

PAPER – 2 : AUDITING

QUESTIONS

1. (a) What do you mean by documentation ?
(b) How working papers aid in auditing?
(c) ABC Pvt. Ltd. Has decided to change his auditor CA. Narendra Kashyap. ABC Pvt. Ltd. Requested his auditor to handover all of its previous years' working papers. CA. Narender refused to handover the working papers. Comment.
2. When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.
(a) Give examples of such circumstances that, individually or in combination, may make the auditor suspect that such a misstatement exists.
(b) When the auditor encounters such circumstances, what would be procedures to be performed by the auditor?
3. (a) Define the term "Principal auditor", "Other auditor", and 'Component' with reference to AAS 10 ("Using the work of an another Auditor").
(b) What is the principle auditor's responsibility in relation to the use of work of the other auditor?
4. (a) What are the various purposes of the AAS 11 "Representation by Management".
(b) What are the basic elements of a "Management Representation Letter" ?
5. (a) When the compliance with AASs is essential?
(b) How can quality control at firm level be ensured?
6. (a) Define the two types of after –balance –date events as per AAS-19.
(b) Discuss procedures to identify events that may require adjustment of, or disclosure in, the financial statements.
7. (a) What is the meaning of "Those charged with Governance" as per AAS 27?
(b) What are the forms of auditor's communication with those charged with governance? What are the factors affecting forms of communication?
8. How will you vouch and/or verify the following?
(a) Goods sent out on Sale or Return Basis
(b) Foreign travel expenses
(c) Goodwill
(d) Sales Return
9. Write Short note on the following:
(a) Operational Audit
(b) inherent limitations of audit.
(c) Reliability of Audit Evidence
(d) Advantages of "Audit Working Papers"
(e) Random sampling
(f) Option on Share Capital
(g) Clean Audit Report

10. Bharat ,proprietor of Bharat kumar & Sons, is a small dealer of milk powder. He wants to get his accounts audited although there is no compulsion of audit under law in his case. Briefly state the advantages of audit for a concern where audit is not compulsory by law.
11. (a) (i) Mr. A is an officer in Shree Udyog Ltd. Mr. A is also a partner of PQR & Co., a partnership firm. CA. B is also a partner of PQR & Co. CA. B is offered by A to act as an auditor of Shree Udyog Ltd. Comment.
 (ii) CA. Sanjay holds one equity share of ST Ltd. Can he act as auditor of ST Ltd?
 (iii) CA. Prabha is indebted to DB Ltd. worth Rs. 1000. She is offered to act as an auditor of the Company. Can she accept the offer?
- (b) CA. Deep is appointed as an auditor of the Company Paras Ltd. and he accepts the appointment. After two months of his appointment he refuses to act as an auditor due to some personal reason and resigns. Board of Directors appoints another auditor CA. Kuldeep and he accepts the appointment. Is the appointment valid?
12. State the number of companies in which a person can be appointed as an auditor?
13. Discuss the steps in case of audit of Situations of Missing or Incomplete Records.
14. Explain in detail the duties of Comptroller and Auditor General of India?
15. How would you proceed to check the misappropriation of cash in a trading concern?
16. (a) 'The auditor of an EDP-based company should remember that if the quality of the input is controlled, the output will look after itself.'
 (b) Describe six major procedural controls which the auditor would expect to find in operation, three relating to input and three to output.
17. Write a short note on audit of local bodies.
18. What are the provisions of the Companies Act, 1956 regarding the appointment of an auditor in the following cases:
 (i) When no auditor has been appointed at the Annual General Meeting.
 (ii) When no General Meeting has been held and no auditor appointed for two years.
 (iii) When it is desired to appoint an auditor other than the retiring auditor.

SUGGESTED ANSWERS/HINTS

1. (a) As per AAS 3 'Documentation' refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.
 (b) Working papers
 (i) aid in the planning and performance of the audit;
 (ii) aid in the supervision and review of the audit work; and
 (iii) provide evidence of the audit work performed to support the auditor's opinion.
 (c) Auditing and Assurance Standard (AAS) 3, Documentation (Paragraph 13), states, "Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client." AAS 3 further requires (paragraph 14), inter alia, that the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers." Requests are sometimes received by the members of the Institute, who have/had been performing the duties as the auditors of an enterprise, to provide access to their audit working papers. The requests may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise. An auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The

main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'. As stated above, the client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client. Therefore ABC Pvt. Ltd. can not force the auditor to handover his working papers.

2. (a) Examples of Circumstances that Indicate the Possibility of Fraud or Error: The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; neither all of these circumstances are likely to be present in all audits nor is the list necessarily complete.
 - Unrealistic time deadlines for audit completion imposed by management.
 - Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
 - Limitation in audit scope imposed by management.
 - Identification of important matters not previously disclosed by management.
 - Significant difficult-to-audit figures in the accounts.
 - Aggressive application of accounting principles.
 - Conflicting or unsatisfactory evidence provided by management or employees.
 - Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
 - Information provided unwillingly or after unreasonable delay.
 - Seriously incomplete or inadequate accounting records.
 - Unsupported transactions.
 - Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year-end.
 - Transactions not recorded in accordance with management's general or specific authorization.
 - Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.
 - Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
 - Significant differences from expectations disclosed by analytical procedures.
 - Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
 - Evidence of an unduly lavish lifestyle by officers or employees.
 - Unreconciled suspense accounts.
 - Long outstanding account receivable balances.
- (b) Procedures when Circumstances Indicate a Possible Misstatement: When the auditor encounters circumstances that may indicate that there is a material misstatement in the

financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.

When the auditor encounters such circumstances, the nature, timing and extent of the procedures to be performed depends on the auditor's judgment as to the type of fraud or error indicated, the likelihood of its occurrence, and the likelihood that a particular type of fraud or error could have a material effect on the financial statements. Ordinarily, the auditor is able to perform sufficient procedures to confirm or dispel a suspicion that the financial statements are materially misstated resulting from fraud or error. If not, the auditor considers the effect on the auditor's report.

The auditor cannot assume that an instance of fraud or error is an isolated occurrence and therefore, before the conclusion of the audit, the auditor considers whether the assessment of the components of audit risk made during the planning of the audit may need to be revised and whether the nature, timing and extent of the auditor's other procedures may need to be reconsidered. For example, the auditor would consider:

- The nature, timing and extent of substantive procedures.
 - The assessment of the effectiveness of internal controls if control risk was assessed below high.
 - The assignment of audit team members that may be appropriate in the circumstances.
3. (a) As per AAS 10 "Using the work of another Auditor", "Principal auditor" means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.

"Other auditor" means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.

"Component" means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

- (b) As per AAS 10 "Using the work of another Auditor" When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

The principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors.

4. (a) The following are the purposes of the AAS 11 "Representation by Management":
- (i) to establish standards on the use of management representations as audit evidence
 - (ii) the procedures to be applied in evaluating and documenting management representations
 - (iii) action to be taken if management refuses to provide appropriate representations and
 - (iv) Documentation of Management Representation.
- (b) Following are the basic elements of a Management Representation Letter:
- (i) A management representation letter should be addressed to the auditor, containing the relevant information and be appropriately dated and signed.
 - (ii) A management representation letter would normally be dated the same date as the

auditor's report on the financial information or a date prior thereto. However, in certain circumstances, in respect to specific transactions or events, separate representation letters may also be obtained during the course of audit.

- (iii) A management representation letter should ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects, e.g., managing director, finance director.
 - (iv) If management refuses to provide representations on any matter that the auditor considers necessary, this will constitute a limitation on the scope of his examination. In such circumstances, the auditor should evaluate any reliance he has placed on other representations made by management during the course of his examination and consider if the refusal may have any additional effect on his report.
 - (v) In case management is not willing to give in writing the representations made by it during the course of audit, the auditor should himself prepare a letter in writing setting out his understanding of management's representations that have been made to him during the course of audit and send it to management with a request to acknowledge and confirm that his understanding of the representations is correct. If the management refuses to acknowledge or confirm the letter sent by the auditor, this will constitute a limitation on the scope of his examination. In such circumstances, the auditor should evaluate any reliance on those representations and consider if the refusal may have any additional effect on his report.
5. (a) Compliance with Auditing and Assurance Standards (AASs) is essential whenever an audit is carried out and requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. An audit firm needs to implement appropriate quality control policies and procedures to ensure that all audits are carried out in accordance with Auditing and Assurance Standards (AASs).
- (b) Quality control at firm level can be ensured by following the under mentioned policies:
- (i) Professional Requirements: Personnel employed by the firm should be Independent, Integral, Objective and they should keep the information of the client Confidential.
 - (ii) Skills and Competence: The firm should be staffed by personnel who have attained and maintain the Technical Standards and Professional Competence required to enable them to fulfil their responsibilities with Due Care.
 - (iii) Assignment: Audit work should be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
 - (iv) Delegation: There should be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.
 - (v) Consultation: Whenever necessary, outside consultation may be done by the firm for the matter of expertise.
 - (vi) Acceptance and Retention of Clients: An evaluation of prospective clients and a review, on an ongoing basis, of existing clients should be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly should be considered.
 - (vii) Monitoring: The continued adequacy and operational effectiveness of quality control policies and procedures should be monitored.

The firm's general quality control policies and procedures should be communicated to its personnel in a manner that provides reasonable assurance that the policies and procedures are understood and implemented.

6. (a) Events occurring between the balance sheet date and the date of auditor's report are subsequent events. The subsequent events may be classified into two types:

Type-I : Those events which provide additional evidence with respect to conditions that existed on the date of balance sheet and effect the estimation made in the preparation of financial statements.

Type- II : Those events which provide evidence with respect to conditions that did not exist on the date of balance sheet being reported on but arose subsequent to the date.

- (b) The procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:
 - Reviewing procedures that the management has established to ensure that subsequent events are identified.
 - Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.
 - Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
 - Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.
 - Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements.
7. (a) As per AAS 27, 'those charged with governance' refers to the management of the entity ; the term "governance" is used to describe the role of persons entrusted with the supervision, control and direction of an entity. Those charged with governance are, ordinarily, accountable for ensuring that the entity achieves its objectives, financial reporting, and reporting to interested parties. Those charged with governance include management only when it performs such functions.
- (b) The auditor's communication with those charged with governance may be made orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by factors such as:
 - The size, operating structure, legal structure, and communications processes of the entity being audited;
 - The nature, sensitivity and significance of the audit matters of governance interest to be communicated;
 - The arrangements made with respect to periodic meetings or reporting of audit matters of governance interest;
 - The amount of on-going contact and dialogue the auditor has with those charged with governance.
8. (a) Goods sent out on sale or return basis:
 - (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
 - (ii) See that price of such goods is unloaded from the sales account and the debtor's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
 - (iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.

- (iv) Confirm that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing stock.
- (b) Foreign Travel Expenses:
 - (i) Examine T.A. bills submitted by the employees stating the details of tour, details of expenses, etc.
 - (ii) Verify that the tour programme was properly authorised by the competent authority.
 - (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill, hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
 - (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms with the authorisation for the tour.
 - (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Part I of Schedule VI to the Companies Act, 1956.
- (c) Goodwill:
 - (i) Ensure that as required by AS 10 on "Accounting for Fixed Assets", goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.
 - (ii) Check the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the book value of the assets or where a specific sum has been paid for the goodwill.
 - (iii) See that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in the company's accounts by way of writing up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company.
 - (iv) See whether goodwill has been written off as a matter of financial prudence.
- (d) Sales Return:
 - (i) Examine the accounting basis for such transactions with reference to corresponding Debit Note to Debit Note. The relevant correspondence may also be examined.
 - (ii) Verify by reference to relevant corresponding record in good inward book or the stores records. Further, the figures in these documentary evidences should be compared with the original invoices for rates and other charges and calculation should also be checked.
 - (iii) Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.
 - (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.
- 9. (a) Operational Audit: Operational Audit involves examination of all operations and activities of the entity. The objects of operational audit include the examination of the control structure and of the relation of department controls to general policies. It provides an appraisal of whether the department is operating in conformity with prescribed standards and procedures and whether standards of efficiency and economy are maintained. It is concerned with formulation of plans. Their implementation and control in respect of production and

marketing activities.

Traditionally, internal audit focussed on accounting operations of the entity. However, operational audit covers all other operation such as marketing, manufacturing, etc.

Thus, operational audit in its initial stages developed as an extension of internal auditing. The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation.

Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey.

- (b) **Inherent limitations of Audit:** The objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements.

In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise.

The process of auditing, however, is such that it suffers from certain inherent limitations, i.e., the limitation which cannot be overcome irrespective of the nature and extent of audit procedures.

Such limitations arise, first of all, on account of exercise of judgment in the auditor's work in deciding the extent of audit procedures and exercising judgment also in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements.

Secondly, much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable.

There is also likelihood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.

Another reason which may contribute to inherent limitation is the fact that the entire audit process is generally dependent upon the existence of an effective system of internal control.

In such an event, it is clearly evident that there will always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations since any system of internal control is ineffective against fraud involving collusion among employees or fraud committed by management.

Certain levels of management may be in a position to override controls; for example, by directing subordinates to record transactions incorrectly or to conceal them, or by suppressing information relating to transactions.

Such inherent limitations of internal control system also contribute to inherent limitations of an audit. Therefore, it is quite apparent from above that an audit suffers from certain inherent limitations.

- (c) **Reliability of Audit Evidence:** The reliability of audit evidence depends on its source-internal or external, and on its nature-visual, documentary, or oral. While the reliability of

audit evidence is dependent on the circumstances under which it is obtained, the following generalisations may be useful in assessing the reliability of audit evidence:

- (i) External evidence (e.g. confirmation received from third party) is usually more reliable than internal evidence.
 - (ii) Internal evidence is more reliable when related internal control is satisfactory.
 - (iii) Evidence in the form of documents and written representations is usually more reliable than oral representations.
 - (iv) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.
- (d) **Advantages of audit working papers:** Audit working papers constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and clients' record.

These include retention of permanent record in the nature of a document to show the actual audit work executed, the nature of the work, the extent of the work and important points, facts, dates and decisions having bearing on the audit of the accounts audited. The working papers, if properly maintained, can be used as defence in case of need. The audit working papers are found very useful in the following aspects as they:

- (i) aid in the planning and performance of the audit;
 - (ii) aid in the supervision and review of the audit work;
 - (iii) provide evidence of the audit work performed to support the auditor's opinion; and
 - (iv) act as an evidence in the Court of law when a charge of negligence is brought against the auditor.
- (e) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below:–
- (i) **Simple random sampling :** Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, debtors balances fall within the range of Rs. 5,000 to Rs. 25,000 and not in the range between Rs. 25 to Rs. 2,50,000.
 - (ii) **Stratified Sampling :** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example in the above case, debtors balances may be divided into four groups as follows:-
 - (a) balances in excess of Rs. 1,00,000;
 - (b) balances in the range of Rs. 75,000 to Rs. 1,00,000;
 - (c) balances in the range of Rs. 25,000 to Rs. 75,000; and
 - (d) balances below Rs. 25,000.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group i.e. balances in excess of Rs. 1,00,000, the

auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected.

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.

- (f) **Option on Share Capital:** Part I of Schedule VI to the Companies Act, 1956 requires disclosure of the particulars of any option on unissued share capital. An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for share in the company if he so chooses. Such options generally arise under the following circumstances:
 - (i) Under the promoter's agreements, subsequently ratified by the company;
 - (ii) Collaboration agreement;
 - (iii) Loan agreements, debenture deeds (Refer to Section 81 of the Companies Act, 1956);
 - (iv) Other contracts, such as for supply of capital goods and/or merchandise.
 - (g) **Clean Audit Report:** A clean audit report is one which is issued by the auditor when he does not have any reservation with regard to the matters contained in the financial statements. In such a case, the audit report may state that the financial statements give a true and fair view of the state of affairs and profit and loss account for the period. The audit report should contain a clear written expression of opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or statute or - regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters dealt with below or as may be laid down or prescribed under the relevant agreement or statute or regulation, as the case may be. Under the following/circumstances an auditor is justified in issuing a clean report:
 - (i) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
 - (ii) the financial information complies with relevant regulations and statutory requirements;
 - (iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.
10. In some cases audit is not compulsory but audit is advantageous to those enterprises also, these advantages are given below:
- (i) It acts as a moral check on the employees from committing defalcations or embezzlement.
 - (ii) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.
 - (iii) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property by fire or some other calamity.
 - (iv) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
 - (v) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.
 - (vi) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

- (vii) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.
 - (ix) Government may require audited and certified statement before it gives assistance or issues a licence for a particular trade.
11. (a) Under sub-section (3) of section 226, the following persons are not qualified for appointment as auditors of a company :
- (1) a body corporate;
 - (2) an officer or an employee of the company;
 - (3) a person who is a partner, or who is in the employment of an officer or employee of the company;
 - (4) a person who is indebted to the company for more than Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs. 1000; and
 - (5) a person holding any security of that company.

Therefore in view of the above provision (i) CA. B is disqualified for appointment of Shree Udyog Ltd as he is a partner of an officer of Shree Udyog Ltd. (ii) CA. Sanjay holds one equity share of ST Ltd. As he holds security of the ST Ltd., he is not qualified for appointment as an auditor of ST Ltd. (iii) CA. Prabha is qualified for appointment as an auditor of the DB Ltd. as she is not indebted to the Company for more than Rs. 1000 at the time of appointment.

- (b) The expression 'casual vacancy' has not been defined in the Act. Taking its natural meaning, it stands for a vacancy created by the auditor ceasing to act after he was validly appointed and the appointment was accepted. This may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firms of auditors, etc. In the given case CA. Deep has resigned from the position of auditor, it is a casual vacancy due to resignation.

A casual vacancy in the office of the auditor can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. In case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor. Therefore the appointment of CA. Kuldeep is not valid in law.

12. Section 224(1)(B) of the Companies Act provides that no company or its Board of Directors shall appoint or re-appoint any person or firm as its auditors if such person or firm is at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. No company or its Board of Directors shall appoint or re-appoint any person who is in full employment elsewhere.

The specified number is 20 company audits is per person of which not more than 10 should be companies with a paid up capital of Rs. 25 lakhs or more. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits of which not more than 30 should be in companies having paid up capital of Rs. 25 lakhs or more. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

Explanation II after sub-section (1C) of section 224 further amplifies the manner of identifying the audit units for calculating the specified number. Under this explanation, when an auditor is appointed to audit even a part of a company's accounts, the part will be considered as a unit of audit for the purpose of calculation of the ceiling. In case of joint auditor each of the joint auditor is considered a part auditor for the purpose. Any joint audit held by an auditor will be included a one audit unit for the purpose of calculating the ceiling of audits. However, audit of a branch of company is not included in the computation of the ceiling. Similarly, audit of corporations which

are not companies and foreign companies are also not to be included. Further, it may be noted that even non-profit companies would be counted for the purpose of ceiling. However, guaranteed companies not having share capital, special audit and investigation of companies will not be counted for the purpose.

Companies (Amendment) Act, 2000 has amended section 224(1B) by adding a proviso that provisions shall not apply to a private company on and after the commencement of the Companies (Amendment) Act, i.e. 13.12.2000. Therefore, with this amendment, while computing the ceiling a number of audits, only audit of public companies would be taken into consideration.

(Note: Ceiling on tax audit assignments: The specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is 45 numbers. The ceiling limit was increased from 30 to 45 numbers in the year 2007. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.)

13. **Audit of Incomplete Records :** Normally, the audit of incomplete records may be necessitated under two circumstances viz. (i) when accounts have been maintained on single entry basis or (ii) accounting records may be destroyed by fire, flood, etc. or seized by government authorities. Under either of the circumstance the audit objective would remain the same and, thus, auditor would have to follow extensive audit procedure before expression of an opinion on such financial statements. Steps which may be followed in this regard are as under:
 1. Ascertain the exact status of accounting records available including memoranda records, if any. Also obtain a list of records i.e. accounting, memoranda, statistical, etc.
 2. Ensure that the management compiles/reconstructs accounting records to the extent practicable. In case of single entry the accounts may be converted to double entry basis.
 3. Perform compliance procedure to assess whether any control system is in operation. Generally, it is difficult rather almost impracticable that any control worth the name would be in existence.
 4. Vouch transaction recorded in books of account with reference to appropriate audit evidence. Check positing, casting, etc. in depth. Auditor may also obtain external evidence as far as possible like confirmation from third parties. Bank reconciliation should also be examined in detail.
 5. Examine the system in operation in respect of custody managed cash memos, receipts, cheque books, etc.
 6. Conduct surprise checks to verify cash in hand, inventory, etc.
 7. Verify fixed assets by observing physical verification.
 8. 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.
 9. Check veracity of memoranda records and obtain further evidence to confirm the same.
 10. Apply analytical review procedures in depth and notice deviations to investigate in detail. Ratio analysis shall be of particular importance since it would provide substantive audit evidence.
 11. Formulate 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. (See Annexure)
14. **Duties of C&AG:** The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under:
 - (i) Compile and submit Accounts of Union and States - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

- (ii) General Provisions Relating to Audit - It shall be the duty of the C&AG –
 - (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
 - (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
 - (c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.
 - (iii) Audit of Receipts and Expenditure - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.
 - (iv) Audit of Grants or Loans - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
 - (v) Audit of Receipts of Union or States - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.
 - (vi) Audit of Accounts of Stores and Stock - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and stock kept in any office or department of the Union or of a State.
 - (vii) Audit of Government Companies and Corporations - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 1956.
15. 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 foregoing.

Some of the methods through which cash may be misappropriated include:

- (a) Omission cash receipts:
 - (i) cash sales not recorded;
 - (ii) teeming and lading;
 - (iii) casual receipts of miscellaneous nature not entered; and

- (iv) sale proceeds of fully written off assets not recorded.
- (b) Recording of less amounts than that actually received.
- (c) Recording of more amounts than that actually expended, e.g., discounts or rebates not taken into account while making payments, etc. Inclusion of fictitious payments in cash book e.g. wages paid to 'ghost' or 'dummy' workers, salary paid to apprentices whose tenure of services expired, etc.
- (d) Intentional errors in totalling, balancing and carrying over of cash book balances.

With a view to check misappropriation of cash, the existence of internal check system is quite essential. In particular, the following may be noted:

- (i) Ascertaining the existence of system of cash receipts and disbursements of cash sales and purchases and existence of internal checks at various stages is quite important. In particular, the separation of duties and incompatible functions, e.g., an employee who receives and deposits cash and cheques should not prepare sales invoices, or reconcile bank accounts, and authorised signatory should not approve vouchers for payment.
- (ii) Checking of cash receipts with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by itself would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated.
- (iii) Checking of date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.
- (iv) Verify cash sales with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process, is that the dates on the cash memos should tally with those on which cash collected in respect thereof, as entered in the Cash Book.

Check receipt of cash from the customers against price of good sold with the counterfoils of receipt issued to them. Also compare entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a prima facie evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in customers' accounts, which ought to have collected in whole, are cleared in small instalments.

16. (a) There can be no doubt that the quality of output from an EDP-based system depends greatly, although not totally, on the quality of the input. The input consists of the raw data taken from source documentation and this is what the programme will process to provide the output. An example of this situation is the processing of a batch of sales despatch-notes to produce sales invoices and update a sales ledger.

There are two circumstances which could lead to inaccurate output. Firstly if the data on the despatch notes is incorrect and secondly if that data is inaccurately converted into machine-readable input. Thus it is clear that controls must be established to ensure errors do not occur at either stage. However, this is not the end of the need for controls, and the auditor should be aware of the vital need to check the processing and output stages. Even if the input is completely and accurately transcribed, the output will not be correct if errors can occur at the processing stage, such as data not being processed or processed more than once. Also the quality of the output will be impaired if it is not in the format required and does not meet the needs of the user or if the output is altered before it reaches the user.

In conclusion it may be more correct to state that the auditor must consider controls over each stage of input, process and output before he can be satisfied with the accuracy of the system.

(b) Major procedural controls which an auditor would expect to find are as follows:

(i) Input Controls:

- (a) Batch preparation and recording of batches so each document can subsequently be traced to a particular batch and so the completeness and accuracy of input can be checked by reference to totals, both real and hash.
- (b) Authorisation procedures for input. Only batches which have been checked and approved should be input. Authorisation should be carried out by a suitably-qualified member of staff.
- (c) Division of duties should occur between those responsible for raising the documents and those responsible for input.

(ii) Output Controls:

- (a) Completeness checks should be carried out to ensure all data input and processed is output. This can be usually effected by comparing file totals before and after processing.
- (b) Physical controls should be exercised over the distribution of output. Printouts should only be sent to authorised personnel with no opportunity for the output to be altered before reaching the user.
- (c) Output in the form of exception reports should be recorded along with subsequent action taken on the report. This should be checked regularly by an independent official.

17. **Audit of Local Bodies:** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Bombay and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

- (i) reporting on the fairness of the content and presentation of financial statements;
- (ii) reporting upon the strengths and weaknesses of systems of financial control;
- (iii) reporting on the adherence to legal and/or administrative requirements;
- (iv) reporting upon whether value is being fully received on money spent; and
- (v) detection and prevention of error, fraud and misuse of resources.

Audit is another method of financial control on local governments. This provision is coupled with the privilege of *ultra vires*. An action of the local authority if it is beyond legal authority can result in 'surcharge' by audit. This procedure is a legacy of colonial days and even in England it is being resorted to less and less. This may well be because of the increasing competence of the local government authorities.

In addition to the external audit, it is also felt that there should be a system of internal audit in all municipal institutions. Internal audit should be provided by the institutions' own staff. It should be

performed on a continuous basis according to a well defined programme. The external auditor should be able to rely upon the work of the internal audit as forming part of a complete system of internal financial control. Where there is no internal audit, as may happen in the case of small or poorly staffed municipalities, the external auditor himself has to do detailed checking. As described under government audit above, 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 (sometimes known as 'the three Es').

18. (i) Under section 224(3) of the Companies Act, if in the annual general meeting no auditors are appointed or re-appointed, the Central Government may appoint an auditor to fill the vacancy. A duty has been cast on the company to give notice to the Central Government about no auditor having been appointed within seven days of the holding of the annual general meeting, under sub-section (4) of section 224.

- (ii) Once an auditor is appointed under section 224 of the Companies Act, he holds the office as auditor till the conclusion of the next annual general meeting. Under this rule, if no annual general meeting is held for two years the auditor appointed in the last held annual general meeting continues to be the auditor of the company. If an auditor is to be appointed under this situation, the company must convene an annual general meeting to appoint a new auditor or to re-appoint the retiring auditor. In case of appointment of a new auditor in place of the retiring auditor, a special notice must be received by the company proposing the name of the new auditor for appointment, a copy of which should be forwarded to the retiring auditor at the earliest. If the retiring auditor makes a representation in writing, the same should be circulated to the members of the company, if time permits. Also a certificate should be obtained from the proposed auditor before actual appointment to the effect that if the appointment is made in his favour, the holding of the proposed audit by him will be within the limit specified by section 224(1B) of the Companies Act. If the retiring auditor is to be reappointed, it is to be ensured that none of the circumstances specified in section 224(2) of the Companies Act exists. Also, a certificate referred to above should be obtained from him.

A resolution appointing the new or the retiring auditor is to be passed in the annual general meeting by a simple majority unless the company is one which is covered by either section 224A or section 619B of the Companies Act.

- (iii) Section 225(1) of the Companies Act requires that a special notice must be sent to the company by the member desiring to appoint a person as auditor in the place of the retiring auditor. On receipt of the notice, the company shall forthwith send a copy thereof to the retiring auditor. Also, the company shall give notice of the proposal, conveyed through the special notice, to its members at least seven days before the meeting. Thereafter, the proposal shall be placed before the general meeting for its consideration. The retiring auditor, if he chooses to send a representation to the company in the matter of the move to remove him, will be free to do so and the representation must be circulated to the shareholders if reasonable time is available to do that. In any case, the retiring auditor will have the right to be heard and, or to read out his representation in the annual general meeting. However, if the representation is meant to give needless publicity to defamatory matter, the retiring auditor may be restrained from getting the representation circulated or read at the annual general meeting.

In the annual general meeting, the proposal to appoint the new auditor is to be passed by a simple majority, unless the company is covered by either section 224A or section 619 B of the Companies Act.

Announcement

Audit in Situations of Missing or Incomplete Records

1. Members of the Institute while carrying out audit assignments might come across a situation where the records of the client are incomplete or destroyed (partially or completely) on account of a natural calamity or otherwise. While guidance on reporting responsibilities of the members in such cases has been provided to the members by way of publications such as Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements", the Statement on Qualifications in Auditor's Report, opinions of the Expert Advisory Committee, and a publication titled, "Study on Audit and Certification in Case of Missing Records", issued by the Institute, the Council, for the benefit of the members, wishes to reiterate the guidance in the following paragraphs.
2. The auditor should, first, obtain a representation from the management that the original accounts are not available for audit. The letter should also include the fact whether the accounts of the entity have been reconstructed by the management. If yes, the extent thereof (partial or complete) and the details of the items of financial statements that have been reconstructed should also be specified in the said letter. In case the accounts have been reconstructed, the members must consider the limitation of scope in audit imposed by the circumstances. Limitation on scope of audit can be of two types, firstly, inability of the management to reconstruct some or all of the items of the financial statements either for the whole financial year or for a certain period during the financial year and secondly, lack of corroborative evidence to support certain or all the entries in the reconstructed accounts. In case of completely reconstructed accounts, the lack of supporting evidence will pose a greater risk of limitation on scope, whereas, for partially reconstructed accounts, both types of limitations, i.e., inability of the management to reconstruct accounts and lack of supporting evidence, can be material. While auditing the reconstructed accounts (partial as well as complete), the auditor should analyse the limitation imposed on application of audit procedures required to be applied in the given situation and use his professional judgment to determine whether to issue an unqualified opinion, qualified opinion or disclaimer of opinion. Further, the fact of scope limitation must clearly be mentioned in the scope paragraph of the audit report.

The AAS 28, "The Auditor's Report on Financial Statements", in its paragraphs 43 and 44 reproduced below, provides the guidance for the auditor in case of a scope limitation:

"43. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

44. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed."

3. Guidance in respect of the matter discussed in the two paragraphs above has been explained in paragraph 45 of the AAS 28 by way of illustrative examples of the scope paragraphs in the audit reports in the cases of qualified opinion and disclaimer of opinion:

In situations of Qualified Opinion

"We have audited

Except as discussed in the following paragraph, we conducted our audit in accordance with

We did not observe the counting of the physical inventories as at 31st March 2XXX since that date was prior to the time we were appointed as auditors of(Name of the entity). Owing to the nature of the entity's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures."

In situations of Disclaimer of Opinion

"The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.

(Add a paragraph discussing the scope limitation as follows:)

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the entity."

4. Paragraph 10 of AAS 13, "Audit Materiality", reproduced below, states that the auditor while auditing the reconstructed accounts must consider the concept of materiality and the audit risk involved with specific account balances and classes of transactions:

"10. There is an inverse relationship between materiality and the degree of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low, but the risk that it could be misstated by an extremely small amount might be very high. The auditor takes the inverse relationship between materiality and audit risk into account when determining the nature, timing and extent of audit procedures. For example, if, after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower, audit risk is increased. The auditor would compensate for this by either:

- (a) reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or
- (b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures."

5. While auditing the reconstructed accounts, since the auditor would normally find it difficult to obtain internally generated corroborative evidences supporting the reconstructed accounts, the auditor should apply alternative audit procedures such as inquiry and external confirmation as outlined in paragraphs 14 and 15 of the AAS 5, "Audit Evidence", reproduced below:

"Inquiry and Confirmation

14. Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.
15. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors."

For assessing the reliability of the evidence obtained by the auditor from various sources, the auditor is guided by the principles enunciated in paragraph 7 of AAS 5.

6. The auditor, if he himself was not the auditor in the immediately preceding financial year, must apply the principles laid down in AAS 22, "Initial Engagements - Opening Balances" while verifying the figures of opening balances.
7. Paragraph 4 of the AAS 28, "The Auditor's Report on Financial Statements", provides that the auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. An unqualified opinion can be expressed only if the auditor is able to satisfy himself, by way of application of sufficient appropriate compliance and substantive procedures, that the financial statements give a true and fair view. The scope limitation imposed by lack of

supporting evidence implies a particular emphasis on obtaining alternative corroborative evidence.

However, if the auditor concludes that an unqualified opinion can not be expressed but the limitation on scope is not so material and pervasive as to require a disclaimer of opinion, a qualified opinion should be expressed. Further, a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements. Paragraph 45 of AAS 28 illustrates the principles enunciated here above. Having regard to the above, two illustrative formats of reporting by the auditor are given in the paragraphs 8 and 10 below for guidance of the members.

8. Illustrative audit report where the auditor decides to express a qualified opinion about the true and fair view of the financial statements:

I. (Where accounts have been reconstructed for some or all of the items for the whole financial year)

"We have audited the attached Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. We have been informed by the management that because of ____ (give reason) _____ the original accounts are not available for audit and hence these financial statements have been prepared from the reconstructed accounts prepared by the management. The accounts as well as the financial statements are the responsibility of the management. Our responsibility is to express an opinion on these financial statements based on our audit of the accounts.

We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We have not been able to obtain corroborative audit evidence supporting following items of the financial statements while auditing the accounts of the entity:

(State the areas for which the corroborative evidences were not available along with their quantification, to the extent possible and also their resultant effect on the financial statements.)

Subject to the above, the financial statements give a true and fair view:

- (i) in the case of the balance sheet, of the state of the _____ (name of the client) affairs as at the end of its financial year;
- (ii) in the case of the profit and loss account, of the profit or loss for its financial year; and
- (iii) In the case of the cash flow statement, of the cash flows for the year ended on that date."

II. (where accounts have been reconstructed only for certain period during the year)

"We have audited the attached Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date annexed thereto. We have been informed by the management that because of ____ (give reason) _____ the original accounts are not available for audit and hence these financial statements have been prepared from the reconstructed accounts prepared by the management for the period from ____ to ____ during the financial year. The accounts as well as the financial statements are the responsibility of the management.

Our responsibility is to express an opinion on these financial statements based on our audit of the accounts.

(Other paragraphs shall be same as in the format given in Part I above.)

9. If the auditor is satisfied after obtaining a representation letter from the management and considering the results of sufficient appropriate audit procedures that the reconstruction of the accounts of the entity is not possible, he has no other option but to issue a disclaimer of opinion. The auditor should issue a report to the shareholders mentioning therein that it is not possible for him to express any opinion. The format of audit report to express disclaimer of opinion has been suggested in the following paragraph for guidance of the members.
10. Illustrative audit report in situations where the reconstruction of the accounts is not possible:

“We were engaged to audit the Balance Sheet of (name of the client), as at 31st March 2XXX, and also the Profit and Loss Account and the cash flow statement for the year ended on that date. The financial statements are the responsibility of the company's management. The management of _____ (name of the client) has informed us that owing to _____ (state the reason for unavailability of records), the books of account and/ or other related records and documents of the _____ (name of the client) have been completely destroyed. The management has also informed us that the reconstruction of the accounts is also not possible.

Since we have not been able to examine the books of account as well as the financial statements of _____ (name of the client), we are unable to form any opinion on the financial statements.”
11. Members' attention is also invited to the opinion given by the Expert Advisory Committee in September 1988 in situation of an audit where the records etc., had been seized by the income tax authorities and released after four years and records were reconstructed for the interregnum. The Committee, apart from the opinion on the type of the opinion to be expressed by the auditor in such cases, has also opined that the auditor should not normally rely on the management's certificate as to the opening balances unless the information therein can be corroborated by other supporting document.