PAPER – 6 : AUDITING AND ASSURANCE

QUESTIONS

1. State with reasons (in short) whether the following statements are True or False.
   a. There is no difference between the terms “external audit” and “statutory audit”.
   b. It is auditor’s responsibility to maintain adequate accounting system incorporating various internal controls.
   c. Fraud is more difficult to detect than error.
   d. An unqualified opinion in audit report is a guarantee as to the future viability of the company.
   e. The auditor of a company has a right to carry out surprise checks of transactions beyond the end of the accounting year for which he is reporting.
   f. Since client pays for the audit, the audit working papers belong to the client.
   g. Potential for individuals to gain unauthorized access to data or to alter data without visible evidence is not there in CIS systems.
   h. If auditor relies on the work of an expert and expresses an unqualified opinion, he should refer to the work of the expert in his report.
   i. A Government company cannot contribute amounts to a political party or to any person for political purpose.
   j. Evidence obtained by the auditor through judgmental sampling cannot be considered sufficient appropriate audit evidence.
2. List six documents or papers, which would normally be retained on the current audit file.
3. What are the two basic types audit tests? Give examples of each type and explain the purpose of each test.
4. As an auditor, how will you, verify the following:
   (a) Provision for Bonus
   (b) Debentures
5. In a manufacturing concern, the management suspects inclusion of ‘dummy workers’ in wage sheets. What would you, as an auditor, suggest to detect such frauds?
6. Write short note on cut-off procedures relating to inventories.
7. As an auditor, how will you verify the following:
   (a) Bills receivable
   (b) Capital commitments
   (c) Assets acquired on hire-purchase basis

8. Comment – The company produced photocopies of fixed deposited receipts as the original receipts were kept in the iron safe of the director finance who was presently out of the country on company business.
9. Give your opinion on whether the following persons can be appointed auditors of a limited company or not.
   (a) A firm of chartered accounts in practice, a partner of which is a secretary of the company.
   (b) A chartered accountant in practice owing Rs.500 to the company
10. Write a short notes on - Audit Trail.
11. What is Joint audit? Discuss whether the liability of joint auditor is joint or several.
12. Mention some situations where statistical sampling methods may not be appropriate.
13. State briefly the duty of the auditor with regard when a loss of Rs.3 lakhs on account of embezzlement of cash was suffered by the company and it was debited to salary account.
14. How would you proceed to check the misappropriation of cash in a trading concern ?
15. Write short notes on :
   (a) Qualified audit report
   (b) Disclaimer of opinion
16. Comment - The management requested your audit firm not to comment on valuation of inventory and realisability of certain debtors, as they had been covered in Director's Report.
17. (a) A sum of Rs.20,000 per month has been paid as remuneration to a director, who is not in whole-time employment of the company.
   (b) The interest of a director in a transaction, entered into by the company has not been disclosed in the records maintained by the company.
18. Describe the salient features of financial administration of local bodies.
19. How will you verify the following assets ?
   (a) Freehold land
   (b) Leasehold property
   (c) Building
20. Write a short note on – Errors of Commission.
21. How will you vouch and/or verify the following?
   (a) Research and Development expenses
   (b) Recovery of Bad Debts written off

(c) Goods sent out on Sale or Return Basis

(d) Borrowing from Banks

22. Explain the meaning of the term "subsequent events" as used in the Standard on Auditing (SA 560).

SUGGESTED ANSWERS/HINTS

1. a. False: "External audit" is a wider term than "statutory audit". It will cover independent audits – whether voluntary audits/statutory audits.

   b. False: As SA 200, it is management's responsibility and not auditor's responsibility.

   c. True: Fraud is more difficult to detect than error. This is because fraud generally involves sophisticated and carefully organized schemes to conceal it such as forgery, deliberate failure to record transactions, intentional misrepresentations to the auditor.

   d. False: Auditor's opinion (even an unqualified one) is not an assurance as to the future viability of the company as given in SA 200A.

   e. True: The auditor is appointed at the Annual General Meeting to hold office until the next Annual General Meeting. He is not appointed for a particular accounting year. Consequently, he has the right of examination of the accounts and records of the company at any time during the period covered by his appointment, in so far as it is necessary for the purposes of his report. He may, therefore, carry out surprise checks of transactions beyond the end of the accounting year for which he is reporting.

   f. False: Working papers are the property of the auditor. The client does not have a right to access the working papers of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to the client.

   g. False: Potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

   h. False: When expressing an unqualified opinion, the auditor should not refer to the work of an expert in his report. If, as a result of the work of an expert, the auditor decides to express other than an unqualified opinion, it may in some circumstances benefit the reader of his report if the auditor refers to or describes the work of the expert. Where, in doing so, the auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure if such consent has not already been obtained.

   i. True: Section 293A of the Companies Act, 1956 prohibits Government company from contributing amounts to a political party or to any person for a political purpose.

j. False: The rates of depreciation prescribed by Schedule XIV to the Companies Act, 1956 are the minimum rates to be charged. AS 6 notified under section 211(3C) of the Companies Act, 1956 also states that rates lower than statutory rates cannot be charged unless permitted by the statute itself.

2. Following six documents or papers, which would normally be retained on the current audit file:

- Correspondence relating to acceptance of annual re-appointment.
- Extracts of important matters in the minutes of the board meetings and general meeting as are relevant to audit (e.g. minutes relating to declaration of dividend).
- Audit plan and audit programme.
- Analysis of transactions and balances (e.g. age-wise analysis of debtors).
- Record of audit procedures and their results (e.g. test checking of purchase invoices to vouch payments for purchases).
- Evidence regarding the supervision and review of the work of assistants.

3. The two types of audit tests are as follows:

1. Compliance test: A compliance test is a test which seeks to provide audit evidence that the internal control procedures are being applied as prescribed.

   Example:

   (i) Checking for authorisation on a credit note: This should confirm that all credit notes are suitably authorised before being issued.

   (ii) Checking for the casting stamp on a purchase invoice: This should confirm that all invoices are cast before being paid.

   (iii) Checking that copy of goods dispatched notes are attached to the copy of sales invoices: This should confirm that invoices would only be posted to the sales ledger after the goods have been dispatched.

2. Substantive test: A substantive test is a test of a transaction or balance, which seeks to provide audit evidence as to the completeness, accuracy and validity of the information contained in the accounting records or financial statements.

   Example:

   (i) Circularisation of debtors to confirm the accuracy of the balance on the sales ledger.

   (ii) Checking the positing of day-book totals to the nominal ledger, which should confirm accuracy of posting.

   (iii) Matching a purchase invoice with the original order and goods received note to confirm that the purchase is bonafied.

4. (a) Provision for bonus – Provision for bonus can be verified by adopting following audit procedures –

   (i) Examine whether the amount for bonus has been provided for in accordance with the Payment of Bonus Act and/or agreement with the employees or award of competent authority.

   (ii) In cases where the amount of the provision is in excess of the amount required to be paid as per the aforesaid Act/agreement/ award, the auditor should examine authority for such excess payments.

   (iii) Examine the relevant documentary evidence to vouch the bonus payment during the year e.g. bank statements, salary slips, etc.

   (b) Debentures – The auditor may adopt the following procedures to verify debentures

   (i) Examine the memorandum and articles of the company to ascertain the borrowing powers of the company and limitation thereon, if any.

   (ii) Vouch the cash received from the issue of debentures with the cash book, bank statement, application and allotment book and register of debenture holders.

   (iii) Examine the list/register of debenture holders and ensure that the total amount received from debenture holders agrees with the total amount of debentures shown in the balance sheet.

   (iv) Examine debenture trust deed in order to ascertain the terms and conditions of the issues.

   (v) Ensure compliance with provisions of the Companies Act such as section 117B (appointment of debenture trustees and his duties) and section 117C (creation of a security and debenture redemption reserve), SEBI guidelines and listing requirements, if any.

   (vi) Examine register of charges to ensure that charge created has been properly registered.

   (vii) Ensure that the provisions regarding redemption of debentures have been adhered to.

5. Effective and appropriate internal control system should be adopted in order to detect the inclusion of the names of dummy workers in the wage sheets. The application of suitable internal check system, however, depends on the nature and procedures of wage payment of the factory concerned. However, following outlines of the system can be suggested.

   (a) Each worker should be provided with a time card or job card as the case may be. Proper records in detail about each worker must be maintained in such cards. The foreman in charge should initial the entries in the cards. At the end of the week or month, the card should be sent to wage office.

   (b) Due care should be given in the preparation of wage sheets. Wage sheets should not be prepared by those employees, who are responsible for recording the

attendance of the workers. The work of wage sheet preparation should be assigned to a number of employees in such a way that the work done by one is automatically checked by the other.

(c) Payment of wages should not be made by those employees, who have taken part in the preparation of wage sheet. It should be done by the cashier in the presence of a responsible officer and also the foreman, who can recognise the workers.

(d) Proper records related to overtime authorised and granted to the workers must be maintained. For casual workers, separate records should be maintained.

6. The auditor should examine that the entity has instituted appropriate 'cut-off' procedures for inventory to ensure that at the financial year end transactions are posted to the relevant period to which they relate. He should ensure their efficacy by the following audit procedures –

(i) Examine invoices (relating to purchase and sales) and credit notes relating to raw materials and finished goods posted to the books of account during the last few days preceding the financial year and the first few days following the financial year and should be matched with the entries in the stock records to ensure that they are entered in the correct periods.

(ii) Ensure stocks represented by such documents were included or excluded, as appropriate during stocktaking.

(iii) Calculate the gross profit percentage, ratio of creditors to purchases and ratio of debtors to sales to assess whether unusual fluctuations exist. If it does, then it implies errors or frauds relating to cut-off may be there, which, in turn necessitate extensive substantive procedures by the auditor.

7. (a) Bills receivable – The auditor should examine the internal control system with regards to bills receivable and he may adopt the following audit procedures to verify bills receivable –

(i) Verify the opening balance of bills receivable with reference to audited balance sheet of the last year.

(ii) Examine the transactions recorded in the bills receivable book with reference to the relevant documentary evidence such as covering note sent by the customer along with payment on maturity of the bill, covering note issued by the ban on discounting etc.

(iii) Carry out a physical verification of the bills receivable on hand as at the end of the year. Ensure they are properly drawn, stamped, duly accepted and not overdue for payment.

(iv) If bills have been discounted with bank, then they should be verified with reference to confirmation obtained from the bank and entries in the cash book. Contingent liabilities in respect of such bills should be shown as a footnote to the balance sheet.

(v) If some bills have been dishonoured, the auditor should ensure adequate provision has been made for irrecoverable amount. Ensure the concerned party has been informed of the dishonour of its bill.

(vi) Ensure that bills which have been matured but the amount in respect thereof has not been received, have been renewed subsequently.

(b) Capital commitments - Capital commitment is the amount of capital expenditure on fixed assets which management wants to spend in near future. It is disclosed as a note to the balance sheet. The auditor should --

(i) Examine the minutes of board's meetings, purchase order and agreement, if any, with respect to capital commitments.

(ii) Obtain a management representation to this effect.

(iii) Ensure that notes to the balance sheet clearly mention the contracted value of the capital expenditure and the amount already disbursed, if any.

(c) Assets acquired on hire-purchase basis – The procedures which may be adopted by the auditor to verify such assets are --

(i) Examine the relevant contract to determine the provisions as to method, time duration, etc. to payment and the title.

(ii) Ensure proper valuation and disclosure i.e.

- The said asset should be shown as its net cash purchase price.
- Initial finance charges such as file charges and interest charged in advance should not be capitalized but should be charged to revenue account on becoming due.
- The total purchase price less down payment i.e. total unpaid balance should be shown as liability in the balance sheet under secured loans.
- Alternatively, only the capital portion of the installment paid upto the date of balance sheet can be debited to plant and machinery account and interest included in each installment charged to profit and loss account as expense.
- Depreciation should be computed on entire asset cost and not merely with respect to paid amounts.

8. (i) According to the Guidance Note on Investment issued by the ICAI, the auditor should physically inspect all securities in which money has been invested during the year to verify existence and ownership of such investments.

(ii) The auditor should not, therefore, accept photocopies and may choose to give disclaimer of opinion in his audit report.

9. (a) As one of the partners of the firm is the secretary of the company, the firm cannot be appointed as the auditors of the company. A secretary is an employee of the company and according to Section 226(3b) of the Companies Act, 1956, an employee of the company cannot be appointed its auditor.

(b) He can be appointed as an auditor of the company as he is indebted to the company for an amount of Rs.500 only, i.e. less than Rs.1,000. According to Section 226(3d) of the Companies Act, 1956, a person who owes to the company an amount exceeding Rs.1,000 cannot be appointed as an auditor of the company.

10. Audit Trail: An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail.

For example, the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt , to management's own healthy skepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor.

It is once again clear from the diagram that there is an abundance of documentation upon which the auditor can use his traditional symbols of scrutiny, in the form of coloured ticks and rubber stamps. Specifically:

(i) The output itself is as complete and as detailed as in any manual system.

(ii) The trail, from beginning to end, is complete, so that all documents may be identified by located for purposes of vouching, totalling and cross-referencing.

Any form of audit checking is possible, including depth testing in either direction.

11. Meaning of Joint Audit

An audit is said to be joint audit when two or more persons or firms of chartered accountants are jointly appointed to conduct the audit of a company. The practice of appointing joint auditors has been adopted by large sized companies, which want to pool the resources of two or more auditors so that the audit work may be undertaken effectively and quickly. The joint auditors stand on equal footing so far as the professional work of audit is undertaken by them.

Liabilities of joint auditors

Section 227 of the Companies Act, 1956 does not contemplate any division of work of audit between two or more persons. Thus, according to the provisions of this section, the joint auditor has an individual responsibility only. Also, it is not quite proper to hold an auditor responsible for the work not done by him. If there are two auditors and both of them are held responsible jointly, that would create many practical problems.

While the Companies Act is silent on this issue, the Institute of Chartered Accounts of India has issued a "Statement on the Responsibility of Joint Auditors". In this statement, it has been made clear that it would not be correct to hold an auditor responsible for the specifically allotted work of another. Each joint auditor will be held responsible only for the work allocated to him. According to the statement, we cannot hold an auditor responsible for the work done by another auditor who is equally qualified and competent to undertake the audit work. This also makes it clear that where the work cannot be clearly divided, the responsibility will be jointly shared between them.

12. The auditor may not find statistical sampling methods appropriate in following situations –

    (i) Population is small.

    (ii) Population is diverse and cannot be divided into strata or clusters.

    (iii) Internal control system is weak i.e. control risk is high.

    (iv) Benefits do not exceed cost.

    (v) Exact accuracy is required.

    (vi) Materiality considerations i.e. item is material because of legal requirements or susceptibility of misstatements due to fraud or error.

13. (i) AS-5 Net Profit or Loss for the Period Prior Period items and Changes in Accounting Polices – "requires that (income and) expenses 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."

    (ii) Embezzlement of cash of Rs.3,00,000 is an ordinary business loss which as per the requirements of AS 5 should be disclosed separately in the profit and loss account. It should not be merged with salary.

14. Types of cash misappropriation

    Cash can be misappropriated in a trading concern by various methods. Some of these are as under:

    (a) Sales and cash receipts

        (i) Teeming and lading;

        (ii) Overstatement, understatement or omission of sales and other revenue items.

    (b) Purchases and cash payments.

        (i) Kiting;

        (ii) Submission of false invoices

    (c) Wages

        (i) Inclusion of 'dummy workers';

        (ii) Misappropriation of unclaimed cheques / pay envelopes.

Steps to proceed to check the misappropriation of cash

(i) Study and evaluation of internal control system – The auditor should study and evaluate the internal control system with regard to cash receipts and cash payments.

A sound internal control system for cash receipts should consist of –

- an internal check system which segregates the functions of all employees clearly
- clearly laid down authorisation procedures which should ensure that transactions are authoris ed by management personnel acting within the scope of their authority
- adequate physical controls such as limited access, numerical series on internal documents, etc.

(ii) Vouching of cash receipts – The usual vouching procedures for cash receipts are discussed below:

(a) Examine cash book: The auditor should examine cash book with reference to relevant documentary evidence, for example – carbon copies or counterfoils of cash receipts, letters of confirmation for verifying balances outstanding against debtors' name, tenancy agreement (in case of rent received), broker's sold note (in case of sale of investments), etc.

(b) Examine the counterfoils of pay-in-slips: The auditor should compare the dates on the counterfoils of pay-in-slips relating to deposit of cash/cheques/drafts into the account with the dates entered in the cash book and should enquire into the causes of delay, if any.

(c) Examine the carbon copies of receipts: The auditor should examine the carbon copies of cash receipts which are issued as acknowledgement by the entity.

(d) Routine checking: The auditor should examine the arithmetical accuracy of cash book, carbon copies of cash receipts and counterfoils of pay-in-slips and posting of transaction from the cash book to relevant ledger accounts.

(iii) Vouching of cash payment: The general vouching procedures in respect of cash payments are mentioned below:

(a) Examine the payments in the cash book: The auditor should examine the entries in the cash book with reference to the relevant payment vouchers. He should pay special attention to details such as –

- The date, amount, serial number, account head, validity and arithmetical accuracy of the voucher.
- Voucher should be supported by relevant documents.

- The auditor should examine whether the cash memo against which payment has been made is in the name of the client, payment relates to the nature of business, goods/services mentioned therein, are in conformity with specifications by the client and cash memo pertains to the period under audit.
- The payment has been classified properly between capital expenditure revenue expenditure.
- The payment is properly authorised.

(b) Examine the bank statement: In case of payments made by cheques, the auditor should examine the numerical sequence of cheques issued and ensure missing numbers are properly accounted for.

(c) Routine checking: The auditor should perform routine checks to establish the arithmetical accuracy of the cash memos and the cash book by verifying the totals, balances and carry forward of balances with the corresponding accounts in the ledgers.

15. (a) Qualified audit report: Qualified audit report is a report wherein the auditor has expressed a qualified opinion, that is to say, an opinion subject to certain reservations.

Important aspects in relation to qualifications in an audit report are mentioned below:

(i) The auditor should give a qualified opinion when the subject-matter of qualification is not highly material and pervasive and he believes that the overall financial statements give a true and fair view.

(ii) A qualification should be preceded by the words 'subject to' or 'expect that' to make it clear that the matter is of exceptional nature.

(iii) The audit report should quantify the effect of individual qualifications and also the total effect of all qualifications on the financial statements. If precise quantification is not possible the auditor can use estimates made by the management after applying proper audit tests. The report should clearly mention the fact of reliance on such figures.

(iv) The auditor shall state the reasons for his qualification.

(v) In case of a limited company, if any of the statutory affirmations in section 227(2) and section 227(3) are answered in negative or with qualification by the auditor; the audit report would be termed as a 'qualified audit report'.

(vi) Qualifications which deal with matters, which have an adverse effect on the functioning of the company should be in thick type or in italics.

(b) Disclaimer of opinion: The auditor issues a disclaimer of opinion if the subject-matter involved is material and pervasive and he is unable to obtain sufficient appropriate evidence to express an opinion on it. A disclaimer can result because

material and pervasive uncertainties could not be resolved, there is going-concern doubt or there is a material limitation on the scope of the audit.

The uncertainty or the ability of an entity should be such as to make it difficult to determine whether assets should be valued at going-concern or liquidation values.

16. (a) Legal requirements – Sections 217, 222 and 227

- As per section 217 board's report is 'attached to' a balance sheet. Sections 227(2) and (3) requires auditors only to report on the documents 'annexed to' financial statements.
- But section 222 has provided that any information, which is required to be given in accounts or in a statement annexed to accounts, may be given in the board's report instead of in the accounts. In such circumstances, the board's report shall be annexed to accounts ('not attached to'). The auditor should in this case, report on the matters reported upon by the directors.

(b) In the present situation as per the requirements of section 222 the auditor has a duty to report on the Board's report. Therefore, he should not accept their contention and verify the debtors and inventory by adopting appropriate audit procedures.

17. (a) (i) Legal provision

- Under section 309(4) of the Companies Act, 1956 a director who is not in whole-time employment of the company nor is the managing director may be paid remuneration on a monthly/quarterly/ annual basis with the approval of the Central Government or by way of commission if the company by special resolution authorises such payment.
- The remuneration paid to such director/(s) shall not exceed –
  - one per cent of the net profits of the company, if the company has a managing or whole-time director or a manager;
  - three per cent of the net profits of the company, in any other case.

However, the company in a general meeting with prior approval of the Central Government may exceed the above rates.

(ii) Present case

In the given case, auditor should examine the compliance to above mentioned provisions.

(b) (i) Legal and professional perspective

- Section 301 of the Companies Act, 1956 requires the company to maintain a Register of transactions with parties with which directors are interested.
- CARO, 2003 also requires the auditor to report whether the particular of contracts or arrangements referred to in section 301 of the Act have been entered in the register maintained under this section and whether

transactions exceeding rupees five lakhs in respect of any such party have been made at reasonable prices.

- The SA 550, "Related parties" has prescribed the procedures for identification and verification of related parties and their transactions and auditor's responsibility in this regard.

(ii) Present case

In the given situation, since the register under section 301 does not disclose the interest of a director in a transaction, the auditor should qualify his report under sections 227(2) and (3) of the Act. If CARO 2003 is also applicable to the company, the auditor should qualify the report thereunder also.

18. (i) Budgetary procedure

(a) Objective – The objectives of local bodies budgetary procedure are :

- Financial Accountability,
- Control of expenditure, and
- To ensure that funds are raised and money is spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the Legislature or council.

(b) Aspects – The aspects covered in budgeting are :

- Determining the levels of taxation e.g. various types of taxes, fees and rates; and
- Laying down the ceilings on expenditure, under revenue and capital heads.

(ii) Expenditure controls

(a) At the State and Central Government level, there is a clear demarcation between the Legislature and executive. In a local body, legislative powers are vested in the Council whereas executive powers are delegated to the Officers e.g. Commissioners.

(b) All matters of regular revenues and expenditures are generally delegated to the executive wing. For special situations like reduction in property taxes, refunds of security deposits etc., sanction from the legislative wing, i.e., the Municipal Council will have to be obtained.

(iii) Accounting system

(a) 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 in some States like Tamil Nadu.

(b) The accounting system is characterised by –

- Subsidiary and Statistical Registers for taxes, assets, cheques, etc.;
- Separate vouchers for each type of transaction;

- Compulsory monthly bank reconciliation;
- Submission of summary reports on periodical basis to different authorities at regional and State level.

19. (a) Freehold Land : The auditor should follow the audit procedures mentioned below to achieve the objects of verification of freehold land.

Objective	Audit Procedure
(i) Existence and ownership	• Inspect original title deeds and conveyance or purchase deed which should be in the name of the client. • Vouch payments in case new land has been purchased during the year.
(ii) Possession and determine liens, if any	• Title deed should be in custody of owners. • In the case of mortgage, obtain a certificate from mortgagee or his lawyer confirming the possession of the title deed. • If any charge or encumbrances exist on land, the auditor should ensure they have been properly disclosed.
(iii) Valuation and disclosure	• Land is a non-depreciable asset. It is, generally, shown in the balance sheet at historical cost which includes purchase price, broker's commission, stamp duties, registration fees, legal charges and also levelling, clearing and draining charges. • Where payments are made to the municipality for constructing side-walks, laying of sewers, etc. such costs should, preferably, be shown separately in 'Land Improvement Account' and adequate depreciation should be provided for on it.

The following documents to be inspected are: title deeds, conveyance or purchase deed, certificate from mortgagee or his lawyer, minutes book or resolutions.

(b) Leasehold Property : A lease is an agreement between a lessor and lessee for the use of property for a certain period or in perpetuity against some consideration. The auditor may adopt the following procedures to verify leasehold property:

Objective	Audit Procedure
(i) Existence and ownership possession	• Examine the lease deed to ascertain its terms and conditions. • Ensure that it is registered with the Registrar. • Ensure compliance with important conditions such as

		payment of rent on due dates, maintenance of property etc. stated in the deed.
(ii)	Determine liens, if any	• Leasehold property cannot be subject to lien. However, it may be sublet. In such a case, the auditor should examine the tenants' agreements.
(iii)	Valuation and disclosure	• It should be valued at cost less depreciation cost includes the capital outlay as well as legal expenses incurred to acquire the lease.

(c) Building : The audit procedures for verification of building are given below:

	Objective	Audit Procedure
(i)	Existence, ownership, possession and determine liens, if any	• The audit procedures followed for ascertaining the existence, ownership and possession are similar to those of freehold land. • The extent of liens against building can be determined by examining records and obtaining proofs similar to freehold.
(ii)	Valuation and disclosure	• Buildings should be valued at cost less depreciation. • In case land and building have been purchased together, ensure that cost has been segregated for depreciation purposes on a reasonable basis. • Ascertain the reasonableness of basis used to calculate the cost if building is purchased or constructed. • In case of revaluation, depreciation should be provided at revalued amount as reduced by estimated residual value.

20. Errors of Commission: When a transaction has been misrecorded either wholly or partially it is called as a error of commission. Error of commission can happen in the following ways:

Errors in posting,

Errors in Casting,

Errors in carrying forward,

Errors occurring during extraction of balances, etc.

Posting errors may be of a wrong account, wrong amount or wrong file. For example, amount received from Mr X and credited to Mr Y, purchase of Rs.360 from Mr A posted in his account at Rs.630 or sales returns from Mr X posted as the debit of his account, etc.

The first type of errors will not affect the trial balance, however, the other two will affect the agreement of trial balance.

Casting errors are the errors committed while making the totals. This error affects the trial balance.

Error of carry forward and errors of extraction of balances also affect the trial balance.

Error of duplication is another type of error of commission which means recording the same transaction twice.

errors however, do not affect the trial balance but they will affect the Profit and Loss A/c (over statement of expenditure).

21. (a) Research and Development Expenses

(i) Ascertain the nature of research and development work at the outset and enquire whether separate Research and Development Department exists.

(ii) See allocation of expenses under revenue and deferred revenue. Ensure that expenses which are routine development expenses are charged to Profit and Loss Account.

(iii) Check whether the concerned research activity is authorised by the Board and has relevance to the objectives of the company.

(iv) Examine that generally research expenses for developing products or for inventing a new product are treated as deferred revenue expenditure to be written off over a period of three to five years, if successful. In case it is established that the research effort is not going to succeed, the entire expenses incurred should be written off to the profit and loss account.

(v) Ensure that if any machinery and equipment have been bought specially for the purpose of research activity, the cost thereof, less the residual value should be appropriately debited to the Research and Development Account over the years of research.

(b) Recovery of Bad Debts written off

(i) Ascertain the total amount of bad debts.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(c) 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.

(d) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

22. (a) Meaning of Subsequent Events: SA 560 on "Subsequent Events", defines the term 'subsequent events" as those significant events which occur between the balance sheet date and the date of the auditor's report. In the case of an audit of a component, such as a branch or division, of an entity, "subsequent events" also refer to significant events which occurred up to the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

(b) Consideration of Subsequent Events by the Auditor: SA 560 requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor's report. However, the exact manner of treatment would depend upon whether the event falls in the category of 'adjusting event' or 'non-adjusting

event'. As per Accounting Standard (AS) 4, events occurring after the date of the balance sheet are of two types, viz., adjusting events which provide further evidence of conditions that existed at the date of the balance sheet; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the date of the balance sheet.

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

23. Auditor's Lien: In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.

On this premise, 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 Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

(i) Documents retained must belong to the client who owes the money.

(ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.

(iii) The auditor can retain the documents only if he has done work on the documents assigned to him.

(iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under Section 209 of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. However, in both the Act, further provisions are thereunder which books of account could be kept at a different place, pursuant to a Board resolution of which notice must be given to Registrar of Companies.

If in a company Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar of Companies. If in a company Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar, the auditor may in such circumstances, exercise the right of lien for non-payment of fees.

However, as per Section 209 he must provide reasonable facility for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints.

His working papers being his own property, the question of lien, on them does not arise.

The SA 230 issued by ICAI on "Audit Documentation" also states that, "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 clients.

Thus, documents prepared by the professional accountant solely for the purpose of carrying out his duties as auditor (whether under statutory provisions or otherwise) belong to the professional account.

In the case of Chantrey Martin and Co. v. Martin, it was held that the following documents were the property of the auditor: working papers and schedules relating to the audit, draft accounts of the company, and the draft tax computation prepared by an employee of the auditor.

It is also clear that the accountant's correspondence with his client (letters written by the client to the accountant and copies of the letters written by the accountant to the client) belong to the accountant. In the case of Chantrey Martin and Co. v. Martin, it was also held that the correspondence between the accountant and the taxation authorities with regard to the client's accounts and tax computations was the property of the client since the accountant merely acted as agent of the client.

However, where the accountant communicates with third parties not as an agent, but as a professional man, e.g., as an auditor, the correspondence with third parties would seem to belong to the accountant. According to the statement, where an auditor obtains documents confirming the bank balance or confirming the custody of securities of the client or other similar documents, it is probable that the courts would hold that these documents belong to the auditor.

24. Reserves and Provisions

Reserves : Reserve denotes retained profits. In other words, certain sum or sums are set apart out of the profits earned for specific or general purposes, and this constitutes reserve (or reserves).

These reserves are not available for dividend purposes in the year concerned. However, subject to decision of the Board of Directors, there can be appropriation out of reserves created in the past for dividend purposes, provided such reserves are not capital reserves.

If there is no profit, no reserve can be created and, basically, reserves are at the disposal of the undertaking; they are not required to be maintained for meeting possible losses or expenses. The term "reserve" has been negatively defined in Part III of Schedule VI to the Companies Act, 1956 as not including any amount written off or retained by way of providing for diminution, renewals or diminution in value of assets or retained by way of providing for any known liability.

Provision: Provision, on the other hand, represents a charge for an estimated expense or loss or for a shrinkage in the cost of an asset or the accrual of a liability.

Except for provision for dividend which is appropriation of profits, provisions are meant to meet expected losses and expenses for which the amount is uncertain.

Profit cannot be ascertained unless the necessary provisions are first made. Part III of Schedule VI to the Companies Act, 1956 has defined "provision" to mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. Amounts provided for depreciation, renewals or diminution in value of assets are expenses and losses.

Hence, the character of provision is of an expense or loss which must be charged against the revenue so as to arrive at the true and fair profit or loss. Since reserve is retained profit, it is necessarily an appropriation of profit obtained after charging all the expenses and losses including provisions. It, therefore, cannot include anything which is properly chargeable as expense or loss, i,.e., provision.

However, if amounts are provided in excess of the needs, the excess should be treated as reserve. For example, the company may provide for depreciation at the rate of 25% as against the statutory rate of 15%. The excess of depreciation to the extent of 10% would be treated as reserve even though the entire 25% has been a charge to the profit and loss account. For creation of reserve, existence of profit is a must while provision is necessary even where there is a loss so as to correctly reflect the operating results of the enterprise.

25. (a) SA 510 on, “Initial Engagements-Opening Balances”, establishes standards regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. It requires that the auditor should obtain sufficient appropriate audit evidence for initial audit engagements that:

    (i) the closing balances of the preceding period have been correctly brought forward to the current period;

    (ii) the opening balances do not contain misstatements that materially affect the financial statements for the current period; and

    (iii) appropriate accounting policies are consistently applied.

    As far as sufficiency and appropriateness of the audit evidence is concerned, the auditor needs to obtain regarding opening balances, would depend on the following matters:

    (i) The accounting policies followed by the entity.

    (ii) Whether the auditor’s report contained an unqualified opinion, a qualified opinion, adverse opinion or disclaimer of opinion where the financial statements for the preceding period were audited.

    (iii) The nature of the opening balances, including the risk of their misstatement in the financial statement for the current period.

(iv) The materiality of the opening balances relating to the financial statements for the current period.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

(b) Should all type of subsequent events be considered by the auditor in his attest function?

List of Institute publications - November, 2009

I. Statements and Standards

1. Framework of Statements on Standard Auditing Practices and Guidance Notes on Related Services.

2. Standards on Auditing as given below

S.No. Standards on Auditing and Number (All these SAs have been hosted in the Institute's Website).

1. Basic Principles Governing an Audit (SA 200)
2. Objectives and Scope of the Audit of Financial Statements (SA 200A)
3. Terms of Audit Engagement (SA 210)
4. Quality Control for Audit Work (SA 220)
5. Audit Documentation (230) (Revised)
6. The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements (SA 240) (Revised)
7. Consideration of Laws and Regulations in an Audit of Financial Statements (SA 250) (Revised)
8. Communication of Audit Matters with Those Charged with Governance (SA 260) (Revised)
9. Responsibility of Joint Auditors (SA 299)
10. Planning an Audit of Financial Statements (300)
11. Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment (SA 315) (Newly issued)*
12. Audit Materiality (SA 320)
13. The Auditor's Responses to Assessed Risks (SA 330) (Newly issued)*
14. Audit Considerations Relating to Entities Using Service Organisations (SA 402)

15. Audit Evidence (SA 500)
16. Audit Evidence - Additional Considerations for Specific Items (SA 501)
17. External Confirmations (SA 505)
18. Initial Engagements – Opening Balances (SA 510) (Revised)
19. Analytical Procedures (SA 520)
20. Audit Sampling (SA 530) (Revised)
21. Auditing of Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures (SA 540) (Revised)
22. Related Parties (SA 550) (Revised)
23. Subsequent Events (SA 560) (Revised)
24. Going Concern (SA 570) (Revised)
25. Written Representations (SA 580) (Revised)
26. Using the Work of Another Auditor (SA 600)
27. Relying Upon the Work of an Internal Auditor (SA 610)
28. Using the Work of an Expert (SA 620)
29. The Auditor's Report on Financial Statements (SA 700)
30. Comparatives (SA 710)

Note 1:

* Presently, SA 200, "Basic Principles Governing an Audit" and SA 200A, "Objective and Scope of an Audit of Financial Statements" correspond to International Standard on Auditing (ISA) 200 (Revised and Redrafted). Both the SAs are currently being revised in the light of the ISA 200 (Revised and Redrafted). Post revision, the principles covered by SA 200 (erstwhile AAS 1) and SA 200A (erstwhile AAS 2) will be merged into one Standard, i.e. SA 200.)

** SA 315 & SA 330 – become effective in April, 2008. For November 2009 Final (Old) Examination 34 standards on Auditing as given in the Annexure – I. The Standard on Auditing (SA) 400, "Risk Assessments and Internal Control", SA 310, "Knowledge of the Business", and SA 401, "Auditing in a Computer Information Systems Environment", issued in June 2002, April 2000 and January 2003, respectively, would stand withdrawn.

Note 2:

Newly issued SA 450 "Evaluation of Misstatements Identified during the Audit"Effective for all audits relating to accounting periods beginning on or after April 1, 2010. It is not applicable for the November, 2009 examination.

3. Statement on Reporting under Section 227(1A) of the Companies Act, 1956
4. Statement on the Companies (Auditor's Report) Order, 2003 [2005 Edition].

II. Guidance Notes/Study Guide/Monograph

Guidance Notes on Auditing Aspects:

1. Guidance Note on Audit of Fixed Assets.
2. Guidance Note on Audit of Inventories.
3. Guidance Note on Audit of Debtors, Loans and Advances.
4. Guidance Note on Audit of Investments.
5. Guidance Note on Audit of Miscellaneous Expenditure.
6. Guidance Note on Audit of Cash and Bank Balances.
7. Guidance Note on Audit of Liabilities.
8. Guidance Note on Audit of Revenue.
9. Guidance Note on Audit of Expenses.