

**Question 1**

*State with reasons (in short) whether the following statements are true or false.*

- (i) *Cut-off procedures are generally applied to trading transactions.*
- (ii) *An unexplained decrease in the Gross profit ratio may result due to fictitious sales.*  
(2 Marks each) (May 2007)

**Answer**

- (i) **True:** They cover the areas of purchases, sales, inventories to ensure that transaction of one year do not get recorded in the following year or preceding year to ensure 'matching' and true and fair view of the accounts
- (ii) **False:** A fictitious sale will increase the gross profit ratio instead of decreasing it. G.P. Ratio normally comes down if there are unrecorded sales or fictitious purchase or decrease in closing stock.

**Question 2**

*How would you vouch/verify the following? (Answer any two):*

- (a) *Rental Receipts.*
- (b) *Assets acquired on Hire-purchase.*

Or

*Cash Sales.*

(5+5=10 Marks) (May 2007)

**Answer****(a) Rental Receipts**

- (i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.
- (ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.
- (iii) Scrutinize the account of collecting agent when the rent is collected by such agent.

## Vouching

- (iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.
- (v) Investigate into abnormal rent outstanding.
- (vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.
- (vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.

### (b) Assets acquired on Hire purchase

- (i) Inspect the hire purchase agreement to ascertain the terms and condition, the installment and amount of interest included in the installment.
- (ii) Ensure that these are treated as assets acquired under finance lease as per AS-19.
- (iii) Verify that initial recognition of lease should be as an asset and a liability at equal amounts.
- (iv) If it is reasonably certain that lessee will get ownership at the end of the term, see that asset is depreciated over its useful life. Otherwise confirm that asset is depreciated over the shorter of its useful life and the lease term.
- (v) Ensure that it is shown separately in the Balance Sheet.

OR

### Cash Sales

- (i) Examine the system of internal check to ascertain any loopholes therein.
- (ii) Ascertain the practice followed in the matter of issuing cash memos and trace the memos into cash sale summary.
- (iii) Ensure that the date of cash memos tally with the entry in the cash book/summary.
- (iv) Verify that prices of goods sold have been correctly recorded and check the calculation.
- (v) Verify the entry in the goods outward book with the sales summary.
- (vi) See that the cancelled cash memos are not removed from the receipt book.

### Question 3

*How would you vouch/verify the following? (Answer any two):*

- (a) *Payment of Retirement Gratuity to employees.*
- (b) *Recovery of Bad Debts written off.*

*(5+5 = 10 Marks)(Nov 2007)*

## Auditing

### Answer

**(a) Payment of retirement gratuity to employees:** This may be vouched in the following manner:-

- (i) Examine the basis on which gratuity payable is worked out-actuarial or agreement or on the assumption that all employees retire on the balance sheet date.
- (ii) Ensure that the basis of computing gratuity is valid.
- (iii) Verify computation of liability of gratuity on aggregate basis.
- (iv) Check the amount of gratuity paid to employees who retired during the year with reference to the no. of years of service rendered by the retiring employees.
- (v) If the concern has taken an insurance policy see that the annual premium has been charged to Profit & Loss account.
- (vi) Ensure that the concern has adhered to the accounting treatment in accordance with AS-15 (revised).

**(b) Recovery of bad debts written off**

- (i) Verify the relevant correspondence with the debtor whose accounts were written off as bad.
- (ii) See that the amount recovered is credited to a separate account recovery of bad debts written off.
- (iii) Verify the acknowledgement receipt issued.
- (iv) Examine notification from the court, bankruptcy trustee, collecting agencies.
- (v) Check credit manager's file for the amount received and see that the amount has been deposited in the bank promptly.
- (vi) Review the internal control system regarding writing off and recovery of bad debts.

### Question 4

*Write short note on Cut off procedure.*

*(5 Marks)(Nov 2007)*

### Answer

**Cut-off procedure:** It refers to segregation of transaction of one period from the other so that the result of working of each period can be correctly ascertained. The arrangement that is made to ensure such separation is technically known as 'cut- off procedure'. It is part of the internal check of the organization. This procedure is generally applied to transactions affected by the continuity of business like sales, purchase and stock. This procedure ensures that goods purchased during a year have been included in inventory and the liability has been provided in the case of credit purchase. Similarly goods sold have been excluded from the inventories and credit has been taken for the sales. Cut-off

## Vouching

procedures are also relevant' in other areas, such as determining the cut offs for cash and bank balances. The auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that:

- (i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and
- (ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.

### Question 5

*State any six important points to be examined by you, as an auditor, in verifying the correctness of bank balance of an Educational Institution which deposits all its collection/receipt in separate collection account of a bank. (6 Marks) (May 2008)*

### Answer

For verifying the balances lying with bank in collection account, the auditor should adopt following procedure:

- (i) Examine and compare the pay-in-slips with the entries in the ledger account of the educational institute.
- (ii) Check the casting, carry forwards and balancing of ledger account.
- (iii) Compare the entries in the ledger account with the bank statement.
- (iv) Review the bank reconciliation statement for its correctness.
- (v) Scrutiny the subsequent period bank statement to ensure that items of reconciliation are subsequently cleared.
- (vi) Verify the balance confirmation certificate.

### Question 6

*How would you vouch/verify the following? (Answer any two):*

- (a) *Advertisement Expenses.*
- (b) *Sale of Scrap.* (5 marks each)(May 2008)

### Answer

**(a) Advertisement Expenses:** It should be vouched on the following basis :

- (i) Verify the bill/invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.
- (ii) See that advertisement relates to client's business.
- (iii) Inspect the receipt issued by the agency.

## Auditing

- (iv) Ascertain the nature of expenditure – revenue deferred and see that it has been recorded properly.
- (v) Ascertain the period for which payment is made and see that pre-paid is carried forward to balance sheet.
- (vi) Compare the statement of account with the ledger account.
- (vii) See that all outstanding advertisement bills have been provided for.

### (b) Sale of scrap:

- (i) Review the internal control as regards generation, storage and disposal of scrap.
- (ii) Check whether the organization is maintaining reasonable record for generation of Scrap.
- (iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- (iv) Check the rates at which scrap has been sold and compare the rate with previous year.
- (v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- (vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- (vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

## Question 7

*How would you vouch/verify the following? (Answer any two):*

- (a) *Insurance Claim*
- (b) *Preliminary Expenses.*
- (c) *Customs Duty.*

*(5 marks each)(Nov 2008)*

## Answer

- (a) **Insurance Claims:** Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims, the auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen Counterfoils of the receipts issued to the insurance company should also be seen. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. The copy of certificate/report containing full particulars of the amount of loss should also be verified. The accounting treatment of the amount received should be seen

## Vouching

particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the profit and loss account is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

**(b) Preliminary expenses:** The auditor takes following steps to vouch/verify preliminary expenses:

1. All such kind of expenses should be related to the formation of the enterprise.
2. With all preliminary expenses, relevant supporting documents should be there.
3. He should examine company's minute's book to determine the pattern of writing off of the preliminary expenses over the period.
4. He must check that if such kinds of expenses are incurred by the promoters or they have been reimbursed to the promoters, it is as per the instructions of the BOD and the powers in AOA.
5. He should make a cross check of the amount of preliminary expenses with that of amount mentioned in the prospectus, statutory report and balance sheet.

**(c) Custom Duty**

1. Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.
2. If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent's bill.
3. If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.
4. Make a list of disputed cases to have knowledge of the amount of duty payable and the provisional payment. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.
5. Lastly, the auditor verifies the duty drawback.

### Question 8

*Comment on the following situations:*

*On 31.12.2008, Amudhan Company Limited invested Rs.45 lakhs in cumulative fixed deposits of Algar Bank Ltd. The deposits carry interest @10% per annum compoundable quarterly and amount of interest is added to the principal and is due and payable on the maturity date which is 5 years from the date of investments.*

*For the year ended 31st March, 2009, the company did not book any revenue of interest on the ground that interest amount is not available at their disposal till maturity date of investment.*

*(6 Marks) (June 2009)*

## Auditing

### Answer

- (i) According to Section 209 of the Companies Act, 1956 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.
- (ii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown under current assets in the balance sheet as per Schedule VI Part I requirement.
- (iii) As such, the profits and current assets are understated and true and fair views of the accounts are thus vitiated.
- (iv) On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report.

### Question 9

- (a) *M, Statutory Auditor of ABC Ltd wants to verify cash on hand as on 31st March, 2009. The Management informs Mr. M. that it is not possible to cooperate, as cashier has been hospitalized. Advise Mr. M. on how to deal with the situation. (4 Marks)*
- (b) *As an auditor of a Limited Company, you observe that during the month of March, 2009, sales invoices were not recorded in books of accounts. You also observe that payment of wages was much higher compared to last year. Keeping in mind the above, analyse possible ways of manipulation of accounts. (6 Marks) (June 2009)*

### Answer

- (a) The scope of audit may be limited for varied reasons, (i) the entity may impose restriction on scope of audit, (ii) the limitation may be imposed by circumstances.

When the audit is carried out under and as per statute, the auditor should not accept the assignment when his duties are curtailed by agreement, unless required by any Law.

When audit is carried out in accordance with the entity's terms voluntarily, the auditor may indicate his scope in his audit report.

Sometimes, the circumstances may impose restrictions on audit scope. For example, if the auditor is appointed after the year end, he may not be able to participate in inventory checking. Or sometimes, the records required may not be available so that the auditor may not be able to check details in the manner he liked. Such limitations in scope may warrant an auditor to express disclaimer of opinion or qualified opinion in his audit report depending upon the circumstances.

The non co-operation of ABC Limited will amount to limitation on scope of auditors.

- (b) **Manipulation of Accounts:** Accounts are falsified in order to conceal the true position of the business for some purpose. They are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed:

## Vouching

- (i) to avoid incidence of income-tax or other taxes by showing profits at a lower figure.
- (ii) for delaying a dividend when there are insufficient profits by showing profits at inflated figures.
- (iii) to withhold declaration of dividend even there is adequate profit.
- (iv) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the following nature:

- (i) Recording fictitious sales or omission of sales
- (ii) Recording fictitious purchases or suppression of purchases
- (iii) Over valuation or under valuation of stock.
- (iv) Recording fictitious expenses or omission of expenses
- (v) Taking credit for accrued income not likely to be received or omission of income.
- (vi) Revenue expenses changed to capital and vice-versa. SA 240 "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements" deals with the auditor's responsibilities for the detection of material misstatement resulting from fraud and error. It requires a considerable skill and vigilance on the part of an auditor. In doubtful cases he may refuse to believe the information supplied to him by any officer of the concern.

An auditor, who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

### Question 10

*How would you vouch/verify the following:*

- (a) *Production incentive paid to workers.*
- (b) *Bad debt*

*(5x2=10 Marks)(June 2009)*

## **Auditing**

### **Answer**

#### **(a) Production incentive paid to workers**

1. The auditor should trace the total production incentive paid to workers from P&L Account to prime records/division wise/dept wise records.
2. The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.
3. The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by the accounts department.
4. He should check list of payment and also acquitted disbursement slips of select departments/periods for scrutiny of various data generated in the fields for their accuracy and completeness.
5. The auditor should make an overall analytical procedure of ensuring the expense booked is commensurate in quantum with statistical data on production and strength of workers.

#### **(b) Bad debts**

1. The amount of bad debts should be traced to the schedule of bad debts written off during the year.
2. Major amount of bad debts in the schedule be taken for scrutiny.
3. Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.
4. Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.
5. The bad debts should be properly disclosed in P&L account according to its materiality.
6. If provision had already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.

### **Question 11**

*State with reasons (in short) whether the following statement is true or false.*

*Analytical procedures are unable to help the Auditor in determining the nature, timing and extent of other audit procedures at the planning stage.* (2 marks)(Nov 2009)

### **Answer**

**False:** SA 520 "Analytical Procedure" states that application of analytical procedures helps the auditor to find the aspects of the business of which he was unaware and it will also assist him in determining the nature, timing and extent of audit procedures.

**Question 12**

*Comment on the following situations:*

*XYZ Ltd. Co. gave a donation of Rs.50,000 each to a Charitable Society running a school and a trust set up for the service of Blind during financial year ending on 31st March, 2009. The average net profits of the company for the last three years were 15 lakhs.*

*(8 Marks) (Nov 2009)*

**Answer**

**Donation to Charitable Institutions**

Section 293 of the Companies Act, 1956 provides that the Board of Directors of a public listed company can contribute with the approval of the company in General Meeting to a charitable organisation and other such organizations not directly related to the business of the company or the welfare of its employees subject to the limit as under:

- (i) Rs.50, 000/- or
- (ii) 5% of the average net profits of the last three years, whichever is greater.

*Facts of the case:* The company has given donation of Rs.50,000/- each to the two charitable organisations which amounts to 1,00,000. Assuming that the charitable organisations are not related to the business of the company, the average profits of the last 3 years is Rs. 15 lakhs and the 5% of this works out to Rs. 75,000. Hence the maximum of donation could be Rs.75,000 only.

*Conclusion:* By paying donations of Rs.1,00,000 which is more than Rs.75,000, the Board has contravened the provisions of Section 293 of the Companies Act, 1956. Hence the auditor should qualify his audit report accordingly.

**Question 13**

*How would you vouch/verify the following. (Answer any one):*

- (a) *Goods sent out on Sale or Return Basis.*
  - (b) *Bank overdraft.*
- (5 Marks each) (Nov 2009)*

**Answer**

**(a) Goods sent out on sale or return basis**

- (i) A record of goods sent out on sale or return basis should be kept in a specially ruled day book. In this book, first memoranda entries are made.
- (ii) When the goods are sold, entry is made by debiting the party and crediting the Sales Account.
- (iii) The auditor should refer the memoranda record to confirm that on receipt of acceptance from each party, his account is debited and corresponding sales account is credited.

## **Auditing**

- (iv) For the goods in respect of which period of approval has expired are either received back subsequently and customer's accounts debited.
- (v) He should ensure that for the stock of goods sent out on approval, the period of approval, in respect of which had not expired till the close the year, are included in closing stock.

### **(b) Bank Overdraft**

- (i) The auditor should ensure that the facility of overdraft is authorised by the Board's resolution / partner's resolution.
- (ii) Pursue the agreement with the bank and see whether the overdraft is clean or against hypothecation or pledge of company's property.
- (iii) Verify the register of charges and ensure that the charge has been registered with Registrar of Companies.
- (iv) Verify the rate of interest and other terms and conditions from the agreement.
- (v) Verify the amount of overdraft from the books of accounts and compare it with the passbook.
- (vi) If the overdraft is against hypothecation of assets like stocks, a certificate from the bank should be obtained.
- (vii) If the overdraft is against hypothecation of assets or pledge of company's property, see that overdraft is properly shown under 'secured loans' and nature of security has been properly disclosed.

## **Question 14**

*Write short note on Cut-off arrangements.*

*(5 marks) (Nov 2009)*

### **Answer**

#### **Cut-off arrangements**

While doing accounting of financial transactions, it is essential that transactions of one period should be separated from those of the ensuing period so that the working results of each period can be correctly ascertained. This type of arrangement is known as "Cut-off arrangement". It essentially forms part of the internal check of the organisation. Accounts other than sales, purchase and stock are not generally affected by the continuity of the business, and therefore, this arrangement is generally applied only to the above mentioned accounts. The auditor has to satisfy himself by examination and test checks that cut-off procedures adequately ensure that:

- (i) Goods purchased, where the property in the goods has been passed to the client, are included in the inventories and that the liability has been provided for in case of credit purchases.
- (ii) Similarly, goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.