statement amounts exposed to the deficiencies.
 - v) Volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
 - vi) Cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
 - vii) Interaction of the deficiency with other deficiencies in internal control.
 - viii) Importance of the controls to the financial reporting process, e.g. – (a) Controls over significant transactions with related parties, (b) Controls over significant transactions outside the entity's normal course of business, (c) Controls over the period-end financial reporting process (Such as controls over non-recurring journal entries).
- c) Communicate in writing significant deficiencies in internal control identified during the audit to TCWG on a timely basis.
- d) Communicate to the Management.
- i) The auditor shall determine whether, he has identified the deficiencies in internal control
 - ii) If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, they constitute significant deficiencies.
 - iii) The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to TCWG on a timely basis.
 - iv) The auditor shall communicate significant deficiencies in internal control regarding:
 - A description of the deficiencies and an explanation of their potential effects; and
 - Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:
 - The Purpose of the audit was for the auditor to express an opinion on the financial statements.
 - The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
 - The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance.

3. Indicators of significant deficiencies in internal control include:

- a) Evidence of ineffective aspects or the control environment, e.g. (a) Indicators that significant transactions in which management is financially interested are not being appropriately scrutinised by Those Charged with Governance, (b) Identification of management fraud, that was not prevented by the entity's internal control (c) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- b) Absence of a risk assessment process within the entity or an evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement.
- c) Evidence of an ineffective response to identified significant risks (e.g. absence of controls over such a risk).
- d) Misstatements detected by the Auditor that were not prevented, or detected and corrected, by the internal controls.
- e) Disclosure of a material misstatement due to error or fraud as prior period items in the current year.
- f) Evidence of management's inability to oversee the preparation of the financial statements.

ADVANCED

4. Previous Communication / Continuous Deficiencies: Management and Those Charged with Governance may already be aware of significant or other deficiencies that the Auditor has identified during the audit (or a previous audit) and may have chosen not to remedy them because of cost or other considerations. In such cases, the Auditor has the following responsibilities –

In case of known Significant Deficiencies	In case of known Other Deficiencies
The Auditor shall repeat the communication, if remedial action has not yet been taken, by: a) Repeating the description from the previous communication, or b) Simply giving reference to the previous communication.	In case of known Other Deficiencies communicated to Management in prior periods, the Auditor need not repeat the communication in the current period, except in case of: a) a change of Management, or b) If new information has come to the Auditor's attention that alters the prior understanding of the Auditor and Management regarding the deficiencies.

Note: The failure of Management to remedy significant or other deficiencies in internal control that were previously communicated, may become a significant deficiency by itself, requiring communication with Those Charged with Governance.

PRACTICAL QUESTIONS

Q.No.1. Define the terms under SA -265

- i) Deficiency in Internal Control,
- ii) Significant Deficiency in Internal Control

Ans: Refer Para: 1.

Q.No.2.What are the Auditor's duties under SA -265 with respect to Communicating Deficiencies in Internal Control to Those Charged with Governance and Management?

Ans: Refer Para: 2(d).

SA 299 RESPONSIBILITY OF JOINT AUDITORS.

1. Joint Auditor:

- a) **Meaning:** When two or more practicing units are appointed to conduct audit of an entity.
- b) **Why:** Due to voluminous work in large entities.

2. Division of work:

- a) **Basis of Division:** Joint Auditor should divide work among themselves on basis of Period, Functional areas, Components of financial statements, or Geographical location, etc.
- b) **Documentation:** Such division should be adequately documented.
- c) **Reliance:** Each joint Auditor is entitled to rely on other Joint Auditor. There is no need to review work done by other joint auditor.

3. Co-ordination: If some joint Auditor comes to know a matter, relevant for other Joint Auditor, then he should communicate it immediately in writing to other joint auditors. The date of such communication should be before date of audit report.

4. Responsibility:

- a) **Separate responsibility of each Joint Auditor for:** Work allocated to him, drafting his own audit program, keeping appropriate documentation, components allocated to him.
- b) **Joint and Several responsibility of all joint auditors:**
 - i) Audit work not divided.
 - ii) Collective decision w.r.t. NTE of audit Procedure.
 - iii) Matters brought to knowledge of all by any one of them and on which they all agree.
 - iv) Disclosure requirements in financial statement.
 - v) Compliance of Audit Report with statutory requirement.

5. Difference of Opinion:

- a) Generally all arrive at unanimous opinion.
- b) However, any joint auditor is not bound by majority opinion.
- c) Those disagreeing with others may provide their own opinion through a separate report.

PRACTICAL QUESTIONS

Q.No.1. Highlight the principles in sa-299 on division of work among joint auditors.

Ans: Refer Para: 2

Q.No.2. Bring out the nature of responsibility of joint auditors. (OR) The responsibilities of joint auditors are joint and several. Discuss. (PM)

Ans: Refer Para: 4

Q.No.3. E & S were appointed as joint auditors of X & Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the attention of both the auditors?

Ans: Refer SA : 200 & London General Bank Case.

Q.No.4. If there is difference of opinion among the joint auditors with respect to any matter, majority joint auditor's opinion will prevail while reporting. Comment? (OR)
'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.'
Justify this statement in the light of responsibilities of Joint Auditors under SA 299. (PM)

Ans: Refer Para: 5

Q.No.5. One of the three joint auditors of a company differs from the views of the other two auditors with regard to certain matters to be covered by the report. Discuss his rights and duties in this regard.

Ans: Refer Para: 5

Q.No.6. State with reasons (in short) whether the following statements are true or false:
All the joint auditors are jointly and severally responsible for the work, which is not dividend and carried on jointly by all the joint auditors. (N15 – 6M)

Ans: Refer Para: 4

Q.No.7. Write short note on responsibility of joint auditors (4M)

Ans: Refer Para: 4

Q.No.8. In joint audit each joint auditor is responsible only for the work allocated to him – comment (PM)

Ans: Refer Para: 4

SA 300 (Revised) PLANNING AN AUDIT OF FINANCIAL STATEMENTS (w.e.f. 1st April 2008)

1. **Scope of this SA:** It deals with the auditor's responsibility to plan an audit of financial statements. This SA is framed in the context of recurring audits. Additional considerations in initial audit engagements are separately identified.
2. **Involvement of Key Engagement Team Members:** The engagement partner and other key members of the engagement team shall be involved in planning the audit.
3. **Steps to be considered in planning an audit:**
 - a) Preliminary engagement activities to be undertaken
 - b) Planning activities so that overall audit strategy is established that sets the scope, timing and direction of the audit, and the guides the development of the audit plan.
 - c) Documentation requirements
 - d) Additional consideration to be undertaken in initial audit engagements.

4. **Preliminary Engagement Activities:** The auditor shall undertake the following activities at the beginning of the current audit engagement:
- a) Performing procedures required by SA 220 regarding the continuance of the client relationship;
 - b) Evaluating compliance with ethical requirements, including independence, as required by SA 220; and
 - c) Establishing an understanding of the terms of the engagement, as required by SA 210.
5. **Planning Activities:**
- a) The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
 - b) In establishing the overall audit strategy, the auditor shall;
 - i) Identify the characteristics of the engagement that define its scope;
 - ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
 - iii) Consider the factors that are significant in directing the engagement team's efforts;
 - iv) Consider the results of preliminary engagement activities.
 - v) Ascertain the Nature, Timing and Extent of procedures.
 - c) The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.
 - d) The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.
6. **Documentation:** The auditor shall document:
- a) The overall audit strategy;
 - b) The audit plan; and
 - c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
7. **Additional Considerations in Initial Audit Engagement:** The auditor shall undertake the following activities prior to starting an initial audit:
- a) Performing procedures required by SA 220 regarding the acceptance of the client relationship and the specific audit engagement; and
 - b) Communicating with the predecessor auditor where there has been a change of auditors, in compliance with relevant ethical requirements.

PRACTICAL QUESTIONS

Q.No.1. The overall audit strategy and audit plan is subject to updates and changes during the course of audit. Comment

Ans: Refer Para: 5

Q.No.2. In late spring of 2003 you are advised of a new assignment as in – charge accountant of your ca firm’s recurring annual audit of a major client, the maruti udyog ltd. You are given the engagement letter for the audit covering the financial year march 31, 2003, and a list of personnel assigned to this audit. It is your responsibility to plan and supervise the work for the audit. Required: discuss the necessary preparation and planning for the maruti udyog ltd. Annual audit prior to beginning the work at the client's office. In your discussion include the sources you should consult, the type of information you should seek, the preliminary plans and preparation you should make for the work, and any actions you should take relative to the staff assigned to the engagement. Do not write an audit program.

Ans: Refer Para: 5

Q.No.3. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, in case of initial audit engagements, the auditor may consider additional matters in establishing the overall audit strategy and audit plan. Explain those additional matters need to be considered as per SA 300. **(N15 MTP1 - 6M)**

Ans: Refer Para: 7

Q.No.4. “Auditor shall establish an overall strategy that sets the scope, timing and directions of the audit, and that guides the development of the audit plan.” **(N14 MTP1 - 5M)**

Ans: Refer Para: 5

**SA 315 IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH
UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT (w.e.f. April 1, 2008)**

1. Objective:

- a) *The auditor should identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.*
- b) *He should understand the entity and its environment, including the entity's internal control.*
- c) *Thus, he can design and implement responses to the assessed risks of material misstatement.*
- d) *This will help the auditor to reduce the risk of material misstatement to an acceptably low level.*

2. Definitions:

- a) **Assertions:** *Representations by management, explicit or otherwise, embodied in the financial statements.*
- b) **Business risk:** *A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect and entity's ability to achieve its objectives.*
- c) **Internal Control:**
 - i) *The process designed, implemented and maintained*
 - ii) *By those charged with governance, management and other personnel*
 - iii) *To provide reasonable assurance about the achievement of an entity's objectives*
 - iv) *With regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of asserts, and compliance with applicable laws and regulations.*

- d) **Risk assessment procedures:** *The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement at the financial statement and assertion levels.*
 - e) **Significant risk:** *An identified and assessed risk of material misstatement that requires special audit consideration.*
 - f) **Material Weakness:** *A weakness in internal control that could have a material effect on the financial statements.*
3. **What is audit risk:** Audit risk is the risk that monetary error greater than tolerable limit will remain undetected and the auditor gives an audit opinion which is not appropriate. Tolerable error is an error that would not materially mistake the financial statements.
4. **Types of audit risk:**
Refer: Chapter 3 - Q.No.8
5. **Risk Assessment Procedures and Related Activities:**
- a) Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion
 - b) The risk assessment procedures shall include the following:
 - i) Inquiries of management, and of others within the entity
 - ii) Analytical procedures.
 - iii) Observation and inspection
 - iv) Discussion among the engagement team.
 - c) The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
 - d) Where engagement partner has performed other engagements for the entity, consider whether information obtained is relevant to identifying risks of material misstatement.
 - e) If auditor uses his previous experience, consider the changes occurred since previous audit.
 - f) The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement.
6. **Required understanding of entity and its environment:** Auditor shall obtain an understanding of:
- a) Relevant industry, regulatory, and other external factors
 - b) The nature of the entity, including: Its operations; Its ownership and governance structures; types of investments; and the way that the entity is structured and how it is financed;
 - c) The entity's selection of accounting policies, including the reasons for changes thereto.
 - d) The entity's objectives and strategies.
 - e) The measurement and review of the entity's financial performance.
7. **The entity's internal control:**
- a) *The auditor shall obtain an understanding of internal control relevant to the audit.*
 - b) *Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.*
8. **Nature and extent of the Understanding of Relevant Controls:** He'll evaluate the design of controls and determine whether they have been implemented.
- a) **Control Environment:** *The auditor shall evaluate whether:*

- i) Management, with those charged with governance, has created and maintained a culture of honesty and ethical behaviour; and
- ii) The strengths in the control environment provide an appropriate foundation for the other components of internal control.

b) The entity's risk assessment process:

- i) Consider if entity has a process for:
 - Identifying business risk relevant to financial reporting objectives;
 - Estimating the significance of the risks;
 - Assessing the likelihood of their occurrence; and
 - Deciding about actions to address those risks.
- ii) If the entity has established entity's risk assessment process, the auditor shall obtain an understanding of it, and the results thereof.

c) The information system, including the related business process, relevant to financial reporting, and communication: The auditor shall obtain an understanding of the following areas:

- i) The classes of transactions;
- ii) The procedures, within both information technology(IT) and manual systems, by which those transactions are initiated, recorded, processed and reported in the financial statements;
- iii) The related accounting records.
- iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- v) The financial reporting process,
- vi) Controls surrounding journal entries.

The auditor shall obtain an understanding of:

- i) Communications between management and those charged with governance; and
- ii) External communications, such as those with regulatory authorities.

d) Control activities relevant to the audit:

- i) The auditor shall obtain an understanding of control to assess the risk of material misstatement at the assertion level and design further audit procedures.
- ii) In understating the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT.

e) Monitoring of controls: Obtain an understanding of the:

- i) Activities that the entity uses to monitor internal control over financial reporting, and
- ii) Sources of the information used in the entity's monitoring activities and their reliability.

9. Identifying and Assessing the Risks of material misstatement: The auditor shall identify and assess the risks of material misstatement at:

- a) The financial statement level; and
- b) The assertion level for classes of transactions, account balances, and disclosures; to provide a basis for designing and performing further audit procedures

10. Risks that require special audit consideration: In exercising judgment as to which risks are significant risks, the auditor shall consider the following:

- a) *Whether the risks is a risk of fraud;*
- b) *Whether the risk is related to recent significant economic, accounting, or other developments;*
- c) *The complexity of transactions;*
- d) *Whether the risk involves significant transactions with related parties;*
- e) *The degree of subjectivity in the measurement of financial information; and*
- f) *Whether the risk involves significant unusual transactions*

11. Revision of risk assessment: *The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. The auditor shall revise the assessment and modify the further planned audit procedures accordingly*

12. Identifying and assessing the risk of material misstatement: The auditor should identify and assess the risks of material misstatement at the :

1. Financial Statement Level
2. Relevant Assertion Level

1. Financial Statement Level:

- a) Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.
- b) Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level.
- c) Risks at the financial statement level may derive from a weak control environment.
- d) The auditor's understanding of internal control may raise doubt about the auditability of an entity's financial statements. For example –
 - i) Concerns about the integrity of the entity's management
 - ii) Concerns about the conditions and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements.
 - iii) Unusual pressures on the management
 - iv) Nature of the entity's business
 - v) Factors affecting the industry in which the entity operates.

2. Assertion Level:

- a) In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.
- b) Risks of material misstatement at the assertion level for classes of transaction, account balances and disclosures need to be considered.
- c) **Assertion about the classes of transactions:** Occurrence, Completeness, Accuracy, Cut-off, Classification.
- d) **Assertion about account balances:** Existence, Rights and obligations, Completeness, Valuation and allocation.
- e) **Assertion about presentation:** Rights and obligations, Completeness, Classifications and understandability, Accuracy and valuation.

13. The auditor shall communicate material weakness in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by SA 260.

ADVANCED

14. **Control Environment – Elements:** The elements of the Control Environment that may be relevant when obtaining an understanding of the Control Environment include the following-
- a) Communication and enforcement of integrity and ethical values,
 - b) Management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
 - c) Participation by and Attributed of those Charged with Governance,
 - d) Management's Philosophy and Operating Style towards managing business risks, financial reporting, etc.
 - e) Organisational Structure,
 - f) Assignment of Authority and Responsibility, and
 - g) Human Resource Policies & Practices.

PRACTICAL QUESTIONS

Q.No.1. "The auditor may exercise his judgment to identify which risks are significant risks". Explain the above statement as per SA-315. **(M15 – 6M)**

Identifying Significant Risks:

Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- a) Greater management intervention to specify the accounting treatment.
- b) Greater manual intervention for data collection and processing.
- c) Complex calculations or accounting principles.
- d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- a) Accounting principles for accounting estimates or Revenue recognition may be subject to differing interpretation.
- b) Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

SA 330 describes the consequences for further audit procedures of identifying a risk as significant. Significant risks relating to the risks of material misstatement due to fraud

SA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.

Q.No.2. In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment".

(PM, N14 MTP2 - 5M)

Refer Para – 6.

Q.No.3. Write short notes on "Performing Risk Assessment Procedures" under SA – 315.

Refer Para – 5.

Q.No.4. IT systems also pose specific risks to an entity's internal control? What are those risks?

Ans: Specific Risk to an Entity's internal Control: As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are:

- a) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both
- b) Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.
- c) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- d) Unauthorized changes to data in Master files
- e) Unauthorized changes to systems or programs.
- f) Failure to make necessary changes to systems or programs.
- g) Inappropriate manual intervention
- h) Potential loss of data or inability to access data as required.

Q.No.5. Write about relationship between materiality and audit risk.

(M07)

As per SA-315, the auditor should consider materiality & its relationship with audit risk while conducting an audit.

Materiality: The information is material if its misstatement could influence the decision of users taken on the basis of such financial information. It depends on the size and nature of item, judged in the certain cases of mis-statement.

Audit Risk: Audit risk probability 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.

Relationship between materiality & Audit risk:

1. The auditor should:

- a) Assess the inherent and control risks;
- b) Consider the level of detection risk; and
- c) Select appropriate substantive audit procedure based upon his judgement.

2. Audit risk can be reduced by performing substantive procedure. If it is not performed the auditor would fail to detect a misstatement. The more extensive the procedure performed, the lower the detection risk. Nature and timing of substantive procedure will also affect the detection risk.
3. The auditor's assessment of audit risk may change during the course of an audit.

For example, in planning the audit, the auditor may believe that he has low inherent and control risk based on his assessment of the probability of errors occurring on his review & testing of internal control system. After performing audit procedures, if the auditors conclude that his earlier assessment was too low in such case, he would have to carry out additional audit procedures to reduce the level of detection risk.

SA 320 (Revised) MATERIALITY IN PLANNING AND PERFORMING AN AUDIT (On or after April 1, 2010).

1. **Materiality – Meaning, Determination & Evaluation.**

Refer: Chapter 2 - Q.No.11

2. **Determining Materiality and Performance Materiality when Planning the Audit:**

- a) When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole.
- b) The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

3. **Revision as the Audit Progresses:**

- a) The auditor shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the audit that would have caused the auditor to have determined amount initially.
- b) If the auditor concludes that a lower materiality for the financial statements as a whole than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

4. **Inverse Relationship between Materiality and Degree of Audit Risk:** There is an inverse relationship between materiality and the degree of audit risk. So, the higher the materiality level, the lower the audit risk and vice-versa.

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5. **Documentation:** The audit documentation shall include the following amounts and the factors considered in their determination –
- a) Materiality for the financial statements as a whole,
 - b) If applicable, the materiality level(s) for particular classes of transactions, account balances or disclosures,
 - c) Performance Materiality, and
 - d) Any revision of (1) to (3) as the audit progressed.

PRACTICAL QUESTIONS

Q.No.1. How does an auditor determine whether a particular item is material or not?

Ans: Refer Para: 1

Q.No.2 "Auditor's assessment of materiality may be different at the time of planning the engagement than at the time of evaluating the results of his audit procedures. Comment.

Ans: Refer Para: 3

Q.No.3 on the audit of insight India Ltd. The audit partner of the engagement set the preliminary level of audit materiality at Rs.1,000,000. After the partner reviewed the audit senior's assessment of inherent risk, he decided that the materiality level should be increased to Rs.1,500,000. Required:

- a) What is the relationship between materiality and audit risk?
- b) How will this new level of materiality affect the nature and extent of auditing procedures?

a) Relationship between Materiality and Audit Risk: SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality levels the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

b) Extent of checking will be reduced.

Q.No.4 ".With reference to SA 320 indicate the factors which may affect the identification of an appropriate bench mark in determining materiality for the financial statement as a whole.

(N - 15)

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

- i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- v) The relative volatility of the benchmark.

SA 330-THE AUDITORS RESPONSES TO ASSESSED RISKS (w.e.f. April 1, 2008)

1. Definitions:

- a) **Substantive procedure:** An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise (M16 – 2M)
 - i) Tests of details (of classes of transactions, account balances, and disclosures), and
 - ii) Substantive analytical procedures
- b) **Test of controls:** An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

2. Overall Responses: The auditor shall design and implement overall responses to address the assessed risks of material misstatements at the financial statement level, to reduce audit risk to an acceptably low level by obtaining sufficient appropriate audit evidence.

3. Audit procedures responsive to the assessed risks of material misstatement at the Assertion level:

- a) The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.
 - i) **Nature:** The nature of further audit procedures refers to their purpose (tests of controls or substantive procedures) and their type, that is, inspection, observation, inquiry, confirmation, recalculation, re-performance or analytical procedures.
 - ii) **Timing:** Timing refers to when audit procedure are performed of the period or date to which the audit evidence applies.
 - iii) **Extent:** Extent refers to the quantity of a specific audit procedure to be performed.
- b) In designing the further auditor procedures to be performed, the auditor shall
 - i) Consider the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk) and whether the risk assessment takes into account the relevant controls (i.e., the control risk).
 - ii) Obtain more persuasive audit evidence the higher the auditor's assessment of risk

4. Tests of Controls: The auditor shall design and perform tests of controls when

- a) He expects that the controls are operating effectively, or
- b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

5. Timing of tests of Controls: The auditor shall test controls for the particular time, or throughout the period

6. Using audit evidence obtained during an interim period: When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall

- a) Consider significant changes to those controls and
- b) Determine the additional audit evidence to be obtained for the remaining period.

7. If there have been changes in the controls, the auditor shall test the controls in the current audit. If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit.

8. Controls over specific risk: When the auditor plans to rely on controls over a significant risk, the auditor shall test those controls in the current period.

9. Evaluating the operating effectiveness of controls:

- a) Auditor should consider whether misstatements that have been detected indices that controls are not operating effectively
- b) Even if there are no identified misstatements, controls may not be effective
- c) The auditor shall communicate material weakness in internal control identified during the audit on a timely basis to management at an appropriate level and TCWG.

10. Substantive Procedures:

- a) Substantive procedures are performed to detect material misstatement at the relevant assertion level, and include tests of details of classes of transactions, account balances and disclosures and substantive analytical procedures.
- b) Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.
- c) **Substantive procedures related to the financial statements closing process:** The auditor's substantive procedures shall include
 - i) Agreeing or reconciling the financial statements with the underlying accounting records and
 - ii) Examining material journal entries and other adjustments made during the course of preparing the financial statements.
- d) **Substantive procedures responsive to significant risks:** When the auditor has determined a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk
- e) **Timing of substantive procedures:** When substantive procedures are performed at an interim date, the auditor shall cover the remaining period.

11. Evaluating the sufficient and appropriateness of audit evidence:

- a) Auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, auditor shall consider all relevant evidences.
- b) If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, try to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or a disclaimer of opinion.

PRACTICAL QUESTIONS

Q.No.1. Director of KK limited informed their newly appointed statutory auditor that they have sound internal control system implemented by a renowned professional firm and he is satisfied with its effectiveness and functioning and therefore, the statutory auditor concentrate on verifying only the routine books and financial statements.

Ans: Refer Para: 7

Q.No.2. Explain the test of controls and substantive procedures as audit procedure of obtaining sufficient appropriate audit evidence for forming an audit opinion.

(N14 - 4M, PM, N15RTP)

Ans: Refer Para: 4, 5 & 6.

SA 402 (Revised) AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION (On or after April 1, 2010)

1. Definitions:

- a) *Report on the description and design of controls at a service organisation (referred to in this SA as a Type 1 report - A report that comprises
 - i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date and
 - ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve specified control objectives.*
- b) *Report on the description, design, and operating effectiveness of controls at a service organisation (referred to in this SA as a Type 2 report) - A report that comprises
 - i) A description, prepared by management of the service organisation, of the service organisation's system, control objective and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period and
 - ii) A report by the service auditor with the objective of conveying reasonable assurance that includes
 - The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls and
 - A description of the service auditor's tests of the controls and the results thereof.*
- c) **Service auditor:** *An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation*
- d) **Service organization:** *A third party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities information systems relevant to financial reporting*
- e) **Sub service organization:** *A service organisation used by another service organisation to perform some of the services provided to user entities*
- f) **User auditor:** *An auditor who audits and reports on the financial statements of a user entity.*
- g) **User entity:** *An entity that uses a service organisation and whose financial statements are being audited.*

2. Obtaining an understanding of the services provided by a service organisation, including Internal Control:

- a) *When obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:*
 - i) *The nature of the services provided by the service organisation and the significance of those services to the user entity.*
 - ii) *The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;*

- iii) *The degree of interaction between the activities of the service organisation and those of the user entity; and*
 - iv) *The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms.*
 - b) *The user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation*
 - c) *The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained*
 - d) *If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:*
 - i) *Obtaining a Type 1 or Type 2 report, if available*
 - ii) *Contacting the service organization, through the user entity, to obtain specific information*
 - iii) *Visiting the service organization and performing procedures or*
 - iv) *Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization.*
- 3. **Using a Type 1 or Type 2 report to support the user auditors understanding of the service organization:** *In determining the sufficiency and appropriateness of the audit evidence provided by a Type1 or Type 2 report, the user auditor shall be satisfied as to:*
 - a) *The service auditor's professional competence (except where the service auditor is a member of the Institute of Chartered Accountants of India) and independence from the service organization; and*
 - b) *The adequacy of the standards under which the Type 1 or Type2 report was issued.*
- 4. **Responding to the assessed risks of material misstatement:** *In responding to assessed risks in accordance with SA 330, the user auditor shall:*
 - a) *Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not*
 - b) *Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.*
- 5. **Tests of controls:** *When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:*
 - a) *Obtaining a type 2 report, if available;*
 - b) *Performing appropriate tests of controls at the service organisation; or*
 - c) *Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.*
- 6. **Type1 and Type 2 reports that exclude the service of a sub service organisation:** *If the user auditor plans to use a Type 1 or a Type 2 report that excludes the services provided by a sub service organisation and those services are relevant to the audit of the user entity's financial statements, the user auditor shall apply the requirements of this SA with respect to the services provided by the sub service organisation also*

7. Fraud, non-compliance with laws and regulations and uncorrected misstatements in relation to activities at the service organisation:

- a) The user auditor shall inquire of managements of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity.
- b) The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

8. Reporting by the user Auditor:

- a) The user auditor shall modify the opinion in the auditor's report if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation.
- b) The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion.
- c) If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

PRACTICAL QUESTIONS

Q.No.1. In the course of the audit of R Ltd., the audit manager of ABC & CO. Observed that R ltd. Has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit. **(4M)**

Refer: Para - 2

Q.No.2. A company gets its accounting data processed by a third party to achieve cost reduction. As a statutory auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit? **(8M)**

Refer: Para – 2

Q.No.3. SA - 402 deals with responsibility of the Auditor of the Service Organization. Say whether True or False.

Hint: False. SA – 402 deals with Audit considerations relating to Entities using Service Organizations, and not the responsibility of Auditor of Service Organization itself.

SA 450 EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT (on or after April 1, 2010)

1. Definitions:

- a) **Misstatement:** A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.
- b) **Uncorrected misstatements:** Misstatements that the auditor has accumulated during the audit and that have not been corrected.

2. **Accumulation of identified misstatements:** The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial (unimportant).
3. **Consideration of identified misstatements as the audit progresses:** The auditor shall determine whether the overall audit strategy and audit plan need to be revised if;
 - a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or
 - b) The aggregate of misstatements accumulated during the audit approaches materiality, if at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.
4. **Communication and Correction of Misstatements:**
 - a) The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.
 - b) If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections.
5. **Evaluating the effect of uncorrected misstatements:** The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
 - a) The size and nature of the misstatements, both in relation to particular item and the financial statements as a whole; and
 - b) The effect of uncorrected misstatements related to prior periods on the relevant and the financial statements as a whole.
6. **Communication with TCWG:** The auditor shall communicate with TCWG uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.
7. **Written Representation:** The auditor shall request a written representation from management whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

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8. **Determinants of Material Mis – statements:** The circumstances related to some mis - statements may cause the Auditor to evaluate them as material (individually or in aggregate), even if they are lower than the materiality for the financial statements as a whole. This includes the extent to which the mis - statement
 - a) Affects compliance with regulatory requirements,
 - b) Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial Statements but is likely to have a material effect on future periods' financial Statements
 - c) Relates to items involving particular parties (e.g. transactions with Related Parties),
 - d) Is an omission of information not specifically required by the applicable Financial Reporting Framework but which, in the judgment of the Auditor, is important to the Users' understanding of the financial position, financial performance or cash flows of the Entity,
 - e) In the case of Central/State governments and related Government Entities, the evaluation whether a mis-statement is material may also be affected by legislation or regulation & additional responsibilities for the Auditor to report other matters.

9. Documentation

The Audit Documentation shall include –

- a) The amount below which mis-statements would be regarded as **clearly trivial**,
- b) All Mis - statements **accumulated** during the audit and whether they have been **corrected**, and
- c) The Auditor's **conclusion** as to whether uncorrected mis-statements are material, individually or in aggregate, and the **basis** for that conclusion.

PRACTICAL QUESTIONS

Q.No.1. Define the terms under –

- a) Mis-statement, and
- b) Uncorrected Mis-statement

Ans: Refer Para: 1

SA 500 (Revised) AUDIT EVIDENCE (w.e.f. April 1, 2009)

1. **Definitions:**

- a) **Appropriateness (of audit evidence):** *The measure of the quality of audit evidence; that is , its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.*
- b) **Audit evidence:** *Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.*
- c) **Management's expert:** *An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.*
- d) **Sufficiency (of audit evidence):** *The measure of the quality of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.*

2. **Sufficient Appropriate Audit Evidence:**

Refer: Chapter 3 – Q.No.7

3. **Information to be used as audit evidence:**

- a) *When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence.*

Refer: Chapter 3 – Q.No.5

- b) *When information to be used as audit evidence has been prepared using the work of a **management's expert**, the auditor shall,*
 - i) *Evaluate the competence, capabilities and objectivity of that expert;*
 - ii) *Obtain an understanding of the work of that expert; and*
 - iii) *Evaluate the appropriateness of expert's work as audit evidence for the relevant assertion.*
- c) *When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes.*

4. **Inconsistency in, or Doubts over reliability of, Audit evidence:** If,

- a) *Audit evidence obtained from one source is inconsistent with that obtained from another; or*

- b) The auditor has doubts over the reliability of information to be used as audit evidence.

Auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, on other aspects of the audit.

PRACTICAL QUESTIONS

Q.No.1. While conducting the audit of a bank, you find that bank has advanced loan for purchase of machinery on the basis of valuation report prepared by the civil engineer. Will you approve the action taken by bank? Justify the answer.

Ans: Refer Para: 3(b)

SA 501 (Revised) AUDIT EVIDENCE - SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS (April 1, 2010)

1. Inventory:

- a) **Sufficient Appropriate Evidence:** When inventory is material Auditor shall obtain sufficient appropriate evidence w.r.t. existence and condition of inventory by:
- i) Attendance at physical inventory counting, unless impracticable, to:
 - Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - Observe the performance of management's count procedures;
 - Inspect the inventory; and Perform test counts
 - ii) Performing audit procedures / examining over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
- b) **Inventory counting conducted at date other than B/S date:**
- i) He shall perform additional procedure
 - ii) w.r.t. changes in inventory
 - iii) Between count date & B/S date.
- c) **Auditor unable to attend inventory count due to unforeseen circumstances:** He shall make some count on alternate date and perform procedures on intervening transactions.
- d) **Attendance at inventory count is impracticable:** He shall perform alternate procedures. If it is not possible, then modify the audit report.
- e) **Inventory under control of a third party:** Obtain evidences by performing one or more of following:
- i) Request confirmation form third party.
 - ii) Obtaining service auditors report w.r.t. adequacy of procedures of third party.
 - iii) Attending / Arranging another auditor to attend third party's counting procedure.
 - iv) Inspecting documentation (Example: warehouse receipts).
 - v) Request confirmation from parties when inventory has been pledged as collateral.

2. Litigation and Claims:

- a) **Identify litigation and claims:** Perform procedures to Identify litigation & claims by

- i) Inquiring mgt. & others
- ii) Reviewing minutes of meetings of TCWG and correspondence with legal council.
- iii) Reviewing legal expense account.
- b) **Risk of misstatement w.r.t. litigation & claims:** If Risk is identified then, seek communication with entity's external legal council.
- c) **Written representation:** Auditor shall request written representation from management, TCWG, that all known litigation & claims affecting financial statements have been disclosed and appropriately accounted for.
- d) **Modify the opinion:** If management does not permit auditor to communicate with legal council or legal council refuse to respond and auditor is unable to obtain sufficient appropriate evidence then modify opinion.

3. Segment information:

- a) **Sufficient Appropriate Evidence:** *W.r.t. presentation and disclosure of segment information as per applicable Financial Reporting Framework.*
- b) **Audit Procedures:** *He should understand the methods used by management and evaluate their consistency with applicable FRF and perform analytical procedures appropriate in circumstances.*

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4. Matters relevant in planning Attendance at Physical Inventory counting.

- a) Nature of inventory.
- b) Stages of completion of Work-in-Progress
- c) Risks of material mis-statement related to inventory.
- d) Nature of the internal control related to inventory.
- e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- f) Timing of physical inventory counting.
- g) Whether the Entity maintains a Perpetual Inventory System.
- h) Locations at which Inventory is held, including the materiality of the inventory and the risks of material mis-statement at different locations, in deciding at which locations attendance is appropriate.
- i) Whether the assistance of an Auditor's Expert is needed.

PRACTICAL QUESTIONS

Q.No.1. You are the auditor of easy communications ltd. For the year 2007 – 08. The inventory as at the end of the year i.e. 31.3.08 was Rs.2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order? **(5M)**

Ans: As per SA 501, "Audit Evidence – Additional Considerations For Specific Items" the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. SA 501 is additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures. .

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (a) the completeness of information provided regarding the inventory and (b) assurance with regard to adherence to laid down procedures for physical inventory count.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

Q.No.2. Responsibility for properly determining the quantity and value of inventory rests with the management. Comment. **(PM)**

Ans: Refer Para: 1 (a)

Q.No.3. How would an auditor proceed to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. Also state reporting requirements in this respect.

Ans: Refer Para: 1

Q.No.4. What are the Auditor's duties under SA-501 with respect to Inventory?
PP Ltd asked their Internal Auditor, a practicing CA, to conduct physical verification of year-end inventory, and the report of such verification was handed over to the Statutory Auditor for their view and use. Can the Statutory Auditor rely on such report?

Ans: Refer Para: 1

SA 505 (Revised) EXTERNAL CONFIRMATION (on or after April 1, 2010)

1. Definitions:

a) **External Confirmation:** Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

2. External confirmation procedures/process: He shall maintain control. Over external confirmation requests including following:

- a) Determining the information to be confirmed.
- b) Selecting the appropriate third party,
- c) Designing the confirmation requests
- d) Sending the request including follow-up request

3. Selecting items for confirmation: While selecting items for confirmation, the auditor should consider.

The materiality of an account balance, assessment of inherent and control risk, particular financial statement assertion

4. Management refusal to allow the auditor to send a confirmation request:

- a) In such case, he shall Inquire mgt's reasons for refusal and assess their validity, evaluate the possibility of risk of material misstatement and Perform alternative procedures.

- b) If mgt's refusal is unreasonable, or auditor is unable to perform alternate procedures, then he shall communicate with TCWG and consider effect on his report.
5. **Intended Respondent:** The reliability of audit evidence provided confirmation is affected by: Completeness, Independence, Authority to respond, Knowledge of matter, Objectivity or unbiased response.
6. **Reliability of Response:**
- a) If he has doubts about reliability of response, he shall obtain further evidences to resolve doubts.
- b) If response is found to be unreliable, it may indicate fraud risk factor. He shall consider its effect on Nature, Timing & Extent of other procedures.
7. **Form of confirmation requests:**
- a) **Positive confirmation requests:**
- i) It asks the third party (Confirming party) to reply to the auditor in all cases
- ii) Either by indicating agreement / disagreement with the given information
- iii) Or by asking third party to provide information
- iv) A response to positive confirmation request is ordinarily expected to be reliable.
- v) If reply to a request is not received in reasonable time, he may send an additional confirmation request.
- b) **Negative confirmation requests:**
- i) It asks the third party to respond directly to the auditor only if there is disagreements with the information provided in the request.
- ii) It is considered to be less persuasive than the positive confirmation request.
- iii) Auditor should use them only if all of following are present:
Risk of misstatement is low, I.C. is effective, Item contains small amount, Low exception rate is expected, No reason to believe that recipient may disregard the request.
8. **Non response to positive confirmation request:** The auditor should perform alternate procedures. If the alternate procedures do not provide sufficient and appropriate audit evidence then the auditor should consider the effect on his audit report.
9. **Exception:**
- a) It means a response indicating disagreement of third party.
- b) Auditor shall investigate exceptions to determine whether these are indicative of misstatement.

PRACTICAL QUESTIONS

Q. No.1. The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd. what can be an appropriate response? **(M 11 - 6M)**

SA 505 "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to send a confirmation request, the auditor shall

1. Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.
2. Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures and
3. Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

Q.No.2. Moon limited replaced its statutory auditor for the financial year 2008-09. During the course of audit, the new auditor found a credit item of Rs.5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor is he traceable. Under the circumstances, no confirmation of the credit balance is available. Comment. **(N 09 - 5M)**

This is a case of external confirmation, covered by SA 505 "External Confirmation". The identities of creditors are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of Rs.5 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

Q.No.3. The accountant of c ltd. Has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the court **(M 05 - 4M)**

Ans: Refer Para: 4

Q.No.4. What are the factors to be considered while designing a confirmation request. **(PM, N14 MTP1 - 5M)**

Ans: Refer Para: 7, 2 & 3.

Q.No.5. Write short notes on reliability of external confirmations. **(PM, N14RTP)**

Ans: Refer Para: 5 & 6.

Q.NO.6. Balance confirmations from debtors / creditors can only be obtained for balances standing in their accounts at the year - end. **(PM)**

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

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

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

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

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

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

Q.No.7.What is meant by external confirmation?

Ans: Refer Para: 1

Q.No.8. Distinguish between Positive and Negative Confirmation Requests.

Ans: Refer Para: 7

SA 510 (REVISED) INITIAL AUDIT ENGAGEMENTS-OPENING BALANCES (on or after April 1, 2010)

1. Definitions:

- a) **Initial audit engagement:** An engagement in which either:
 - i) The financial statements for the prior period were not audited; or
 - ii) The financial statements for the prior period were audited by a predecessor auditor.
- b) **Opening balances:** *Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period.*
- c) **Predecessor auditor:** *The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.*

2. Audit Procedures for verifying Opening Balances:

- a) The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.
- b) The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
 - i) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
 - ii) Determining whether the opening balances reflect the application of appropriate accounting policies; and
 - iii) Performing one or more of the following:
 - Where the prior year financial statements were audited, perusing the copies of the audited financial statements.

- Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - Performing specific audit procedures to obtain evidence regarding the opening balances.
- c) If the opening balances contain misstatements that could materially affect the current period's financial statements, auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements.
- d) If such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and TCWG.
3. **Consistency of Accounting Policies:** The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable reporting framework.
4. **Relevant Information in the Predecessor Auditor's Report:** If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with SA 315.
5. **Audit Conclusions and Reporting:**
- a) **Opening Balances:**
- i) If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion,
 - ii) If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.
- b) **Consistency of Accounting Policies:** If the auditor concludes that:
- i) The current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
 - ii) A change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework
 - iii) The auditor shall express a qualified opinion or an adverse opinion.
- c) **Modification to the Opinion in the Predecessor Auditor's Report:** If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements.

PRACTICAL QUESTIONS

Q.No.1. Outline the mode of obtaining evidence in respect of opening balances under SA-510. In an initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of "opening balances" to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases – (i) when the financial statements are audited for the preceding period by another auditor, and (ii) when the financial statements are audited for the first time.

Ans: Refer Para: 2 – 4

Q.No.2. Mr.X, a chartered accountant and a partner of X & Co., chartered accountants was first time appointed the auditor of Philips Ltd. Mr. X carried the audit procedure for verifying the opening balances only but not the previous year accounting policies as Mr. X thinks that as per SA-510 it is not needed. Comment.

Ans: Refer Para: 3

Q.No.3.

- a) What are 'initial audit engagements'? (2M)
- b) In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'opening balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time. (7M)
- c) If, after performing the procedure, you are not satisfied about the correctness of 'opening balances'; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above? (N 04 - 7M)

1. **Initial Engagement – Opening Balances:** As per SA 510 'Initial Audit Engagements - Opening Balances' initial audit engagements mean:

- a) When the auditor is engaged to carry out the audit of financial statements of an entity for the first time; or.
- b) When the financial statements of the entity for the preceding period were audited by another auditor;

The situation mentioned in (i) above is obviously when the auditor is appointed to take up the audit for the first time or no audit was carried out of the financial statements of the entity for the immediately preceding period. The situation mentioned in (ii) above arises whenever there is a change of auditor.

2.

a) **Financial Statements Audited by Another Auditor – Audit Procedure:**

- i) Ordinarily the current auditor can place reliance on the closing balances contained in the audited financial statements of the preceding period. Sufficient audit evidence will be obtained for verifying opening balances, which are closing balances of the earlier period by perusing the copies of the audited financial statements.
- ii) If during the performance of audit for the current period the possibility of misstatements in opening balances is indicated, some indirect audit evidence can be obtained as part of the audit procedures performed during the current period. For example, the collections and payments of opening balances in the accounts of debtors and creditors respectively during the current period will provide evidence as to their existence, correctness and valuation at the beginning of the period.

b) **Audit of Financial Statements for the First Time - Audit Procedure:** When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

3. **Drafting Audit Report:** If after performing the laid down procedure in SA 510, "Initial Audit Engagements - Opening Balances", the auditor is not satisfied in either of the above situations, he should, as appropriate express a qualified opinion or disclaimer of opinion. At times, it is also likely that the auditor opines that the profit and loss account is qualified but balance sheet is found to be unqualified. If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

Q.NO.4 Auditors of M/s fortune india (Pvt. Ltd.) were changed for the accounting year 2004-05. The closing stock of the company as on 31.3.2004. amounting to Rs. 100 lakhs continued as it is and became closing stock as on 31.3.2005. the auditors of the company proposed to exclude from their audit programme the audit of closing stock of Rs.100 lakhs on the understanding that it pertains to the preceding year which was auditor by another auditor. Comment. **(N05)**

Ans: Refer Para: 2

TRUE OR FALSE QUESTIONS (FOR STUDENT SELF STUDY)

1. It is no part of subsequent auditor's duty to verify opening balances of Ledger accounts of current years, on the basis of Balance Sheet audited by Previous Auditor.

False: According to SA 510 "Initial Audit Engagements - Opening Balances", it is

The responsibility of the auditor to verify and obtain appropriate evidence in respect of opening balances brought forward from the preceding period.

SA 520 (Revised) ANALYTICAL PROCEDURES (on or after April 1, 2010)

- This SA deals with the auditor's use of analytical procedures as substantive procedures and assist the auditor when forming an overall conclusion on the financial statements. Analytical procedures are used in planning the audit, as substantive procedures, in overall review.*
- Analytical Procedures meaning:**
 - Means evaluation of financial information through analysis of relationship among both financial & non-financial data.*
 - Analytical Procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected valued by a significant amount.*
- Nature of Analytical Procedures:** *It includes comparison with: Comparable information for prior periods, anticipated results like budgets or forecasts, similar industry information.*
- Objectives of Auditor w.r.t. Analytical Procedures:**
 - Obtain evidences when using Substantive analytical Procedures &.*
 - Design & perform analytical Procedures near end of audit to conclude whether financial statements are consistent with auditors understanding of entity.*
- Substantive Analytical Procedures (SAP):** *When using substantive analytical procedures, he shall consider the following four factors:*
 - Suitability of particular SAP:** *He should determine suitability of SAP for a particular item. These are generally adopted for those transactions that tend to be predictable over time.*
 - Reliability of Data to be compared:** *It is influenced by the following:*
 - Source of information available (for example it is more reliable if obtained from some independent source)*

- ii) Comparability of information available (Entities should be comparable)*
- iii) Relevance of the information available (budgets should be realistic)*
- iv) Control over Preparation of information (if last year's financial statements are audited)*

c) Difference of Recorded amount from expected values that is acceptable:

- i) SA 330 requires the auditor to obtain more persuasive evidence if he identifies high risk.*
- ii) Thus, for risky items, acceptable differences should be low.*
- iii) If difference is more than acceptable difference, he shall further investigate to rule out the possibility of misstatement.*

6. Analytical Procedures that assist when forming overall conclusion:

- a) He shall design and perform analytical procedures near the end of audit.*
- b) This way he can conclude whether financial statements are consistent with his understanding of entity.*
- c) Thus, it helps him in forming opinion on financial statement*

7. Investigating results of analytical Procedures: If he identifies fluctuation or a significant difference between recorded & expected values, he shall investigate by

- a) Inquiring of management and thereafter obtaining evidences to corroborate the same,*
- b) Performing other procedures as necessary in the circumstances.*

ADVANCED

8. Examples of Analytical Procedures

- a) Trends:** Analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.
- b) Reasonableness Tests** are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts. Examples of accounts that may be reasonably tested are –
 - i) Interest Expense** against Interest-bearing Obligations
 - ii) Raw Material Consumption** to Production (Quantity)
 - iii) Wastage & Scrap %** against Production and Raw Material Consumption (quantity)
 - iv) Work-in-Progress** based on issued of Materials and Sales (quantity)
 - v) Sales Discounts and Commissions** against Sales Volume
 - vi) Rental Revenues** based on occupancy of premises
- c) Analysis by Computation of Ratios** includes the study of relationships between Financial Statement amounts. Commonly used ratios include –
 - i) Elements of Income or Loss** as a percentage of sales
 - ii) Gross Profit Turnover**
 - iii) Accounts Receivable turnover**
 - iv) Inventory Turnover**
 - v) Profitability, Leverage, and Liquidity**

9. Sources of Information for Analytical Procedures

- a) Interim Financial Information**

- b) Budgets
- c) Management Accounts
- d) Non-Financial Information
- e) Bank and Cash Records
- f) VAT Returns
- g) Board Minutes
- h) Discussion or correspondence with Client at year-end

PRACTICAL QUESTIONS

Q.No.1. What factors should be considered while analytical procedures are performed as substantive procedures?

Ans: Refer Definitions & Para: 5 a & b

SA 530 (Revised) AUDIT SAMPLING (w.e.f. 1st April, 2009)

1. Definitions:

- i) **Audit sampling (Sampling):** The application of audit procedures to less than 100% of items within a population such that all sampling units have a chance of selection in order to draw conclusions about the entire population.
- ii) **Population:** The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- iii) **Sampling risk:** The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
 - i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned about this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate opinion.
 - ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- iv) **Non-sampling risk:** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.
- v) **Anomaly:** A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- vi) **Sampling unit:** The individual items constituting a population.
- vii) **Stratification:** The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- viii) **Tolerable misstatement:** A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
- ix) **Tolerable rate of deviation:** A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

2. Sample Design, Size and Selection of Items for Testing:

Refer: Ch.4 – Q. No. 9

3. Performing Audit Procedures:

- a) The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
- b) If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation or a misstatement

4. Nature and Cause of Deviations and Misstatements:

- a) The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluates their possible effect.
- b) In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.

5. Evaluation of sample results:

a) **Analysis of error in sample:**

- i) The auditor should analyze cause of the error and its impact on the other phases of audit.
- ii) If he finds a common trend in error, he may carry out extended audit procedures in those areas.
- b) **Projection of errors:** After establishing an error, the auditor should project the possibility of error to the entire population by a suitable method. When projecting errors, the auditor should consider the qualitative aspects of error found.
- c) **Reassessing sampling Risk:** The auditor needs to consider whether errors in population exceed the tolerable error. In case it does, he has to revise the sampling risk, alternatively, he may have to extend his audit procedure or perform alternate audit procedures.

6. Sample Selection Methods

- a) **Monetary Unit Sampling:** It is a type of **value-weighted selection** in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- b) **Haphazard Selection:** The Auditor selects the sample without following a structured technique. Although no structured technique is used, the Auditor should avoid any conscious bias or predictability (e.g. avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection.

Note: Haphazard Selection is **not** appropriate when using statistical sampling.

PRACTICAL QUESTIONS

Q.No.1. While planning the audit of S Ltd. You want to apply sampling techniques. What are the risk factors you should keep in mind? **(PM, N14RTP)** (OR)
"The auditor is faced with sampling risk in both tests of control and substantive procedures."
Comment on this statement with reference to SA 530 on "Audit Sampling".
(PM, N15 MTP1 - 5M)

Sampling Risk: Sampling Risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedures as follows:

a) Tests of Control:

- i) **Risk of Under Reliance:** The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.
- ii) **Risk of Over Reliance:** The risk that, although the sample result supports the auditor's assessment to control risk, the actual compliance rate would not support such an assessment.

b) Substantive Procedures:

- i) **Risk of Incorrect Rejection:** The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is materially mis-stated, in fact it is not material mis-stated.
- ii) **Risk of Incorrect Acceptance:** The risk that, although the sample result supports the conclusion that a recorded amount balance or class of transactions is no materially mis-stated, in fact it is materially mis-stated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection. Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Q.No.2. Distinguish between Sampling risk and Non-Sampling risk.

Ans: Refer Para: 1(c,d).

Q.No.3. What are the duties of the Auditor in the evaluation of Sample Results?

Ans: Refer Para: 5

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

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

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

- a) **Random Selection:** This method is applied through random number generators, for example, random number tables. Stratified Sampling is one of the methods of Random Sampling. This method involves dividing the whole population to be tested in a few groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgement e.g. entire expense vouchers may be divided into:
 - i) Vouchers above Rs. 1,00,000

- ii) (ii) Vouchers between Rs. 25,000 and Rs. 1,00,000
- iii) (iii) Vouchers below Rs. 25,000

The auditor can then decide to check all vouchers above Rs. 1,00,000, 50% between Rs. 25,000 and Rs. 1,00,000 and 25% of those below Rs. 25,000. The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

- b) **Systematic Selection:** In this method, the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- c) **Monetary Unit Sampling:** This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- d) **Haphazard Selection:** In this method, the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
- e) **Block Selection:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

SA 540 (Revised) AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES (w.e.f. 1st April, 2009)

1. Definitions:

- a) **Accounting estimate:** *An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty. Ex: Provision for bad and doubtful debts, Provision for a loss from legal case filed against the enterprise, Losses on construction contract in progress, Provision to meet warranty cost/claims, Provision for retirement benefits, Amortisation of certain items like goodwill and deferred revenue expense, Providing depreciation on fixed assets and estimating the useful life of assets.*
- b) **Auditor's point estimate or auditor's range:** *The amount, respectively, derived from audit evidence for use in evaluating management's point estimate.*
- c) **Estimation uncertainty:** *The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.*
- d) **Management bias:** *A lack of neutrality by management.*
- e) **Management's point estimate:** *The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.*
- f) **Outcome of an accounting estimate:** *The actual monetary amount which results from the resolution of the underlying transaction (s) and event (s).*

2. Accounting Estimates and Auditor's Responsibility:

- a) *Estimation of expenses sometimes is very simple (monthly rent) but sometimes very difficult (PBD, warranty claims).*
- b) *While evaluating accounting estimate of complex nature, auditor should exercise judgment based on past experience whether estimates are reasonable.*
- c) *In some cases the accounting estimates are made by the management based on certain formula, the auditor should ensure that such formula is continuously reviewed.*
- d) *As per the auditor's judgment the estimation / provision for expenses cannot reasonably be made. Auditor should consider this while expressing his opinion on the financial statements.*

3. Risk Assessment Procedures and Related Activities: Auditor shall obtain an understanding of the following in order to identify and assess the risks of material misstatement for accounting estimates:

- a) Methods, procedures followed by the management to calculate accounting estimates.
- b) Environment under which estimates are made by management like internal control system, external / internal evidence on which estimates are based, etc.
- c) Assumptions on which estimates are based.
- d) Review and test the process followed by the management for accounting estimates.
- e) Testing of calculation involved in accounting estimates
- f) Compare, if possible, with earlier year's estimates
- g) Consider whether data on which accounting estimates are based, are objective.
- h) In case accounting estimates are complex in nature use the work of expert.
- i) Review the continuing formula
- j) Make or obtain an independent estimate and compare it with accounting estimates
- k) Review and consider the subsequent events after the balance sheet date but before the completion of audit to judge the appropriateness of the accounting estimate.
- l) Obtain an understanding of the applicable financial reporting requirements regarding fair value measurement.
- m) Review the outcome of accounting estimates included in the prior period financial statements.

4. Response to the Assessed Risks: Based on the assessed risks of material misstatement, the auditor shall determine:

- a) Whether management has appropriately applied the applicable financial reporting framework.
- b) Whether the methods are appropriate and have been applied consistently,

5. Response to Significant Risks Estimation Uncertainty:

- a) **For accounting estimates that give rise to significant risks, the auditor shall evaluate the following:**
 - i) How management has considered alternative assumptions or outcomes, and why it has rejected them.
 - ii) Whether the significant assumptions used by management are reasonable.
- b) If, in the auditor's judgement, management has not adequately addressed the effects of estimation uncertainty, the auditor shall, develop a range with which to evaluate the reasonableness of the accounting estimate.

6. Measurement and Disclosures Related to Accounting Estimates:

- a) The auditor shall obtain sufficient appropriate audit evidence about whether the accountings estimate and their disclosure in the financial statements is appropriate.
- b) For accounting estimates that give rise to significant risks, the auditor shall check adequacy of the disclosure of their estimation uncertainty in the financial statements.

7. Written Representations: The auditor shall obtain written representations from management whether management believes significant assumptions used by it in making accounting estimates are reasonable.

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8. General Examples of Accounting Estimates:

Examples of Accounting Estimates other than Fair Value Accounting Estimates	Examples of Fair Value Accounting Estimates
a) Allowance for Doubtful Accounts. b) Inventory Obsolescence. c) Warranty Obligations. d) Depreciation Method or Asset Useful Life. e) Provision against the carrying amount of an Investment where there is uncertainty regarding its recoverability. f) Outcome of long-term contracts. g) Financial Obligations / Costs arising from litigation settlements and judgments.	a) Complex Financial Instruments, which are not traded in an active and open market. b) Share-based payments. c) Property or equipment held for disposal. d) Certain assets or liabilities acquired in a business combination, including Goodwill and Intangible Assets. e) Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of Plant facilities in different lines of business.

PRACTICAL QUESTIONS

Q.No.1. Outline the auditor's duties under SA-540 vis-à-vis accounting estimates.

Ans: Refer SA 540, Para No-2

Q.No.2 What are accounting estimates according to the Standards on Auditing 540? Give some examples.
(PM, M15 MTP1 - 5M, N14 MTP2 - 4M)

Ans: Refer Para – 1(a)

Q.No.3. What are accounting estimates? Give example.

Ans: Refer Para – 8.

SA 550 (Revised) RELATED PARTIES (on or after April 1, 2010)

1. **Definitions:** For purposes of the SAs, the following terms have the meanings attributed below:

- a) **Arm's length transaction:** A transaction conducted on such terms and conditions as between a willing buyer and willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.
- b) **Related party:** A party that is either:
 - i) A related party as defined in the applicable financial reporting framework; or
 - ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:
 - A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - Another entity that is under common control with the reporting entity through having:
 - i) Common controlling ownership;
 - ii) Owners who are close family members; or
 - iii) Common key management.

2. **Audit procedure to identity the related parties:**

- a) Review working papers of prior years for the names of known related parties
- b) Evaluate the company's procedures for identifying & proper accounting of related party transactions
- c) Ask for the list of related parties from appropriate management personnel
- d) Inquire as to the affiliation of directors and key management personnel
- e) Review shareholders' records to determine the name of major and influential share holders
- f) Review minutes of meeting of board of directors, executive committees and share holders
- g) Review the papers or prospectus file with SEBI
- h) Review the statutory records maintained for interested parties
- i) Review joint venture and other agreements
- j) Review accounting records for long, unusual or non-recurring transactions
- k) Review major investment transactions during the year
- l) Review income-tax return and assessment proceedings of the entity.

3. **Risk Assessment Procedures and Related Activities:**

- a) **Understanding the Entity's Related Party Relationships and Transactions:** The auditor shall inquire of management regarding:
 - i) The identity of the entity's related parties, including changes from the prior period;
 - ii) The nature of the relationships between the entity and these related parties; and
 - iii) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.
- b) **Understanding of controls:** The auditor shall inquire of management and other within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- i) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
 - ii) Authorise and approve significant transactions and arrangements with related parties; and
 - iii) Authorise and approve significant transactions and arrangements outside the normal course of business.
- c) **Maintaining Alertness for Related Party Information When Reviewing Records or Documents:**
- i) During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.
 - ii) If the auditor identifies significant transactions outside the entity's normal course of business the auditor shall inquire of management about:
 - The nature of these transactions; and whether related parties could be involved.
- d) **Sharing Related Party Information with the Engagement Team:** The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team.
4. Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions in accordance with SA 240.
5. Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions:
- a) **Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions:** If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:
- i) Promptly communicate the relevant information to the other members of the engagement team;
 - ii) Where the applicable financial reporting framework establishes related party requirements:
 - Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
 - Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
 - iii) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
 - iv) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
 - v) If the non-disclosure by management appears intentional evaluate the implications for the audit.
- b) **Identified Significant Related Party Transactions outside the Entity's Normal course of Business:** For identified significant related party transactions outside the entity's normal course of business, the auditor shall:
- i) Inspect the underlying contracts or agreements, if any, and evaluate whether:

- The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
 - The terms of the transactions are consistent with management's explanations; and
 - The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- ii) Obtain audit evidence that the transactions have been appropriately authorised and approved.
- c) **Assertions that Related Party Transactions were Conducted on Terms Equivalent to those Prevailing in an Arm's Length Transaction:** When management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing on an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.
6. **Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions:** *In forming an opinion on the financial statements the auditor shall evaluate:*
- a) *Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and*
 - b) *Whether the effects of the related party relationships and transaction:*
 - i) *Prevent the financial statements from achieving true and fair presentation; or*
 - ii) *Cause the financial statements to be misleading.*
7. **Reporting of audit conclusion of related party:** *If the auditor is unable to obtain sufficient appropriate evidence concerning related parties and transactions with such parties and concludes that their disclosure is not appropriate in financial statement, the auditor should express:*
- a) *A qualified opinion, or*
 - b) *A disclaimer of opinion in the audit report as appropriate.*
8. **Written representations:** *Where the applicable FRF establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate TCWG that:*
- a) *They have disclosed to the auditor the identity of entity's related parties and all the related relationships and transactions of which they are aware; and*
 - b) *They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.*

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9. **Examples of Fraudulent Transactions with Related Parties:**
- a) Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
 - b) Fraudulently organizing the transfer of assets from or to Management or others at amounts significantly above or below market value.
 - c) Engaging in complex transactions with Related Parties, such as Special Purpose Entities, that are structured to misrepresent the financial position or financial performance of the Entity.

- 10.** Communication with those Charged with Governance: Unless all of those Charged with Governance are involved in managing the Entity, the Auditor shall communicate with those Charged with Governance **significant matters** arising during the audit in connection with the Entity's Related Parties. Such matters shall include
- a)** Non - disclosure (whether intentional or not) by Management to the Auditor of related parties or significant Related Party transactions, which may alert those Charged with Governance to significant Related Party relationships and transactions of which they may not have been previously aware.
 - b)** The identification of significant Related Party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud.
 - c)** Disagreement with Management regarding the accounting for and disclosure of significant Related Party transactions in accordance with the applicable financial reporting framework.
 - d)** Non-compliance with applicable law or regulations prohibiting or restricting specific types of Related Party transactions.
 - e)** Difficulties in identifying the party that ultimately controls the Entity.
- 11.** Documentation: The Auditor shall include in the audit documentation, - (a) the names of the identified Related Parties, and (b) the nature of the Related Party Relationships.

PRACTICAL QUESTIONS

Q.No.1. How can an auditor identify related parties? (or) Elaborate how the statutory auditor can verify the existence of related parties for the purpose of reporting under accounting standard 18. (M 06 - 8M)

Ans: Refer Para No. 2

Q.No.2. Write about Identification of significant related party transaction outside business. (PM)

Ans: Refer Para No. 5(b)

Q.No.3. Define –

- a)** Related Party,
- b)** Arm's Length Transaction, under SA – 550.

Ans: Refer Para No. 1

Q.No.4. Explain the risk assessment procedures and related activities associated with Related Party Relationships and Transactions.

Ans: Refer Para No. 3

Q.No.5. The Auditor should be alert while inspecting documents relating to Related Parties. Comment. As an Auditor, how will you verify the existence of Related Parties?

Ans: Refer Para No. 2

SA 560 (Revised) SUBSEQUENT EVENTS (w.e.f. 1st APRIL, 2009)

1. Definitions:

- a) **Date of the financial statements:** The date of the end of the latest period covered by the financial statements.
- b) **Date of approval of the financial statements:** The date on which the financial statements have been prepared and those with the recognized authority have asserted that have taken responsibility for those financial statements.
- c) **Date of the auditor's report:** The date the auditor dates the report on the financial statements.
- d) **Date of the financial statements is issued:** The date that the auditor's report and audited financial statements are made available to third parties.
- e) **Subsequent events:** Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

2. Types of subsequent events:

- a) **Type I:** *Those events that provide additional evidence with respect to conditions that existed on the date of balance sheet and effect the estimation made in the preparation of the financial statements. The statement should be adjusted for any change in estimates resulting from the use of evidence of subsequent events. For example –*
 - i) *Debtors as on balance sheet date are declared insolvent after the balance sheet date but before auditor's report*
 - ii) *Settlement of legal disputes before audit report date, which arose before balance sheet date*
- b) **Type II:** *Those events which provide evidence with respect to conditions that did not exist on the date of the balance sheet being reported on but arose subsequent to the date. These events should not result in adjustments of the financial statements. Some of these events however may be of such a nature that disclosure of them is required to keep the financial statements from not being misleading. Ex: Purchase of business, Sale of shares and debentures, Settlement of legal disputes, Loss of plant or inventory as a result of fire*

Above contents are as per AS: 4

3. Events occurring Between the Date of the Financial Statements and the Date of the Auditor's Report: The auditor shall:

- a) Obtain an understanding of any procedures management has established to ensure that subsequent events that subsequent events are identified.
- b) Inquiring of management and TCWG.
 - i) Whether new commitments, borrowings or guarantees have been entered into.
 - ii) Whether sales or acquisitions of assets have occurred or are planned.
 - iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
 - iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
 - v) Whether there have been any developments regarding contingencies.

- vi) Whether any unusual accounting adjustments have been made or are contemplated.
 - vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
 - viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - ix) Whether any events have occurred that are relevant to the recoverability of assets.
 - c) Read minute, If any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements.
 - d) Read the entity's latest subsequent interim financial statements, if any.
 - e) If auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.
- 4. Facts which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued:**
- a) The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.
 - b) However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall
 - i) Discuss the matter with management and TCWG
 - ii) Determine whether the financial statements need amendment and, if so,
 - iii) Inquire how management intends to address matter in the financial statements.
 - c) If management amends the financial statements, the auditor shall
 - i) Extend the audit procedures referred to the date of the new auditor's report; and
 - ii) Provide a new auditor's report on the amended financial statements.
 - d) When law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent events, the auditor is permitted to restrict the audit procedure on subsequent events to that amendment. In such cases, the auditor shall either
 - i) Amend the auditor's report to include an additional date restricted to that amendment or
 - ii) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter(s) paragraph that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.
 - e) However, when management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then
 - i) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion: or
 - ii) If the auditor's report has already been provided to the entity, the auditor shall notify management and TCWG, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

5. Facts which Become Known to the Auditor after the Financial Statements have been issued:

- a) After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements.
- b) However, when. After the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
 - i) Discuss the matter with management and TCWG.
 - ii) Determine whether the financial statements need amendment and, if so,
 - iii) Inquire how management intends to address the matter in the financial statements.
- c) If the management amends the financial statements, the auditor shall:
 - i) Carry out the audit procedures necessary in the circumstances on the amendment.
 - ii) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
- d) If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation, the auditor will seek to prevent future reliance on the auditor's report.

6. Dual Dating:

- a) *The auditor amends the auditor's report to include an additional date restricted to that amendment; the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed.*
- b) *However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements.*
- c) *Illustration of such an additional date "(Date of Auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)"*

PRACTICAL QUESTIONS

Q.No.1. Write short note on events occurring after balance sheet date.

Ans: Refer SA 560 Para No-2, AS – 4

Q.No.2. Explain the meaning of the term subsequent events as used in SA-560. Should all types of subsequent events be considered by the auditor in his attest function?

(PM, N14 MTP1-6M)

(OR)

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

(N15, PM, MTP2-6M)

Ans: Refer SA 560 Para No - 1, 2, 3 Summary of 4, 5

Q.No.3 Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in financial statements. or how are subsequent events requiring adjustment or disclosure identified?

(PM)

Ans: Refer SA 560 Para No-4,5

Q.No.4 You are the auditor of manufacturing company whose year ends on 30th June. The following events occur after the year and before you complete the audit. the audit report issued by you is dated 20th September.

The sales ledger balance at 30th June were Rs.95,000. by 20th September, cash had been received against this amount totaling Rs.65, 000.

On 20th August, a batch of goods which were shown in the stock records at 30th June at a cost of Rs.10, 000 was sold for Rs.25, 000 and another batch costing Rs.30,000 was sold for 15,000.

A customer who had purchased a large consignment of goods during the accounting year claimed damages of Rs.40, 000 because the goods were faulty and unfit for use. The company has denied any liability.

A warehouse was destroyed by fire on 31st July containing stocks which were worth Rs.1,00,000. The warehouse was valued in the company's books at worth rs.80,000

State giving reasons, for your answer, how the above events would affect the account for the year ending 30th June

Ans: Consideration of subsequent events:

1. SA-560 requires that the Auditor should consider the effect of subsequent events- (a) on the financial statements, and (b) On the Auditor's Report.
2. The manner and treatment of each event depends upon its nature, i.e. (a) Adjusting event, or (b) None Adjusting Event.
3. The auditor's duties in report of each of the above situations is Described below,

Situation (a): Debtors remaining uncollected:

1. Examine the actual experience of the company in collecting due to it.
2. Examine the terms under which goods are sold and see to what extent they are being exceeded.
3. Verify whether the amount still remaining due will be collected in the immediately foreseeable future.
4. Review the correspondence with debtors since the year-end.
5. Ascertain the need, if any, to create provision for Bad Debts.
6. Discuss the necessary Bad Debts provision with the company's Directors, to make necessary adjustments in the financial statements, if required.

Situation (b): Stocks sold below cost:

1. **Valuation of stock:** As per prudent accounting principles and AS-2, Stocks should be valued at lower of cost or net realizable value. For this purpose, stocks have to be considered on a item-by-item basis or in groups and not in total.
2. **Goods sold above cost:** in respect of items costing Rs.10,000 and sold at Rs.25,000 in the next period, there is further evidence as to the realisability. Hence, such items should be stated at cost and the profit should be considered only in the next accounting period.
3. **Goods sold below cost:** In respect of items costing Rs.30,000 but sold for Rs.15,000, the subsequent event provides an indication of its realizable value/market price as at the balance sheet date. Hence, such goods shall be valued at Net Realisable value as on 31st June. The necessary adjustment should be made in the financial statements of this period.

Situation (c): Liability for Damages:

1. The Auditor should advise the company to obtain legal advice on this matter to establish – (a) Whether there was any Legal liability, and (b) What would be the extent of the potential damages.

2. The company should identify the extent of the liability to know whether any excessive claim has been made by the claimant, which is not likely to be endorsed by the courts.
3. In case of ascertainable Liability: The company, on legal advice, should make a provision in its accounts as at 30th June, to cover the estimated amount of damages payable together with legal costs.
4. In case of unascertained liability, If the amount payable cannot be estimated it should be shown as a contingent liability in the Notes to the Accounts as at 30th June.

Situation (d): Fire subsequent to Balance Sheet Date:

1. The fire took place after the year-end, and hence its accounting effect should be reflected in the next year's accounts.
2. In case of material losses, adequate disclosure shall be made in the report of the Board of Directors.
3. The Auditor should examine the appropriateness of the going concern Assumption and report accordingly.

Q.No.5. Sundry debtors of a company as on 31st march include Rs.10 lakhs from m/s unreliable traders, who have been declared as insolvent on 14th April. Comment.

- a) **SA - 560:** SA - 560 requires that the Auditor should consider the effect of Subsequent Events-(i) On the financial Statements, and (ii) On the Auditor's Report.
- b) **AS - 4:** AS - 4 requires that all significant events occurring after the balance sheet date and before the date of approval of the financial statements by the Board of Directors should be adjusted against assets/liabilities as on Balance Sheet date, if additional evidence is available in respect of conditions existed on the Balance Sheet Date.

Analysis and Conclusion: In the Given case, Debtors should be suitably adjusted in the financial statements, to show their realizable amount, since conditions existed on the balance sheet date in respect of which additional evidence has been provided by the insolvency of M/s unreliable Trades.

So, the Auditor should examine the Company's compliance with AS-4, and report accordingly.

Q.No.6. Briefly explain the audit procedures on subsequent events. (or) briefly describe the auditor's responsibility regarding subsequent events. **(M 01- 4M, N 09 - 4M)**

Ans: Refer SA 560 Para No-3

Q.No.7. An auditor became aware of a matter regarding a company only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion. Comment. **(M15RTP)**

Ans: Refer Para – 2

Q.No.7. Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements. **(PM)**

Ans: Refer Para – 3 (b)

TRUE OR FALSE QUESTIONS (FOR STUDENT SELF STUDY)

1. Events occurring after the balance sheet date must be disclosed in the financial statements.

False: As per AS-4 on "Contingencies and Events Occurring After the Balance Sheet Date", Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

SA 570 (Revised) GOING CONCERN (w.e.f 1ST APRIL, 2009)

1. Going Concern Assumption:

- a) *Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future.*
- b) *General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations.*
- c) *When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.*

2. Responsibilities of Management:

- a) *In case the financial statements have not been prepared on a going concern basis, the fact would need to be appropriately disclosed.*
- b) *Any judgment about the future is based on information available at the time at, which the judgment is made. However, Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.*

3. Responsibilities of Auditor

- a) *The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption.*
- b) *He shall consider whether there is a material uncertainty about the entity's ability to continue as a going concern.*
- c) *The absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern. (SA 200).*

4. Consequences of Going Concern Concept not Justified: *If going concern concept / assumption is not valid, the assets will be recorded at its disposal value and liabilities at its payment value. As per the statement, the amount of classification of assets and liabilities need to be adjusted, the depreciation will not be provided, etc.*

5. Risk Assessment Procedures and Related Activities

- a) *The auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern (discuss with management).*
- b) *The auditor shall remain alert throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.*

6. Types of indicators:

a) Financial Indicators:

- i) *Negative Net worth/working capital;*

- ii) Arrears/discontinuance of Dividends;
- iii) Adverse financial ratio;
- iv) Substantial operating losses;
- v) Borrowing approaching maturity without any chance of renewal/repayment;
- vi) Short term borrowing for long term asset financing;
- vii) No payment to creditors on due date.
- viii) Non compliance with terms in loan agreement;
- ix) Negative cash flow from operations;
- x) Rearrangement with creditors for reduction in liability; or
- xi) Change from creditors to cash on delivery transaction with supplier.

b) Operating indicators: (M14 – 5M, PM, N14 MTP2-5M)

- i) Management intentions to liquidate the entity or to cease operations.
- ii) Loss of key management and no replacement available;
- iii) Loss of major market or supplier;
- iv) Labour difficulties, strikes etc; or
- v) Loss of major licence, franchise, etc.
- vi) Shortages of important supplies
- vii) Emergence of a highly successful competitor.

c) Other indicators:

- i) Pending legal proceedings;
- ii) Change in law or regulations or Government Policy affecting the entity adversely; or
- iii) Non – compliance with Statutory requirements

7. Evaluating Management's Assessment:

- a) In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management.
- b) In evaluating management's assessment, the auditor shall consider whether management has considered all relevant information of which the auditor is aware.

8. Additional Audit Procedures When Events or Conditions Are Identified: When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall perform procedures as follows:

- a) Request management to make its assessment of the entity's ability to continue as a going concern.
- b) Evaluating management's plans for future actions.
- c) When the entity has prepared a cash flow forecast, then consider its reliability.
- d) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- e) Requesting written representations from management or those charged with governance, regarding their plans for future action and the feasibility of these plans.

9. Audit Conclusions:

- a) Auditor shall conclude whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

- b) A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary.

10. Auditors report and Going Concern Concept:

- a) **Going concern assumption being appropriate:** He should issue an unqualified report.
- b) **Going concern assumption being questionable and resolved by the management explanation:** An unqualified report may be issued, provided adequate disclosure is made by way of notes. However, auditor must draw attention to those notes in his report.
- c) **If going concern assumption is questionable and management explanation is found to be inadequate:** The auditor must qualify his report stating reasons thereof.
- d) **Going concern assumption being inappropriate:** If the auditor after considering all the information collected by the audit procedures and mitigating factors of the management, opines that the going concern assumption is inappropriate in the preparation of financial statements and effect of the same being material so as to make financial statements being misleading he must express adverse opinion.

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11. Requirements of SA 570

- a) **Evaluating Management's Assessment:** If Management's assessment of the Entity's ability to continue as a Going Concern covers **less than 12 months** from the date of the Financial Statements as defined in SA-560, the Auditor shall request Management to extend its assessment period to **atleast 12 months** from that date.
- b) **Period beyond Management's Assessment:** The Auditor shall inquire of Management as to its knowledge of events or conditions beyond the period of Management's assessment that may cast significant doubt on the Entity's ability to continue as a Going Concern.
- c) **Management unwilling to make or extend its assessment:** If Management unwilling to make or extend its assessment when requested to do so by the Auditor, he shall consider the implications for the Auditor's Report (i.e. a qualified / disclaimer opinion in the Audit Report may be appropriate)
- d) **Significant delay in approval of financial statements:**
- i) When there is significant delay in the approval of the financial statements by management or Those Charged with Governance after the date of the financial statements, the Auditor shall inquire as to the reasons for the delay.
- ii) When the Auditor believes that the delay could be related to events or conditions relating to the Going Concern assessment, the Auditor shall perform those additional audit procedures necessary, as well as consider the effect on the Auditor's conclusion regarding the existence of a material uncertainty.

PRACTICAL QUESTIONS

Q.No.1. List the indications upon which the auditor should assess the appropriateness of going concern assumption. (PM, N15 RTP) (OR)

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

Ans: Refer SA 570 Para No - 6

Q.No.2. There is evidence that the public interest would be best served by the inclusion of fuller information about risks facing companies in audited financial statements. Doubts about the going-concern presumption must be detected and adequately disclosed in financial statements and auditor's reports. You are required to list six factors, which might cause doubt on the going-concern status of a company. (Final level)

Ans: Refer SA 570 Para No-6

Q.No.3. Specify additional audit procedures, which an auditor may perform while evaluating appropriateness of going concern assumption. **(N15 MTP1-4M)**

Ans: Refer SA 570 Para No-8 & 9

Q.No.4 Describe the audit procedures necessary in order to gain sufficient audit evidence to be able to form an opinion on the going concern status of a company **(PM, N14RTP)**

Ans: Refer SA 570 Para No-8 & 9

Q.No.5. A company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders. **(J 09 - 4M)**

Ans: In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 "Going Concern".

Q.No.6. It Ltd. Has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, have also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. Comment. **(RTP N 12)**

Ans: As per SA 570 on "going concern", when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor's judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.

To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources.

In the instant case, IT Ltd. has suffered continuous losses and is having negative net worth also. Besides, its production head has also left the company resulting in steep fall in production. Thus, there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

Q.No.7. What is Going Concern assumption? Outline the significance.

Ans: Refer SA 570 Para No - 1.

Q.No.8. It is now an accepted fact that an auditor cannot take the “going- concern” assumption for granted. The problem has become acute in view of ever growing sickness in our industries. You are required to prepare a checklist designed to test the assumption that a particular client organization is in fact a going-concern.

Ans: SA 570 - Checklist: If the answers to the following questions are “Yes”, then the going concern assumption may not be appropriate, subject to other findings of the auditor.

1. Capital structure and financial aspects:

- a) Does the concern have a high Debt-Equity Ratio?
- b) Is the concern heavily or increasingly dependent upon short-term finance?
- c) Is the company utilizing the borrowing facility to the maximum or whether there is any scope for further borrowing?
- d) Are leasing arrangements preferred to capital expenditure?

2. Working capital aspects:

- a) Is there a gradual and significant decline in current ratio, i.e. current assets ÷ Current liabilities?
- b) Are purchases being deferred, thereby reducing stocks to dangerously low levels?
- c) Is there a marked slow down in the collection of sundry Debtors?
- d) Is there any inability to take advantage of cash discounts from creditors?
- e) Is there any increase in the time taken to pay creditors?

3. Operational Aspects:

- a) Are there substantial investments in R & D projects, which have not yielded any commercially exploitable products?
- b) Has there been any cancellation of capital projects for lack of funds?
- c) Is the concern substantially dependent upon a few products/patents/ production methods which may suddenly become obsolete?
- d) Is the business of the concern dependent upon the growth of a handful of customers?
- e) Are there substantial loans from directors, in case of small concerns? If such loans rank pari passu with other unsecured creditors, has the current ratio deteriorated?
- f) Are there defaults in making statutory payments like taxes, ESI, PF etc.?

4. Profit and Loss Account Aspects:

- a) Does the concern incur substantial cash losses?
- b) Is there a steady decline in the rate of profitability?
- c) Is there a growth beyond limits such that the company is over trading?

Q.No.9 Where a public or private company fails to enhance the paid up capital to the statutory minimum, will the going concern assumption be considered appropriate?

Ans: The minimum paid up capital of a private limited company and public limited company are Rs.1 lakh and Rs.5 lakhs respectively. Where a company fails to enhance the paid up capital to the statutory minimum, such company shall be deemed a defunct company within the meaning of sec.560 of the companies Act, 1956 and its name shall be struck off from the register by the ROC.

However, such an entity may decide not to carry on business or may decide to carry on the business in some other form of organization e.g. Partnership etc. This situation gives rise to the risk that the going concern assumption may no longer be appropriate.

In such situations, the auditor should perform the procedures as required by SA-570. Unless the entity demonstrates otherwise, the auditor should consider the going concern assumption as inappropriate and report the same in accordance with SA-570.

SA 580 (Revised) WRITTEN REPRESENTATIONS (w.e.f. 1st April, 2009)

1. Written Representations as Audit Evidence:

- a) *Similar to responses to inquiries, written representations are audit evidence.*
- b) *Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.*
- c) *Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains.*

2. Objectives of auditor:

- a) *To obtain written representations from management that management believes that it has fulfilled the fundamental responsibilities.*
- b) *To Support other audit evidence by means of written representations, if determined necessary by the auditor or required by other SAs ; and*
- c) *To respond appropriately to written representations provided by management or absence thereof.*

3. Written representations: A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein or supporting books and records.

4. From whom: The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

5. Written Representations about Management's Responsibilities:

- a) **Preparation and Presentation of the Financial Statements:** Written representation that management has fulfilled its responsibility for the preparation and presentation of the financial statements.
- b) **Information provided to the Auditor:** Written representation that management has provided with all relevant information agreed in terms of audit engagement and that all the transactions have been recorded and are reflected in the financial statements.

6. Date of and Period(s) Covered by Written Representations: The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

7. Form of Written Representations:

- a) The Written representations shall be in the form of representation letter addressed to the auditor
- b) If law or regulation requires management to make written public statements about its responsibilities, the relevant matters covered by such statements need not be included in the representation letter.

8. Doubt as to the Reliability of Written Representations

- a) If the auditor has concerns about the competence, integrity, ethical values or diligence of management, the auditor shall determine their effect on the reliability of representations (oral or written) and audit evidence in general.
- b) In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter.
- c) If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion.

9. Requested Written Representations Not Provided: If management does not provide one or more of the requested representation, he shall discuss the matter with mgt. and re-evaluate the reliability and integrity of mgt. He shall consider its effect on his audit report as well.

10. Effect on Audit Report: The auditor shall disclaim an opinion on the financial statements if:

- a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations are not reliable ; or
- b) Management does not provide the written representations.

11. Contents of representation by management: *Accounting policies, Assets, their cost, carrying amounts, title, physical existence, etc., Investments, Capital commitments, Inventories, Debtors less provisions, Liabilities, Provision for claims and losses, Changes in accounting policies, Assets pledged as collateral, Compliance with relevant laws, The financial statements are free from material misstatements.*

PRACTICAL QUESTIONS

Q.No.1. Explain what is meant by “representation by management” and indicate to what extent an auditor can place reliance on such representations. or write short notes on management representation or briefly out the salient features of SA-580 representations by management.

(PM)

Ans: Refer SA 580 Para No-1,5 & 8

Q. No.2. Discuss the position of an auditor in case he chooses to rely upon the certificates from the management in respect of closing stock, cash-in-hand etc. List the circumstances under which he will be justified in accepting and relying upon the certificates.

1. Role of management representations:

- a) Management representations are generally given for certifying the value of inventories, provision for Liabilities, Disclosure of contingent Liabilities, etc. These are intended to impress upon the Directors their responsibility for accounts.
- b) Mere Possession of such certificates does not absolve the auditor from carrying out a proper audit. These certificates can only act as second line of defense for an auditor who has carried out his work with reasonable care, skill and diligence.
- c) The auditor should not seek or accept certificates from the management when the subject matter is such that it is capable of direct verification by the auditor himself.

2. Situations when management certificates can be justifiable:

- a) The subject matter should not be capable of direct verification by the Auditor.
- b) The matter relates to items. Which are beyond the competence of a professionally qualifies Accountant.

- c) There are proper records and reliable internal checks in the client's system that can enable the directors to prepare and issue the certificates.
 - d) The certificate should be prima facie in agreement with the records maintained.
 - e) The certificate should be put to common-sense tests by the auditor.
3. **In case of Third party certificates** e.g. Bankers, Architects, Agents etc. the following rules of reliance may be taken into account:
- a) The party issuing the certificate is reputable and trustworthy,
 - b) The certificates relate to an item which is normally dealt with or held by such party,
 - c) The auditor himself is not in a position to verify the item because of its technical nature or because it would be too costly or cumbersome for him to do so,
 - d) The certificate prima facie is reliable and reasonable, and
 - e) Reference to the third party if available in the books and documents of the client as in possession of the concerned goods, property or securities belonging to the clients.

Q.No.3. At the statutory audit of Tor limited, the physical verification of fixed assets was conducted. However, the auditor was not able to confirm the existence of valuables and important machinery. In this connection, the auditor obtained a certificate from the management to prove its existence and value and accepted the same blindly without any audit procedures. As a statutory auditor, how will you deal with the above issue? Or an auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

1. **Management's Duties:** Physical verification of fixed assets is the primary responsibility of the management. But, the auditor should examine the verification programme adopted by the management. Through his audit procedures, the auditor must satisfy himself about the existence, ownership and valuation of fixed Assets.
2. **Auditor's Duties:**
 - a) Under SA-580, when a management representation relates to matters which are material to the financial information, the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be will informed on the matter.
 - b) The Auditor should also report whether he has obtained all information and explanations which are necessary for the purpose of his audit. As per the generally accepted audit principles, he is required to verify the existence of fixed assets.
 - c) If a representation by management is contradicted by other evidence, the auditor should examine the circumstances and, also reconsider the reliability of other representations made by management.
 - d) The auditor is also guilty of professional misconduct in case he expresses an opinion on financial statements without obtaining sufficient information warranting such opinion.
3. **Role of Management Representations:** Representation by Management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination, even if he has obtained a representation from management on the matter. Therefore, the auditor's approach in the above case is not correct.

Conclusion: If the auditor expresses a clean opinion on the financial statements based on management's certificate only without any further audit procedures, he will be guilty of dereliction of duties statutorily prescribed under the companies Act. Hence, he should not express a clean opinion on the financial statements in the given case.

Q.No.4. In the course of audit of ABC Ltd. Its management refuses to provide written representations. As an auditor what is your duty? **(4M) (OR)**

Discuss with reference to SA:

What do you mean by "Written Representations"? As an auditor, how you will deal if management does not provide requested written representations? **(PM, M14 – 5M)**

Ans: Duty of an Auditor if management refuses to provide written representations: As per SA 580 (Revised) "Written Representations", if the management does not provide one or more of the requested written representations, the auditor shall:

- a) Discuss the matter with management
- b) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and
- c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

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

Q.No.5. Auditor of X Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence. Comment. **(N07, N15RTP, N14 MTP2-5M)**

Ans: According to SA-580, Representation by Management, auditor may rely on management representation as audit evidence but he should

- a) Use professional judgment to determine the matter on which representation is to be obtained.
- b) Representation may be oral or written but on material matters seek written representation where other sufficient audit evidence does not exist.
- c) If matter involved is material then he should seek corroborative evidence, evaluate the reasonableness and consistency of such a representation with other audit evidences.
- d) Management is not a substitute for other audit evidence and if contradicted by other evidences, the auditor may reconsider the reliability of management representation.

Inference: Thus in the given case, the auditor should not have relied on management representation but could have verified the imported material with purchase order, invoice, bill of entry, custom document, payment of F.C etc. therefore he may be held liable for negligence and professional misjudgment.

Q.No.6. The management of Ankita Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. It wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management. Comment.

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

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

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

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

Q.No.7. Briefly explain Management Representation.

Management Representation: SA 580 "Written Representations" deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

SA 600 USING THE WORK OF ANOTHER AUDITOR

1. Meaning:

- a) **Component:** Any branch, division, subsidiary, joint venture or associates, etc., whose financial information as used in the financial statements of client.
- b) **Principal Auditor:** Auditor of client
- c) **Another Auditor:** Auditor of component of client

2. Applicability of the standard:

- a) This Standard is applicable to material components, w.r.t. financial statements as a whole.
- b) This Standard is not applicable to
 - i) Those instances where two or more auditors are appointed as joint auditors
 - ii) The auditor's relationship with the predecessor auditors.

3. Consideration by Principal Auditor:

- a) Principal Auditor is entitled to rely upon another auditor, provided he exercised due skill and care and there is nothing to doubt.
- b) Principal auditor should advise another auditor regarding.
Use to be made of his report, Areas requiring special consideration, Time Table for completion of audit, Significant accounting auditing and reporting requirement.
- c) Principal auditor should ask another auditor regarding any limitation on his work.

- d) Auditor should consider his findings. He may discuss them with him and branch officials.
- e) Principal auditor may require another auditor to submit questionnaire w.r.t. work performed by him.
- f) Principal auditor may require supplement tests to be performed by Another auditor ; or himself
- g) In case of foreign component, he should consider another auditor's qualification and experience.
- h) If there is modification in another auditors report then, principal auditor should consider whether modification in his report is required.

4. **Co - ordination:**

- a) The Other Auditor, knowing the context in which his work is to be used by the Principal Auditor, should co-ordinate with him and assist him actively.
- b) He should bring to the Principal Auditor's immediate attention any significant findings requiring to be dealt with at entity level and adhere to the time-table for audit of the component.
- c) He should also ensure compliance with the relevant statutory requirements.

5. **Documentation by principal auditor:**

- a) Components audited by another auditor ;
- b) Audit procedures adopted and evidence obtained ;
- c) Conclusion that particular component is not material ;
- d) Manner of dealing with modification in another auditor's report

6. **Reporting by Principal auditor:**

- a) **Principal auditor should Qualify / Disclaim his audit report if he:**
 - i) Can't use another auditors work & Procedures
 - ii) Can't be able to perform sufficient additional procedures.
- b) There should be statement of division of responsibility in Principal Auditor's Audit report by showing extent to which financial statement of component audited by another auditor has been included in financial statement of entity.

7. **Responsibility of Principal Auditor** The principal auditor would **not** be responsible in respect of the work entrusted to the other auditor, except in circumstances, which should have aroused his suspicion about the reliability of the work performed by the other auditor.

8. **Example of Reporting:** *The financial statements of 15 branches were audited by the other auditor whose assets represent approximately 30% of the total assets. We were furnished with the report of the other auditors and we have considered the report of other auditors in preparing our own reports.*

PRACTICAL QUESTIONS

Q.No.1. Discuss the principal auditor's procedures as enshrined in SA-600. State any six procedures to be adopted by the principal auditor in using the work of other auditors. **(N14 – 8M)**

Ans: Refer SA 600 Para No – 3

Q.No.2. Write short notes on co-ordination between principal auditor and other auditor.

Ans: Refer SA 600 Para No - 1, 2, 4.

Q.No.3. Discuss the reporting considerations of the principal auditor under SA-600.

Ans: Refer SA 600 Para No -1, 5, 6

Q.No.4. "There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor
(N 02 - 8M)

Ans: Refer SA 600 Para No - 1, 2, 4.

Q.No.5. Principal auditor means the partner of the firm signing the audit report.

Ans: False Refer Definitions

Q.No.6. A branch auditor is a joint auditor according to SA – 299 and his relationship with company auditor is governed by the said standard.

Ans: False Refer Definitions

SA 610 (Revised) USING THE WORK OF INTERNAL AUDITORS (on or after April1, 2010)

1. Relationship between the Internal Audit Function and the External Auditor:

- a) *The role and objectives of the internal audit function are determined by management and, where applicable, those charged with governance. While the objectives of the internal audit function and the external auditor are different, some of the ways in which the internal audit function and the external auditor achieve their respective objectives may be similar.*
- b) *Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. The external auditor has sole responsibility for the audit opinion expressed, and the responsibility is not reduced by the external auditor's use of the work of the internal auditors.*

2. Objectives: *The Objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the audit, are to determine:*

- a) *Whether, and to what extent, to use specific work of the internal auditors; and*
- b) *If so, whether such work is adequate for the purposes of the audit*

3. Definitions: *For purposes of the SAs, the following terms have the meanings attributed below:*

- a) **Internal audit function:** *An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, the adequacy and effectiveness of internal control.*
- b) **Internal auditors:** *Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.*

4. Determining Whether and to What Extent to Use the Work of the Internal Auditors:

- a) **The external auditor shall determine:**
 - i) *Whether the work of the internal auditors is likely to be adequate for purposes of the audit ; and*

- ii) If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.
- b) **In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:**
 - i) The Status of Internal Audit function within the entity,
 - ii) The objectivity of the internal audit function,
 - iii) The technical competence of the internal auditors,
 - iv) Whether the work of the internal auditors is likely to be carried out with due professional care, and
 - v) Whether there is likely to be effective communication between the internal auditors and the external auditor.
- c) **In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:**
 - i) The nature and scope of specific work performed, or to be performed, by the internal auditors;
 - ii) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures ; and
 - iii) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

5. Using Specific Work of the Internal Auditors:

- a) In order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes.
- b) To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether :
 - i) The work was performed by internal auditors having adequate technical training and proficiency;
 - ii) The work was properly supervised, reviewed and documented ;
 - iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions ;
 - iv) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed ; and
 - v) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

6. Co-ordination:

- a) External auditor should discuss with internal auditor his plan at early stage.
- b) Meeting should be conducted at regular interval.
- c) There should be sharing of information between external and internal auditor.

ADVANCED

- 7. Matters to be agreed between Internal and External Auditors:** Where the work of the Internal Auditors is to be a factor in determining the nature, timing or extent of the External Auditor's procedures, it may be useful to agree in advance the following matters with the Internal Auditors, -

- a) Timing of such work,
 - b) Extent of audit coverage,
 - c) Materiality for the Financial Statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and Performance Materiality,
 - d) Proposed methods of item selection,
 - e) Documentation of the work performed, and
 - f) Review and reporting procedures.
8. **Others:** The Statutory Auditor may be required to see whether Internal Audit is mandatory for the Company under the Companies Act.

PRACTICAL QUESTIONS

Q.No.1. What aspects should be considered in the evaluation of internal audit function? or you have been appointed as auditor of a large industrial company which has an established internal audit department. You are required to state the main aspects you would consider to find out the effectiveness of the department. **(N14 – 8M)**

Ans: Refer SA 610 Para No - 2, Para No - 4

Q.No.2. Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an internal auditor.

Ans: Refer SA 610 Para No - 5, Summary of Para No - 5

Q.No.3. How far is the internal audit useful to the statutory auditor? To what extent the statutory auditor can rely on the internal audit report? or can an auditor ignore checking of areas already checked by internal auditors? "The statutory auditor is entitled to rely on the internal auditor". Comment. Or can the statutory auditor rely upon the work of an internal auditor?

Ans: Refer SA 610 Summary of Para No - 4, 5

Q.No.4. Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an internal auditor. **(6M)** **(OR)**
Can the External Auditor rely upon the work of an Internal Auditor? **(PM)**

Ans: Refer SA 610 Summary of Para No-5

Q.No.5. The auditor needs to review the system of internal audit only when such review is required for the purpose of reporting by the auditor u/s 227 (4a) of the act. Comment.

Ans: Refer SA 610 Para No-3, Summary of Para No - 4, 5

SA 620 (REVISED) USING THE WORK OF AN AUDITORS EXPERT (ON OR AFTER APRIL 1, 2010)

1. Meaning:

- a) **Auditor's expert** is an Individual / organization possessing expertise in a field other than accounting or auditing whose work is used by auditor in obtaining evidence. An Auditor's Expert may be either an Auditor's Internal Expert (who is a Partner or Staff, including Temporary Staff, of the Auditor's Firm or a Network Firm), or an Auditor's External Expert.
- b) **Management expert** whose work is used by Entity in preparing the financial statements.

2. SA not applicable when:

- a) Engagement team includes a member with expertise in specialized area of accounting or auditing, or
- b) Auditor's use of management's expert

3. Need for auditor's expert:

- a) He shall consider whether it is necessary to use the work of auditor's expert
- b) For example it may be required to understand the entity operating in a complex environment.

4. Expertise in a field other than accounting or auditing may include expertise in relation to such matters as:

- a) The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- b) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- c) The estimation of oil and gas reserves.
- d) The valuation of environment liabilities, and site clean-up costs.
- e) The interpretation of contracts, laws and regulations.
- f) The analysis of complex or unusual tax compliance issues.

5. Auditor's Responsibility:

- a) Auditor has sole responsibility of his audit opinion
- b) His responsibility is not reduced by using auditor's expert
- c) However, he may accept the work of auditor's expert as evidence if he concludes that auditor's expert is adequate

6. Auditor's Procedures w.r.t. determining adequacy or work of auditor's expert: In case, auditors considers that using the work of auditors expert is necessary, he shall determine whether the work of that expert is adequate by considering the following:

a) Competence, capability and objectivity of auditor's expert's:

- i) He shall evaluate whether expert is having necessary skills & objectivity.
- ii) He should inquire regarding expert's objectivity also.
- iii) He should be aware of the relationships that may hamper expert's independence.

b) Understanding the field of expertise of auditor's expert:

- i) He should understand the field of expertise of that expert through discussion with him.
- ii) This understanding will help the auditor in evaluating the adequacy of work of auditor's expert.

c) Agreement with Auditor's expert: Auditor shall agree with auditor's expert on following matters:

- i) Nature, scope & objectives of that expert's work.
- ii) The role & responsibilities of auditor & that expert.
- iii) Timing etc. of communication (including report to be provided by expert) between the auditor & that expert.
- iv) Need for auditor's expert to observe confidentiality.

d) Evaluating Adequacy of auditor's expert's work:

- i) Reasonableness of expert's findings.
- ii) Consistency of findings of that expert with other evidences.
- iii) Reasonableness of assumptions used by expert,
- iv) Reasonableness & accuracy of source data used by expert
- v) If auditor determines that work of expert is not adequate, he shall perform further procedures.

7. Reference to auditor's expert in auditor's Report:

a) *In case of unmodified opinion:*

- i) Auditor shall not refer to work of auditor's expert in the report containing unmodified opinion unless required by law / regulations to do so.
- ii) *If required by law / regulations, he shall indicate in auditors report that such reference does not reduce auditor's responsibility for the audit opinion.*

b) *In case of modified opinion:*

- i) He shall refer to work of auditor's expert if such reference is necessary for understanding the nature of modification.
- ii) *He shall indicate that such reference does not reduce auditor's responsibility for the audit opinion.*

PRACTICAL QUESTIONS

Q.No.1. SA - 620 applies when an auditor seeks legal opinion from an advocate. Comment.

Ans: Refer SA 620 Para No - 1, 2, 5 & Conclusion.

Q.No.2. How does an auditor evaluate the work of an expert? What are the auditor's duties vis-à-vis using the work of an expert?

Ans: Refer SA 620 Para No - 6

Q.No.3. The new audit trainee of your firm of auditors has asked you to advise him on the reliability of the evidence for valuation of land and buildings by a valuer. Describe the work you would carry out to check the independence, qualifications and experience of the valuer and the accuracy of the valuation.

Ans: Refer SA 620 Para No - 1, 2 & Summary of Para No - 6

Q.No.4. While doing audit, Ram, the auditor requires reports from experts for the purpose of audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?
(N 10 - 4M)

Using the Work of an Expert: As per SA 620, "Using the Work of an Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or opinions or statements of an expert for the purpose of audit evidence:

1. Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
2. Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, mineral and petroleum reserves, and the remaining useful life of plant and machinery.
3. Determination of amounts using specialised techniques or methods, for example, an actuarial valuation.
4. The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.
5. Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

When the auditor intends to use the work of an expert, he should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering the sufficiency, relevance and reliability of source data used, the assumptions and methods used and, if appropriate, their consistency with the prior period, and the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

Q.No.5. An expert is a person, firm or association of persons possessing special skill, knowledge and experience in auditing.

Ans: False Refer Definitions

Q.No.6 An auditor's external expert is not subjected to quality control policies and procedures of an audit firm.
(Nov - 14)

Ans: True

**SA 700 (Revised) FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS
(w.e.f 01.04.2012)**

1. **General purpose framework:** *Fair presentation framework* requires compliance with the requirements of FRF and acknowledges that Management may provide disclosures beyond those specifically required by framework (or) Management may depart from a requirement of framework to achieve fair presentation of financial statements (in very rare case)

Compliance framework requires compliance with requirements of framework

2. **Forming an Opinion on Financial Statements:**

- a) The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

- b) To form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- c) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments and involves:
 - i) Sufficiency and appropriateness of audit evidence
 - ii) The financial statements adequately disclose the significant accounting policies selected and applied;
 - iii) The accounting policies selected and applied the consistent with the applicable financial reporting framework and are appropriate;
 - iv) The accounting estimates made by management are reasonable;
 - v) The information presented in the financial statements is relevant, reliable, comparable and understandable;
 - vi) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
 - vii) The terminology used in the financial statements, including the title of each financial statement, is appropriate.
- d) The auditor's evaluation as to whether the financial statements achieve fair presentation (fair presentation framework) shall include consideration of:
 - i) The overall presentation, structure and content of the financial statements; and
 - ii) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

3. Report:

- a) The auditor should review the conclusions drawn from the audit evidence obtained for the expression of an opinion on the financial statements.
- b) The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

4. Elements / contents of audit report:

Refer: Chapter 6 – Q.No.20

5. Audit Report types:

- a) **Unmodified opinion:** *An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view.*
- b) **Modified opinion:** *Under following situations auditor's report may have to be modified*
 - i) *When the auditor concludes that financial statements as a whole are not free from material misstatements*
 - ii) *When the auditor is unable to obtain sufficient and appropriate audit evidence to conclude that the financial statements are free from material misstatements.*

6. Supplementary information presented with the financial statements:

- a) *Auditor shall evaluate whether such supplementary information is clearly differentiated from the audited financial statements.*
- b) *If such supplementary information is not clearly differentiated from the audited financial statements, the auditor shall ask management to change how the unaudited supplementary information is presented.*
- c) *If management refused to do so, the auditor shall explain in the auditor's report that such supplementary information has not been audited.*

ADVANCED

7. **Features of Good Audit Report:** A good Audit Report should have the following characteristics –
- a) **Sincerity:** The opinion stated in the report should, in fact and in appearance, express an independent mind, unaffected by any bias. There should be a sincere effort of the Auditor in expressing his opinion
 - b) **Language:** The Report should be in a lucid and clear language informing the Shareholders about the existing state of affairs of the company. It should assure them that the presentation contained in the Financial Statements have been found to be true and fair. The Report should also inform the members about the material matters, which have not been mentioned in the Financial Statements.
 - c) **Accuracy:** The collection, interpretation and presentation of data in the Audit Report should be accurate.
 - d) **(d) Simplicity:** Technical jargons should be avoided. Brevity in word, phrase and sentences would make the report live and interesting.
 - e) **Coherence:** The Report must be coherent. There must be a thread of unified thought binding sentence would make the report live and interesting.
 - f) **Contents:** The Report should contain the following information required by SAs, and / or Laws or Regulation.
 - g) **Reasons:** When the Auditor has given a Qualified or Adverse Report or a Disclaimer of Opinion, he should state the reasons thereof in his report itself

INDEPENDENT AUDITOR'S REPORT (format)

To,

The Members of ABC Company Limited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Limited ("the Company"), which comprise the Balance Sheet as at March 31, 20XX, and the Statement of Profit and Loss and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibilities for the Financial Statements: *Management is responsible for the preparation of these financial statements that give a true and fair view of the financial position, financial performance and cash flows of the company in accordance with the Accounting Standards referred to in sub-section (3C) of section 129 of the Companies Act, 2013 ("the Act"). This responsibility includes the design, implementation and maintenance of internal control relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.*

Auditor's Responsibility: *Our responsibility is to express an opinion on these financial statements based in our audit. We conducted our audit in accordance with the Standards on Auditing issued by the ICAI. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.*

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit includes evaluating the appropriateness of accounting policies used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion: *In our opinion and to the best of our information and according to the explanations given to us. The financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:*

- a) *In the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;*
- b) *In the case of the Profit and Loss Account, of the profit/loss of the year ended on that date; and*
- c) *In the case of the Cash Flow Statement, of the cash flows for the year ended on that date.*

Report on other Legal and Regulatory Requirements:

- 1. *As required by the companies (Auditor's Report) Order, 2003 ("the Order") issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Act, we give in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the order.*
- 2. **As required by section 227(3) of the Act, we report that:**
 - a) *We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit;*
 - b) *In our opinion proper books of accounts as required by law have been kept by the Company so far as appears from our examination of those books [and proper returns adequate for the purpose of our audit have been received from branches not visited by us]*
 - c) *The Balance sheet, Statement of profit and Loss, and Cash Flow Statement dealt with by this Report are in agreement with the books of account [and with the returns received from branches not visited by us]*
 - d) *In our opinion, the Balance Sheet, Statement of Profit and Loss, and Cash Flow Statement comply with the Accounting Standards referred to in sub-section (3C) of section 129 of the Companies Act, 2013;*
 - e) *On the basis of written representations received from the directors as on March 31, 20XX, and taken on record by the Board of Directors, none of the directors is disqualified as on March 31, 20XX, from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956.*
 - f) *Since the Central Government has not issued any notification as to the rate at which the cess is to be paid under section 441A of the Companies Act, 1956 nor has it issued any Rules under the said section, prescribing the manner in which such cess is to be paid, no cess is due and payable by the company.*

*For XYZ and Co,
Chartered Accountants,
Firm's Registration Number*

*Place of Signature
Date*

*Signature
(Name of the Member Signing the Audit Report)
(Designation)
Membership Number*

PRACTICAL QUESTIONS

Q.No.1. ENUMERATE THE 'BASIC ELEMENTS OF AUDIT REPORT' AS ENSHRINED IN SA - 700. **(N 04 - 8M)**

Ans: Refer Para- 2

SA 705 MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

1. **Types of Modified Opinions:** This SA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The decision regarding which type of modified opinion is appropriate depends upon:
 - a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
 - b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the effects or Possible effects on the Financial Statements	
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

2. **Determining the Type of Modification to the Auditor's Opinion:**

Refer: Chapter 6 – Q.No.21

3. **Form and Content of the Auditor's Report when the opinion is modified :**

- a) **Basis for modification paragraph:** The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified opinion", "Basis for Adverse opinion", or "Basis for Disclaimer of opinion", as appropriate. He shall describe the matter giving rise to modification including quantification of financial effects of matter unless impracticable. If auditor is unable to quantify the effect he should state that fact.
- b) **Opinion Paragraph:** When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified opinion", "Adverse opinion", or "Disclaimer of opinion", as appropriate, for the opinion paragraph.
- c) **When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the basis for qualified opinion paragraph:**
 - i) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
 - ii) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s)" for the modified opinion.

- d) When the auditor expresses an adverse opinion, the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse opinion paragraph:
- i) The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
 - ii) The financial statements have not been prepared in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.
- e) When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence the auditor shall state in the opinion paragraph that :
- i) Because of the significance of the matter(s) described in the basis for disclaimer of opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly,
 - ii) The auditor does not express an opinion on the financial statements.
- f) Description of auditor's responsibility when the auditor expresses a qualified or adverse opinion: When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

Description of Auditor's Responsibility when the auditor disclaims an opinion:

- i) When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements.
 - ii) The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following:
 - iii) "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with standards on Auditing issued by the institute of Chartered Accountants of India. Because of the matter(s) described in the Basis for Disclaimer of opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion".
- g) Communication with those charged with governance: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

EXAMPLE OF MODIFIED REPORT – QUALIFIED OPINION DUE TO LIMITATION ON SCOPE

(Same introductory paragraph as of an unmodified report)

Basis for qualified opinion: X Ltd's investment in XYZ company, a foreign associate acquired during the year and accounted for by the equity method, is carried at Rs.XXX in the balance sheet as at March 31, 20XX, and company's share of XYZ company's net income is included for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of X Ltd's investment in XYZ company as at March 31, 20XX and X Ltd's share of XYZ company's net income for the year because we were denied access to financial information, management and auditor's of XYZ company. Consequently, we were unable to decide whether any adjustments to these amounts were necessary.

Qualified Opinion: In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects of the matter described in the basis for qualified opinion paragraph, The financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

- a) In the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;
- b) In the case of the Profit and Loss Account, of the profit/loss of the year ended on that date; and
- c) In the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

EXAMPLE OF MODIFIED REPORT - QUALIFIED OPINION DUE TO DISAGREEMENT WITH MANAGEMENT

(Same introductory paragraph as of an unmodified report)

Basis for qualified opinion: The company's inventories are carried in the balance sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the accounting standards referred to in sub section (3C) of section: 211 of the Act. The company's records indicate that had management stated the inventories at lower of cost or net realizable value, an amount of Rs XXX would have been required to write the inventories down to their net realizable value. Accordingly cost of sales would have been increased by Rs XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs XXX, Rs XXX and Rs. XXX, respectively.

Qualified Opinion: In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the basis for qualified opinion paragraph, The financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

- a) In the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;
- b) In the case of the Profit and Loss Account, of the profit/loss of the year ended on that date; and
- c) In the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

EXAMPLE OF MODIFIED REPORT – ADVERSE OPINION DUE TO DISAGREEMENT WITH MANAGEMENT

(Same introductory paragraph as of an unmodified report)

Basis for Adverse opinion: The company's inventories are carried in the balance sheet at Rs. XXX. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from the accounting standards referred to in sub section (3C) of section: 211 of the Act. The company's records indicate that had management stated the inventories at lower of cost or net realizable value, an amount of Rs XXX would have been required to write the inventories down to their net realizable value. Accordingly cost of sales would have been increased by Rs XXX, and income tax, net profit and shareholders' funds would have been reduced by Rs XXX, Rs XXX and Rs XXX, respectively.

Adverse Opinion: In our opinion because of the significance of the matter described in the basis for adverse opinion paragraph, the financial statements do not give true & fair view in conformity with the accounting principles generally accepted in India:

- a) In the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX;
- b) In the case of the Profit and Loss Account, of the profit/loss of the year ended on that date; and
- c) In the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

EXAMPLE OF DISCLAIMER OF OPINION - LIMITATION OF SCOPE AUDITOR'S REPORT

(Same introductory paragraph as that of a standard unmodified report)

(Omit the scope paragraph)

The company does not have records supporting existence of fixed assets shown in B/S at Rs. 500000. Further, the company did not conduct a physical count of inventory during the year stated in the financial statements at Rs. 4,00,000 as on March 31, 2008. Further, evidence supporting the Sales and purchases during the year is not available. The company's records do not permit the application of other auditing procedures to fixed assets, inventory and trading items. Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on financial statements.

PRACTICAL QUESTIONS

Q.No.1. List the situations where the Auditor would issue a Modified Opinion.

Ans: Refer SA 570 Para No- 1(b).

Q.No.2. Disclaimer of Opinion is issued when an Auditor confronts a different stand by Management in respect of a material issue which the Auditor does not approve of. Say True or False.

Where the accounts of a Company do not show a true and fair view, the Auditor should express Disclaimer of Opinion. Comment.

Ans: False. Adverse report is to be issued.

Q.No.3. An Adverse Report is one where an Auditor gives an opinion subject to certain reservation. Say True or False.

Ans: False. Qualified report is to be issued.

**SA 706 EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE
INDEPENDENT AUDITOR'S REPORT (w.e.f 01.04.2011)**

1. **Objective:** The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:
 - a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that is fundamental to user's understanding of the financial statements; or
 - b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
2. **Emphasis of Matter Paragraphs in the Auditor's report:** When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:
 - a) Include it immediately after the opinion paragraph in the auditor's report;
 - b) Use the heading "Emphasis of Matter", or other appropriate heading;
 - c) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements;

- d) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.
3. **Examples of circumstances where the auditor may consider it necessary to include an emphasis of matter paragraph are:** (M14 – 5M)
- a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
 - b) Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
 - c) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
 - d) There is substantial doubt about the entity's ability to continue as a going concern.
 - e) There has been a material change between periods in accounting principles or in the method of their application.
4. **Other Matter Paragraphs in the Auditor's Report:**
- a) If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter", or other appropriate heading.
 - b) The auditor shall include this paragraph immediately after the opinion paragraph and any emphasis of matter paragraph, or elsewhere in the auditor's report if the content of the other matter paragraph is relevant to the other reporting responsibilities section.
5. **Communication with Those Charged with Governance:** If the auditor expects to include an emphasis of matter or another matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph.

EXAMPLE OF EMPHASIS OF MATTER PARAGRAPH AUDITOR'S REPORT

(Same introductory and scope paragraphs as of an unqualified report)

We draw your attention to Note: X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by XYZ Ltd. Our opinion is not qualified in this regard.

ADVANCED

6. **Special circumstances for Other Matter Paragraphs**
- a) **Resignation not possible:** In the rare circumstance where the Auditor is unable to resign from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by Management is pervasive, the Auditor may consider it necessary to include an Other Matter Paragraph in the Auditor's Report, to explain why it is not possible for the Auditor to resign from the engagement.
 - b) **Restriction on distribution or use of Auditor's Report:** Financial Statements prepared for a **Specific purpose** may be prepared in accordance with a General Purpose Framework because the intended Users have determined that such General Purpose Financial Statements meet their Financial information needs. Since the Auditor's Report is intended for Specific Users, the Auditor may consider it necessary in the circumstances to include an Other Matter Paragraph, stating that the Auditor's Report is intended solely for the intended Users, and should not be distributed to or used by other parties.

PRACTICAL QUESTIONS

Q.No.1 Give examples of situations when an Emphasis of Matter Paragraph may be used in the Report.

Ans: Refer SA 570 Para No - 3.

Q.No.2 ABC company files a law suit against Unlucky Company for Rs. 5 Crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the Notes accompanying its Financial Statements. As an Auditor of Unlucky company, how will you deal with the situation?

Hint: Auditor may include an Emphasis of Matter Paragraph, if it is required so in his judgment.

Q.No.3 where should the Emphasis of Matter Paragraph be included in the Auditor's Report?

Ans: After the opinion paragraph.

Q.No.4 Write short notes on the content of Other Matter Paragraph in the Auditor's Report.

Ans: Refer SA 570 Para No - 4.

Q.No.5 Where should the Other Matter Paragraph be included in the Auditor's Report?

Ans: After the opinion paragraph and Emphasis of Matter Paragraph

TRUE OR FALSE QUESTIONS (FOR STUDENT SELF STUDY)

Q.No.1 Emphasis of matter paragraph in the auditor's report is a substitute of disclaimer of opinion. (N 14)

Ans: FALSE

SA 710 (Revised) COMPARATIVE INFORMATION – CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS. (w.e.f 01.04.2011)

1. The nature of Comparative information:

- For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; were as
- For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.
- This SA addresses separately the auditor's reporting requirements for each approach.

2. Audit Procedures:

- For the purpose, auditor shall evaluate whether :
 - The comparative information agrees with the amounts and other disclosures presented in the prior period; and

- ii) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
- b) If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 subsequent events (Revised).
- c) As required by SA 580 written representation (Revised), the auditor shall request written representation for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

3. **Audit reporting:**

Corresponding Figures: When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except:

- a) If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.
- b) If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.
- c) **Prior Period Financial Statements Audited by a Predecessor Auditor:** If the financial statements of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:
 - i) That the financial statements of the prior period were audited by the predecessor auditor;
 - ii) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
 - iii) The date of that report.
- d) **Prior Period financial statements not Audited:** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding Revised Standard on Auditing (SA) 710 figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Comparative Financial Statements: When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.

- a) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.

b) Prior period financial statements audited by a predecessor Auditor:

- i) If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:
 - That the financial statements of the prior period were audited by a predecessor auditor;
 - The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore and
 - The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.
- ii) If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor has previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed.
- iii) If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.
- c) Prior period financial statements not audited: If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

PRACTICAL QUESTIONS

Q.No.1. What are the auditor's responsibilities in respect of corresponding figures?
(PM, N14RTP)

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

- a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

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

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

Q.No.2. The audit report of p ltd. For the year 2007-08 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2008-09, how would you report, if: the company does not make provision for doubtful debts in 2008-09?
The company makes adequate provision for doubtful debts in 2008-09? **(J 09 - 8M)**

Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

1. Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
2. In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Q.No.3. Auditor's responsibilities regarding comparatives. **(N 03 - 4M)**

Ans: Refer summary of Comparative Financial Statements in SA: 710

SA 720 THE AUDITOR'S RESPONSIBILITY IN RELATION TO OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS (w.e.f 01.04.2010)

1. Definitions:

Other Information: Financial and non financial information (Other than the financial information and the auditor's report thereon) which is included in a document containing audited financial statements and the auditor's report there on.

Inconsistency: Other information that contradicts information contained in the audited financial statements.

Misstatement of fact: Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

2. The auditor shall make appropriate arrangements with the management and TCWG to obtain the other information prior to the date of Auditor's report. He should read the other information to identify material inconsistencies, if any with the audited financial statements.

If on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.

3. **Material misstatements identified in other information prior to the date of auditor's report:**

- a) Where revision is necessary in FS and management/TCWG refuses to do so modify the opinion
- b) Where revision is necessary in Other Information and management/TCWG refuses to do so mention the same in other matter paragraph.

4. **Material misstatements identified in other information after the date of auditor's report:**

- a) Where revision is necessary in FS, follow relevant requirements of SA : 560
- b) Where revision is necessary in Other Information and management/TCWG refuses to do so take appropriate action.

PRACTICAL QUESTIONS

Q.No.1. What should the Auditor do under SA-720, when he identifies material inconsistencies while reading "Other Information"?

Ans: Refer Para No- 3 & 4.

THE END