

VERIFICATION OF ASSETS AND LIABILITIES

Question 1

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

As per AS-13, Investment should be classified into Current investments and Marketable investments. (2 Marks each) (May 2007)

Answer

False: As per AS-13, Investments are classified into current and long term investment. Marketable investments are short term and classified as current.

Question 2

Distinguish between Reserves and Provisions:

(5 Marks) (May 2007)

Answer

Reserves and Provisions

- (i) Reserve is an appropriation of profit whereas provision is a charge against Profit.
- (ii) Reserves are not intended to meet any liability, contingency or diminution in the value of assets. Provisions are made to provide for depreciation, renewal or a known liability or a disputed claim.
- (iii) Reserves cannot be created unless there is a profit except revaluation reserve and capital subsidy. Provisions must be created whether or not there is profit.
- (iv) Reserves are generally optional except in certain situations – Capital Redemption reserve, Debenture Redemption Reserve, Declaration of dividend higher than 10% etc. Provisions are not optional and have to be made as per generally accepted accounting principles.
- (v) Reserves are shown on the liability side. Provisions for depreciation and provision for doubtful debts are shown as deduction from respective assets. Provision for liability is shown on the liability side.

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Question 3

How would you vouch/verify the following?

Contingent Liabilities.

(5 Marks) (May 2007)

Answer

Contingent Liabilities

- (i) Review minutes of the meetings of the Board of Directors or other similar bodies.
- (ii) Review contracts, agreements and arrangements.
- (iii) Review list of pending law suits and obtain a certificate and opinion of the lawyer dealing with the cases.
- (iv) Review of records relating to contingent liabilities maintained by the company.
- (v) Review of terms and condition of grants and subsidy availed.
- (vi) Obtain representation from the management.
- (vii) Ensure that proper disclosure is made of all the contingent liabilities.

Question 4

Distinguish between Capital expenditure and deferred revenue expenditure.

(4 Marks) (Nov 2007)

Answer

Distinction between capital expenditure and deferred revenue expenditure: They differ in the following manners:

- (a) Capital expenditure result in acquisition of new fixed assets or increase in future benefits from existing fixed assets beyond pre-assessed level.
Deferred revenue expenditure are expenditure of a revenue nature which bring in future benefits without creating a tangible or intangible fixed assets or by way of improvement in the existing assets.
- (b) Capital expenditure adds to the net worth of the concern.
Deferred revenue expenditure is not considered in calculating net worth
- (c) Capital expenditure is shown under the head fixed assets in balance sheet. Deferred revenue expenditure is shown under the head "Miscellaneous expenditure not written off or adjusted"

Question 5

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

- (a) *Trade Creditors.*
- (b) *Advances to suppliers.*

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

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Answer

(a) Trade creditors:

- (i) Check the adequacy of cut off procedure to ensure that transaction of next period are not accounted and all transactions of year end are accounted.
- (ii) Check posting in the bought ledger from books of prime entry.
- (iii) Compare the balances in the schedule of creditors with balances in bought ledger.
- (iv) Compare the balances with the confirmation or statement of account received from trade creditors.
- (v) Pay special attention to long outstanding items and enquire about the reason thereof.
- (vi) Verify subsequent payments and reversal entries in the bought ledger of year end entries.
- (vii) See that trade creditors are classified and shown in the balance sheet as per requirement of Schedule VI of the Companies Act. 1956.

(b) Advances to suppliers

- (i) Examine the bought ledgers to ascertain the debit balance of creditors and trace the corresponding entry to the cash/bank book.
- (ii) Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.
- (iii) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.
- (iv) Obtain/resort to direct confirmation procedure.
- (v) Ensure proper classification in the balance sheet as per requirement of Schedule-VI.
- (vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

Question 6

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

Interest accrued but not due on "Secured loans" is required to be shown under appropriate sub-heads under the head "Secured loans". (2 Marks) (May 2008)

Answer

False: As per Part-I, Schedule VI to the Companies Act, 1956 interest accrued but not due on secured loans is required to be shown under "current liabilities".

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Question 7

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

(a) *Borrowings from Bank.*

(b) *Work in progress.*

(5 + 5 = 10 Marks) (May 2008)

(a) Borrowings from a bank: Borrowings from a bank may be either in the form of overdraft limits; or short term or medium term or long term loans. The audit procedures which an auditor may adopt are outlined below:

- (i) Ensure that balance as per books of the client and the bank statement tally. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.
- (ii) Examine whether borrowings from the bank have been duly authorized.
- (iii) Examine documents to ensure that statutory requirements, if any, with regards to creation and registration charges have been met.
- (iv) Examine the loan agreement and ensure that the terms therein have been duly complied with.
- (v) Ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made.

(b) Work in Progress:

- (i) Involve a technical expert in verification and valuation of WIP, if necessary.
- (ii) Ensure that cost sheets are duly attested by the works manager.
- (iii) Test the correctness of the cost sheet by verification quantities, Cost of material wages and other charges with reference to the record.
- (iv) Verify stage of completion with component of cost involved with underlying records.
- (v) Compare the unit cost as shown by the cost sheet with standard cost for any large variations.
- (vi) Ensure that the allocation of overhead expenses has been made on reasonable basis and is same as used in earlier period.
- (vii) Compare the cost sheet with that of the previous year and if there is any large variation, investigate the reason thereof.

Question 8

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

(i) *Secret reserve strengthens financial position, hence they are allowed.*

(ii) *Management Certificate obtained by the Auditor is enough for verification of Inventories.*

(2 marks each) (Nov 2008)

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Answer

- (i) **False:** A secret reserve is that whose existence is not disclosed on the face of the Balance Sheet. Its existence strengthens the financial position. However, in the light of Provisions Contained in Part-III of Schedule VI to the Companies Act, 1956, it is not possible for a company to create secret reserve.
- (ii) **False:** As per SA 580, i.e. "Written Representations", it is clear that certificate from management cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

Question 9

As an Auditor how would you react to the following situations/comments?

- (a) *In a company Fixed Assets have been revalued and there has been resulting surplus of Rs.2,00,000, which is transferred to revaluation reserve. The Company has a Debit balance in Profit and Loss account Rs.1,20,000 as accumulated brought forward losses. The company has adjusted this loss balance against Revaluation reserve.*
- (b) *The Central Government sanctioned Rs.20 lakh as Grant to a Hospital for the purchase of certain equipments and paid Rs.10 lakh as advance. The hospital took Rs.10 lakh as income in the Profit and Loss account for the year.*

(8+6 = 14Marks)(Nov 2008)

Answer

- (a) The guidance Note on Treatment of Reserve created on Revaluation of 'Fixed Assets' advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealized gains.

In the given problem Rs.2 lakhs transferred to revaluation reserve is unrealized gain whereas Rs.1.20 lakh being debit balance in P & L A/c is actual accumulated loss. This loss cannot be adjusted from unrealized gain raised as revaluation reserve.

- (b) As per AS-12, government grant received for specific asset should be treated in either of the following way:
 - (1) Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in P&L account on a systematic and rational basis over the useful life of the asset.

OR

- (2) Grant to be shown as a deduction from gross value of the asset concerned in arriving at its book value and depreciation is charged on reduced value of fixed asset.

Interview of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the P&L account

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and has distorted the P&L account by treating the capital item as revenue. The audit should accordingly qualify the report.

Question 10

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

Trade Marks and Copy rights.

(5 Marks) (Nov 2008)

Answer

Trademark and Copyright: The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fee have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amortized over the period of legal validity or useful commercial life, whichever is short. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS 26 has suggested a useful life of 10 years unless and until there is clear evidence that useful life is longer.

Question 11

Write short note on Impairment of Assets.

(5 Marks) (Nov 2008)

Answer

Impairment of assets: Besides charging annual depreciation on assets by the reason of normal wear and tear, afflux ion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the assets can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss. The treatment of impairment loss is similar to depreciation except the fact that it can be re-instated in future, if the recoverable amount of the asset exceeds the carrying amount.

The auditor must ensure that provisions of AS 28 "Impairment of assets" are followed.

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Question 12

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

- (i) *Contingent liabilities are provided for in the accounts if they crystallize between the end of the accounting year and the date of signing the audit report.*
- (ii) *The fixed deposit held with bank by a company is to be shown under the head investments in Balance Sheet as per the requirements of part I of schedule VI to the Companies Act, 1956.* (2 Marks each) (June 2009)

Answer

- (i) **False:** Contingent liabilities existing on the balance sheet date are disclosed by way of note and not provided for even if it had crystallized subsequently.
- (ii) **False:** They are shown under current assets, loans and advances under sub head bank balances as per schedule VI part I requirement.

Question 13

- (a) *A Limited Company has filed a suit against debtor from whom Rs.25 lakhs are receivable. A judgement is received from court in favour of the company after the date of Balance Sheet. Discuss auditors' duty in this regard.* (6 Marks)
- (b) *While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer.*

(4 Marks) (June 2009)

Answer

- (a) (i) Subsequent events are events occurred after balance sheet date but before the date of audit report.
- (ii) In case of audit of components, such as branch or division the subsequent events are events after the balance sheet date and before the date of audit report of that component.
- (iii) The subsequent events, according to AS 4 and as reproduced in SA 560 are of two types – (a) those which provide further evidence of conditions that existed at the balance sheet date and (b) those which are indicative of conditions that arose subsequent to the balance sheet date.
- (iv) Depending upon the type of subsequent events, the auditor should decide on adjustment of accounts based on evidential value gathered for conditions that existed as on the date of balance sheet date or disclosure of the conditions that arose subsequent to the date of balance sheet.
- (v) The auditor should perform audit procedures to identify the subsequent events that are relevant for adjustment/disclosure. These procedures would include

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reading minutes of Board subsequent to accounting period, contacting lawyers for knowing progress of pending Cases, inquiry with the company management, scrutinizing subsequent interim accounts etc.

- (vi) The auditor should perform these procedures as near as practicable to the date of his audit report.
- (vii) If the management does not account for the subsequent events in the financial statements where they are to be accounted, the auditor should appropriately comment his report by a qualification or disclaimer.
- (b) The Auditor while considering advances granted by bank for purchase of machinery has to consider valuation report given by civil engineer to the bank.

SA 620 "Using the Work of an Expert" clearly states while reliance on work done by expert, the auditor should consider:

- (i) Professional qualification of experts
- (ii) Experience and reputations.

If auditor finds that civil engineer can not be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

Question 14

How would you vouch/verify the following:

(a) *Goods lying with third party.*

(b) *Proposed dividend.*

(5x2=10 Marks)(June 2009)

Answer

(a) Goods lying with third party

- (a) The auditor should check that the materiality of the item under this caption included in stocks.
- (b) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.
- (c) He should inquire into the necessity of sub contractor retaining the stock. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.
- (d) The goods lying with them for the very long period would merit auditors' special attention for making provision.
- (e) The records, voucher/slips for the regulating the movement of stock into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

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- (f) The excise gate pass, entry in such records, information in returns, be also cross-verified.
- (g) The valuation of stocks should be correctly made for including material cost on appropriate stock valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.
- (h) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

(b) Proposed dividend

1. Proposed dividend is to be provided for even though it is proposed and is to be declared after the end of the accounting period in terms of AS 4 and also schedule VI disclosure requirements.
2. The Auditor should check the minutes of the Board for the amount of dividend proposed to be considered for its declaration in general meeting.
3. The auditor should check the amount of paid up share capital and verify the quantum of dividend proposed by checking the calculations.
4. The interim dividend if any paid should be checked and ascertained that the proposed dividend is properly computed by adjustment to it, if the same had been reckoned for the total dividend.
5. Dividend tax payable on proposed dividend should be provided for.
6. The account should be properly disclosed in P&L account and also in balance sheet according to the requirements of schedule VI to the Companies Act 1956.

Question 15

Write short note on Physical attendance by auditor during inventory taking

(5 Marks) (June 2009)

Answer

Attendance at stock taking

1. The physical verification of stock is the responsibility of the management. The auditor may find it appropriate to attend the stock taking, if the inventory value is material in his opinion.
2. The extent of participation in inventory taking depends upon the internal control system prevailing, results of examination of inventory records and analytical review procedures.
3. When auditor attend inventory taking, he ensure that the instructions given for inventory taking is followed.
4. He test checks few items by himself for their existence and quantum. He selects to test high value items importantly.

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5. The physical conditions of stock – like its age, deterioration, obsolescence etc., are looked into by auditor.
6. The auditor reviews stores records and notes down major discrepancies for reconciling them in a subsequent date.
7. The cut off arrangement is also looked into ensure that the entity accounts for stock for which liability had been booked and excludes stock which had been sold.

Question 16

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

A Company which has been unable to negotiate borrowings from its bankers claims that it will be able to continue as a 'going concern'. (2 Marks) (Nov 2009)

Answer

False: In the case of the company which has not been able to negotiate its borrowings with its bankers, there will be a substantial doubt in its ability to continue as a going concern without such financial support.

Alternative Answer – True: If the company is not able to negotiate borrowings from its bankers for reasons like delay/failure in the submission of adequate documents/ information or for other reasons other than the company's financial status then the statement is true.

Question 17

State the information to be disclosed in the financial statements according to the requirements of AS 6. (5 Marks) (Nov 2009)

Answer

Requirements of AS 6: AS 6 requires following information to be disclosed in the financial statements:

- (i) Historical cost or other amount substituted for historical cost of each class of depreciating asset;
- (ii) Total depreciation for the period for each class of assets.
- (iii) The related accumulated depreciation.

It also requires following disclosure of information in the financial statements along with the disclosure of other accounting policies:

- (i) Depreciation method used and
- (ii) Depreciation rates or the useful life of the assets, if any, if they are different from the principal rates specified in the statute governing the enterprise.

Question 18

As an auditor, comment on the following situation:

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MNR Co. Ltd. did not provide for depreciation during the financial year 2007-08 due to inadequacy of profits. The company declared dividend during the financial year 2008-09 without providing for the previous year's depreciation. (5 Marks) (Nov 2009)

Answer

Payment of dividend without providing for arrears of depreciation

Section 205 (1) of the Companies Act, 1956, prescribes that if a company has not made provision for depreciation for any previous financial year, it should provide for such depreciation before declaring / paying dividend:

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

In the present case, it would be necessary to make provisions for depreciation in respect of 2007-08 and 2008-09 in the first instance and the balance of profit after providing depreciation including the previous year, could be used for distribution as dividend. Since the company has contravened the provisions of Section 205(1), the auditor should qualify his audit report.

Question 19

How would you vouch/verify the following. (Answer anyone):

Leasehold property.

(5 Marks) (Nov 2009)

Answer

Lease Hold Property: Following are the main steps involved in verification/vouching of lease hold property:

- (i) Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions. A lease exceeding the period of one year is not valid unless it has been registered by an instrument. Hence this has to be ensured.
- (ii) Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with, e.g. payment of ground rent, insurance premium, maintenance of lease and property in satisfactory state etc.
- (iii) Ensure that due provisions for any claims that might arise under the dilapidation clause on the expiry of the lease have been made. If such provision has not been made, the auditor should draw the client's attention to it.
- (iv) Ensure that the outlay and legal expenses incurred to acquire lease property have been capitalised. The property must be written off in such a way that it completely wipes off the asset at the end of the lease period.
- (v) He should ascertain that the clause entitles the lessee to sub let any part of the leased property and ensure its proper compliance.