CA IPCC Auditing: Nov. 2012

Q.1 (a) Shares issued at discount. [Marks – 5]

Answer: Power to issue shares at a discount:(Original Text of Section 79 of The Companies Act, 1956)

Subsection (1) *A company shall not issue shares at a discount except as provided in this section.*

Sub-section (2): *A company may issue at a discount shares in the company of a class already issued, if the following conditions are fulfilled, namely:*

(i) the issue of the shares at a discount is authorized by a resolution passed by the company in general meetings, and sanctioned by the central government;

(ii) the resolution specifies the maximum rate of discount at which the shares are to be issued;

Provided that no such resolution shall be sanctioned by the central government if the maximum rate of discount specified in the resolution exceeds ten per cent, unless that government is of opinion that a higher percentage of discount may be allowed in the special circumstances of the case;

(iii) at the date of the issue, not less than one year has elapsed from the date on which the company was entitled to commence business; and

(iv) the shares, to be issued at a discount, are issued within two months after the date on which the issue is sanctioned by the central government or within such extended time as the central government may allow.

Sub-section (3): *Where a company has passed a resolution authorizing the issue of shares at a discount, it may apply to the central government for an order sanctioning the issue; and on any such application, the central government, if, having regard to all the circumstances of the case, it thinks proper so to do, may make an order sanctioning the issue on such terms and conditions as it thinks fit. Provided that………..*

Sub-section (4): *Every prospectus relating to the issue of the shares shall contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the prospectus……..]*

Q.1 (b) Ceiling on number of audits in a company to be accepted by an auditor: [Marks-5]

Answer: ***Section 224 (1B)*** places a ceiling on the number of "audit of public companies", which an auditor can't exceed. This ceiling is referred to as the 'specified number' per chartered accountant. Following points may be noted:

(i) The 'specified number' is 20 of which not more than 10 should be the companies with a paid up capital of Rs. 25 lakhs or more. In other words, an auditor can audit a maximum of 10 companies having a paid up capital of Rs. 25 lakhs or more while the maximum number of audit of public companies permissible for a chartered accountant is 20 inclusive of 10 large public companies having paid up capital of Rs. 25 lakhs or more.

(ii) In the case of a firm of auditors, the ceiling is 'specified number' for every partner of the firm **who is not in full time employment elsewhere** (as per the Companies Act, 1956)**.**

(iii) Where any partner of the firm is also a partner of any other firm of auditors, the ceiling is 'specified number' for such person in all the firms taken together.

(iv) Where any partner of a firm of auditors is also practicing in his individual capacity, the ceiling is 'specified number' for such person in the partnership firm and in his individual capacity taken together.

(vi) Where a chartered accountant (i.e. member of ICAI) is in employment in the firm, he shall not be counted for the purpose of computing the 'specified number' for the firm. *The reason is that the **proviso to section 224(1B)** is applicable over partners only and an employee cannot be partner simultaneously.*

Following audits are not counted in computing ceiling:

In computing the specified number, following shall not be taken into account:

(a) Audit of a private company *[As provided by Companies (Amendment) Act, 2000].*

(b) An audit of a guarantee company having no share capital. *[Circular No.8/12(224)/74-CL-V dt.28-9-1974]*

(c) An audit of a foreign company. *[Circular No.21/75dt.24-9-1975]*

(d) A branch audit. *[Circular No.21/75dt.24-9-1975] [Because what is included in the computation of ceiling, is statutory Audit u/s. 224 but branch audit is conducted u/s. 228 of the Companies Act, 1956 which is not covered]*

(e) Audit of registered societies, cooperative societies, trusts and corporations *[Because they are not Companies as per the Companies Act, 1956]*

(f) Tax audits under Income Tax Act, 1961*. [Because they are not statutory Audit u/s. 224 of the Companies Act, 1956]*

(g) Special audit (Sec.233A), Cost Audit (Sec. 233B) and investigations. *[Because they are not statutory Audit u/s. 224 of the Companies Act, 1956]*

(h) Audit of liquidator's account of statement [In case of liquidation of company]. But it should not be confused with the audit of the company under liquidation.

Following audits are counted while computing ceiling:

The following audits shall be considered for the purpose of computing the specified number.

(a) An audit of a company in which the auditor is appointed as a joint auditor.

(b) An audit of a non-profit company.

Maximum number of audits of companies, a Chartered Accountant is permitted to conduct (i.e. Ceiling as per the Chartered Accountant Act, 1949): **An audit of a private company is excluded while computing the ceiling limit of audit assignment under section 224 (1B). However, as per a notification issued by ICAI, a chartered accountant can accept a maximum of 30 audits including the audits of private companies. Non-observance of this ceiling would amount to professional misconduct [*ICAI Guidelines No. 1-CA(7)/02/2008 dt. 08.08.2008*]**

Important points:

(1) *As per para 8.3 & 8.4, Chapter VIII of Council General Guidelines No.1-A(7)/02/2008 dated 08-08-2008, a Chartered Accountant who is in;*

(a) full-time employment,

(b) part-time employment, or

(c) part-time practice,

shall not be taken into account for the purpose of reckoning the quota of audit assignments of the firm for ceiling purpose.

(2) Relevant date: Relevant date for the purpose of checking number of eligible partners in the firm to ascertain the quota under ceiling is date of acceptance of audit assignment.

Q.1 (c) Purposes of providing depreciation: [Marks -5]

Answer: Depreciation is the reduction or diminution in the value of an asset due to its use. It is a reasonable allowance for the exhaustion, wear and tear of the property used in the trade or business including a reasonable allowance for obsolescence

Causes of depreciation:

1. Wear and tear.
2. Efflux of time.
3. Obsolescence.
4. Depletion or exhaustion.
5. Deterioration.
6. Fall in market value.

The necessity to provide depreciation:

(i) ***Depreciation is an expenses:*** An asset decreases in value over its useful life. This decrease is like an expense. If depreciation is not added to the cost as an expense, true profit cannot be known.

(ii) ***Profit will be inflated:*** If depreciation is not charged as an expenses the profit will be inflated.

(iii) ***Balance Sheet will not exhibit a true and fair state of affair* :** If depreciation is not deducted from an asset it will be shown at its original cost which will be higher than its actual value on the date of the balance sheet.

(iv) ***To make provisions for replacement of an asset*:** One important object of providing depreciation is to set aside funds out of profits to replace an asset after it becomes useless.

(iv) ***To keep capital intact*:** If depreciation is not charged, profit will be paid out of capital. Hence, to keep capital intact it is necessary to charge depreciation.

Q.1 (d) Filling of a casual vacancy of auditor in respect of company audit: [Marks -5]

Answer: The expression 'casual vacancy' has not been defined in the Companies Act, 1956. Simply stated, a casual vacancy in the office of an auditor means a vacancy caused in the office of an auditor by his death, disqualification, resignation, etc. ***Casual vacancy can arise by death, disqualification, resignation, etc. of first auditor or regular auditor whether appointed in BOD meeting by a resolution or in the general meeting of the company either by ordinary resolution or special resolution. It can even arise on the death of auditor appointed against casual vacancy.*** It has been held in the case of the *Institute of Chartered Accountants v. Janendranath Saikia (1955) 25 Comp. Case 53, 56 (Assam)* that casual vacancy is not a vacancy created by any deliberate omission on the part of the company to appoint an auditor at its Annual General Meeting. The tenure of auditor appointed against casual vacancy commences from the date of appointment and ends on the conclusion of next AGM. For the purpose of reckoning the financial year(s) covered under his tenure, the period of the auditor against whom casual vacancy was aroused, is also considered/included in his tenure.

Section 224 (6)(a): *The Board may fill any casual vacancy in the office of an auditor; but while any such vacancy continues, the remaining auditor or auditors, if any, may act.*

(proviso): *Provided that where such vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in General Meeting.*

Section 224 (6)(b): *Any auditor appointed in a casual vacancy shall hold office until the conclusion of the next Annual General Meeting.*

Q.2 (a) Explain the concept of "True and Fair" view: [Marks -6]
Answer: Statutory Requirement:

⇒ **[Section 227 (2)]** *The auditor shall state whether, in his opinion and to the best of his information and according to the explanation given to him;*

- *the balance sheet and profit and loss account and documents annexed thereto give the information required by this Act in the manner so required; and*
- *the balance sheet* ***gives a true and fair view*** *of the state of the company's affairs as at the end of its financial year and the profit and loss account gives a true and fair view of the profit and loss for the financial year.*

⇒ **[Section 211(5)]** *of the Companies Act, 1956 provides that the accounts of the company,* ***shall be deemed not disclosing true and fair view*** *if they do not disclose any matter which is required to be disclosed :*

(a) by virtue of provisions of schedule VI to the Act, or
(b) by virtue of a notification or an order of central government modifying the disclosure requirements.

⇒ *Directors Responsibility Statement under* ***section 217(2AA)*** *requires that the Board's Report shall state that the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a* ***true and fair view*** *of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for that period.*

Nature of the Audit Report: Audit report is partially statement of facts and partially auditor's opinion about the true and fairness of financial statements. In any audit, the question of fact is more important because essentially the auditor's job is to test the assertions in financial statements by reference to available evidence, apart from the following aspects:

(i) presentation,
(ii) disclosure,
(iii) arithmetical accuracy,
(iv) adherence to accepted accounting principles, and
(v) compliance with the requirements of law.

The primary duty of the auditor is to determine whether the **Balance Sheet** shows a true & fair view of the state of affairs as at the end of financial year and whether the **profit and loss** account shows a ***true & fair view*** of the working results of the company for the year.

- ***Truth and fairness implies here*** the depiction of a full and ***reasonably*** correct position of financial statements in authenticity, in integrity, in accuracy, in presentation and in disclosure.
- ***Reasonable implies here*** intelligent care and deliberation i.e. choice of a course which reason dictates. Reasonability has to be evaluated from the substantive as well as procedural standpoint.
- Auditor's ***view about the financial statements*** is whether the entity is in profit or in loss as depicted in financial statements if audit report is clean or subject to such reservations/limitations if report is qualified. Auditor does not confirm view in adverse audit report or disclaimer of opinion.

The Concept of true and fair view of Financial Statement is subjective matter therefore the auditor is excepted to use his professional skill and competence when he is faced with the problem as to whether or not a particular error or omission is so fundamental and/or material to affect to true and fair view of financial statement. [Para 10 of **SA 320**]

Since, most of the audit evidences are persuasive of nature rather than conclusive and, often, accounting figures are not precisely correct figures, they are reasonable estimates based on valid assumptions and guiding principles, therefore, true & fairness of financial statements depends upon exercise of judgment in relation to accounting assumptions, conventions and principles that are as follows:

(a) **Cost convention:** The basis for preparing accounts must be acceptable, like - historical cost convention.

(b) **Fundamental Accounting Concepts Including Assumption:** A true & fair view implies that the financial statements have been prepared with due recognition of fundamental accounting principles / concepts and assumptions, which are as hereunder:

(i) Going Concern Concept.
(ii) Accrual Concept.
(iii) Consistency Concept. — ***Fundamental accounting assumptions***
(iv) Prudence Concept
(v) Substance Over Form
(vi) Materiality — ***Considerations in selecting an accounting policy***
(vii) Objectively
(viii Comparability
(ix) Relevance
(x) Adherence to Statutes

What constitutes a true & fair view is a matter of the auditor's judgment in the particular circumstances of a case. However, if every audit report were based entirely on the subjective judgments, the report would do little to give credibility to the financial statements. For this reason, the following guidelines may be laid down in this regard;

(i) The financial statements should be drawn in conformity with the relevant statute.
(ii) Financial statements should be without any material mis-statement or window-dressing.
(iii) All unusual, exceptional or non - recurring items should be disclosed separately. [AS - 5]
(iv) Financial statements should be prepared and presented consistently in conformity with generally accepted principles of accounting. [AS - 1]
(v) Appropriate incorporation of events occurring after balance sheet date in the financial statements. [AS - 4]
(vi) Financial statements should convey required information in very clear and unambiguous terms as auditor owes general duty of care, which is not discharged, merely, by giving them so much of information as is calculated to either induce them or force them to ask for more, as information and means of information are by no means equivalent terms.

Q.2 (b) Mention the areas in which different accounting policies are encountered and how that would be disclosed? [Marks -10]

Answer: **Areas in which different Accounting Policies are encountered [AS 1]:**

The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

- Methods of depreciation, depletion and amortization [Tangible assets (AS 10) Intangible

Assets (AS 26)]..

- Treatment of expenditure during construction (AS 7).
- Conversion or translation of foreign currency items (AS 11).
- Valuation of inventories (AS 2).
- Treatment of goodwill (AS 14 & 21).
- Valuation of investments (AS 13).
- Treatment of retirement benefits (AS 15).
- Recognition of profit on long-term contracts (AS 7).
- Valuation of fixed assets [tangible (AS 10), Intangible (AS 26)].
- Treatment of contingent liabilities (AS 29).
- Valuation of DTA & DTL (AS 22)
- Treatment for impairment loss (AS 28).

Disclosure of Accounting Policies (AS 1):

- To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements and such disclosure should be at one place instead of being scattered over several statements, schedules and notes.
- Any change in the accounting policies, which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed.
- In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated **[AS 5]**.
- If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts **[Auditing principle]**.

Q. 3 (a) What are the duties of C & AG? [Marks -10]

Answer: Duties of Comptroller and Auditor General of India:

The main duties of Comptroller and Auditor General within the framework of the constitution of India are as follows;

(1) Compilation and Submission of Accounts: The Comptroller and Auditor General should compile the accounts pertaining to annual receipts and disbursements of the Union or state or Union Territory, and submit these to the President or Governor or Administrator.

(2) Rendering Assistance in Accounts Maintenance: The Comptroller and Auditor General should provide such information to the Union or State or Union Territory, as they may require from time to time and render such assistance in preparing annual financial statements as they would be reasonably ask for.

(3) Auditing and Reporting: The Comptroller and Auditor General should audit and report on:

(i) All the expenditures from Consolidate Fund of India/State/Union Territory having a Legislative Assembly and to determine whether the monies disbursed were legally available for and applicable to the purpose and service for which they are applied and whether the expenditures comply with the authority governing it.

(ii) All the transactions of Union or state pertaining to Contingency Funds and Public Accounts.

(iii) All the trading, manufacturing, profit & loss Accounts and Balance Sheets and other subsidiary accounts kept in any department of a Union or State.

(4) Audit of Receipts and Expenditure: The Comptroller and Auditor General should audit and report on all the receipts and expenditure of any body or authority substantially financed by Consolidated Fund of India or state or union territory. For such purpose, a body or authority shall be treated as substantially financed if the amount of grant or loan in year is;

(i) More than Rs.25 lacs, or

(ii) More than 75% of the total expenditure of the body or authority.

(5) Audit of Grants or Loans: This applies to the grant or loan of any specific purpose, provided from the consolidate Fund of India or state or Union Territory, to any body corporate or authority other than a foreign state or international organization. The Comptroller and Auditor General should examine in detail the procedures by which the approving authority satisfies itself about the fulfillment of the conditions of providing such grants or loans.

(6) Audit of Receipt of Union or State: The Comptroller and Auditor General should audit all the receipts payable into the Consolidated Funds of India or state or union territory. He may satisfy himself that the rules and procedures have been designed to make an effective check on the assessment, collection and proper allocation of revenue and are duly being observed.

(7) Audit of stores and stock accounts: The Comptroller and Auditor General should be authorized to audit and report on the stores and stock accounts kept in any office or department of the union or state.

(8) Audit of Government Companies and Corporation's Accounts: The Comptroller and Auditor General should exercise such powers and duties according to the provisions of the Companies Act, 1956, pertaining to government Companies and Corporations.

Q. 3 (b) State any six basic elements of the Auditor's Report. [Marks -6]

Answer: Basic Elements of the Auditor's Report (SA: 700):

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

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph

(i) identification of the financial statements audited;

(ii) a statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph (describing the nature of an audit)

(i) a reference to the auditing standards generally accepted in India;

(ii) a description of the work performed by the auditor;

(e) Opinion paragraph containing

(i) a reference to the financial reporting framework used to prepare the financial statements; and

(ii) an expression of opinion on the financial statements;

(f) Date of the report;

(g) Place of signature; and

(h) Auditor's signature.

Q.4 (a) What are the factors that are to be considered while designing a confirmation request? [Marks -8]

Answer: *External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item. Before making use of external confirmations, auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level. Auditor should employ external confirmation procedures in consultation with the management. External confirmations are mostly sought for account balances and their components but they are not to be restricted to these items only. The use of confirmation procedures may be effective in providing sufficient appropriate audit evidence when auditor determines higher level of assessed inherent and control risk. The request for confirmations is to be made either at the date of financial statements or at a date close to it. Requests are to be designed to specific audit objectives. Auditor's understanding of client's arrangements and transactions with third parties is important in determining the information to be confirmed. Auditor may use positive or negative external confirmation requests or a combination of both. The former request asks the respondent to reply to Auditor in all cases either by indicating respondent's agreement with the given information, or by asking the respondent to fill in information. Letter asks the respondent to reply only in the event of disagreement with information provided in the request. Auditor should perform alternative procedures where no response is received to a positive external confirmation request. Auditor should consider whether there is any indication that external confirmations received may not be reliable. Auditor should evaluate the conformity between results of external confirmation process together with results from any other procedures performed. If Auditor seeks for an external confirmation and management requests the auditor not to do so, auditor should consider whether there are valid grounds for such a request and obtain evidence to support validity of management's requests.*

Q. 4. (b) Distinguish between Auditing and Investigation: [Marks-8]

Answer: Auditing: *An audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.* It is mandatory for corporate assesses and voluntary for proprietorship/ partnership firm.

- Normal time period of coverage is one financial year.
- Audit is carried out on behalf of owners.
- It is conducted by a practicing Chartered Accountant.
- Uses persuasive as well as conclusive, both type of audit evidences.
- Propriety elements are not subject matter of audit except what is specifically required in section 227(1A) and AAS 16.
- Test checking/sampling is acceptable audit technique subject to materiality concept.
- Audit begins with no preconceived notion.
- Format of audit report is prescribed.
- It's prime objective is to render audit opinion whether financial statements exhibits true and fair view or not.

(iii) Investigation: *Investigation implies systematic, critical and special examination of the records of a business for a predetermined specific purpose. It is a voluntary activity conducted at the instance of management.* ***Ex.*** *Special audit u/s. 233A, Investigation in case of oppression &*

mismanagement u/s. 397-409.

- Normal time period of coverage may be less then or more than one financial year.
- Investigation is carried out on behalf of owners / management / third party.
- It may be conducted by staff of the entity, Chartered Accountant or External Agency.
- Conclusive evidences are preferred but such persuasive evidences could also be used which are consistent with each other and corroborate the issue to such an extent that only one conclusion could be drawn.
- May cover any type of aspects. Ex. financial or non-financial.
- Detailed, exhaustive and through examination is required.
- Investigation is started with preconceived notion.
- No specific format is prescribed.
- It's prime objective is to confirm or dispel allegations or facts.

Q. 5 (a) What are the eight audit points to be considered by the auditor during the audit of a hospital? [Marks -8]

Answer: Audit of Hospital

The special steps involved in such an audit are stated below;

(1) Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients. attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(2) Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(3) See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(4) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(5) Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(6) Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(7) Verify that grants, if any, received from Government or local authority have been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(8) Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.

(9) Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.

(10) See that depreciation has been written off against all the assets at the appropriate rates.

(11) inspect the bonds, share scrips, title deeds of properties and compare their particulars

with those entered in the property and Investment Registers.
(12) Obtain inventories, specially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

Q. 5(b) As an auditor , how you will verify application and allotment money received on shares for cash? [Marks -8]

Answer: **Procedure to be adopted for the purpose of auditing the issue of shares, issued for cash:**

Usually, there are three stages in the issue of shares for cash, viz.:

(i) Receipt of applications for shares along with application money;
(ii) Allotment of shares and receipt of allotment; and
(iii) Making calls and receipt of call money.

The audit program to be carried out in respect of each of the above mentioned three stages is stated below :

(a) Applications: Verify the amount received along with the applications for shares in the following manner:

(i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;
(ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;
(iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;
(iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

(b) Allotment:

(i) Examine Director's Minutes Book to verify approval of allotments.
(ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.
(iii) Trace entries in the Cash book into the Application and Allotment Book for the verification of amounts collected on allotment.
(iv) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.
(v) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

Q. 6(a) What are the audit working papers? Discuss various contents of current file? [Marks -8]

Answer: Audit Working Papers:

Standards on Auditing Para 11 of **SA 200(old)**, ***"Basic Principles Governing an Audit"*** states, *"The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles."* Documentation refers to working papers prepared or obtained and retained by the auditor with regard to performance of audit. Working papers aid in the planning, performance, supervision and review of the audit work and provide evidence of the audit work performed to support the auditor's opinion *[Para 3 of* ***SA 230****]*. Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained *[Para 4 of **SA 230**]*. All significant matters which require the exercise of judgement, together with the auditor's conclusion thereon, should be included in the working papers *[Para 8 of **SA 230**]*. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of documentation is a matter of professional judgement since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers *[Para 7 of **SA 230**]*. Further, the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers"*[Para 14 of **SA 230**]*.

Current File [original text: Para 12 of SA 230]: The current file normally includes:

(i) Correspondence relating to acceptance of annual reappointment.
(ii) Extracts of important matters in the minutes of Board Meetings and General Meetings as relevant to audit.
(iii) Evidence of the planning process of the audit and audit program.
(iv) Analysis of transactions and balances.
(v) A record of the nature, timing and extent of auditing procedures performed, and the result of such procedures.
(vi) Evidence that the work performed by assistants was supervised and reviewed by the auditor.
(vii) Copies of communication with other auditors, experts and third parties.
(viii) Letters of representation or confirmation received from the client/management.
(ix) Conclusions reached by the auditor on the matters significant to the audit and how he dealt with exceptional and unusual matters, if any.
(x) Copies of the financial information being reported on and draft audit report.

Q. 6 (b) Explain , what are the factors to be considered while vouching of travelling expenses?
[Marks -8]

Answer: Travelling Expenses:

S. No.	Auditor's Assertion to be proved	Methods of performing vouching
1	Documentary verification for Accuracy, Authenticity and Belongingness of transactions	(i) Check the rules and regulations framed by the company in respect of reimbursement of traveling expenses, if no rules or regulations are prescribed, only actual amount incurred should be reimbursed. (ii) Check whether there is pre-sanction of journey and approval of reimbursement of traveling expenses from appropriate authority. (iii) Check the mathematical accuracy for recording, posting and casting in cash book, journal, ledger account and bank account etc. (iv) Check whether the purpose of travelling is related to business or not. (v) In case of a company, expenses related

		to director's travel should be checked carefully to see that:- (a) The travel was approved at the board level, (b) The amount of claim is within limit, and (c) These are in accordance with the rules framed by the entity with respect to traveling expenses. (vi) The journey must be approved before the journey started by appropriate authority and if advance has made for journey, those advances should be adjusted in claim for traveling expenses made by staff/officers/directors. (vii) Check whether any amount paid to the directors as TA amounts to remuneration and if so; check that ceiling limit of director's remuneration prescribed u/s.309 is not violated.
2	Evaluation of compliances of relevant Statutes	(i) Check the compliance of relevant provisions of FEMA and RBI guidelines if journey is of abroad and foreign exchange is involved. (ii) As per the schedule VI of companies Act 1956 every type of expenditure which is either 1% of turnover of Company (in amount) or Rs. 5000/- whichever is higher, should be disclosed separately in P/L account.
3	Evaluation of compliances of pronouncements of the Institute	(i) Capitalization of traveling expenses is prohibited under AS 26 except when journey is solely occurred for the acquisition of asset. (ii) Compliance of AS 11, in case of involvement of foreign exchange.

Q. 7 (a) Audit of discounted bills receivable dishonoured: [Marks -4]

ANSWER: **Discounted Bills Receivable dishonoured:**

1 Bill wise schedule:

Obtain a schedule of discounted bills dishonoured and examine the same.

2 Bank Statements:

(i) Trace the credit entry and subsequent dishonour entry in the bank statement.

(ii) Confirm that no deficit is raised by the banks for dishonour, without first crediting the amount to the client's account.

3 Bills Receivable (B/R):

(i) Verify whether B/R has been returned along with banker's advice.

(ii) Ensure that the dishonour has been properly "Noted" on the B/R.

4 Debtor's Ledgers:

(i) Verify entries for dishonour passed in the parties account.

(ii) Confirm whether bank charges, noting charges, etc have been debited to party along with B/R's amount.

5 Lawyer Correspondence file:

Examine correspondence with lawyer and other subsequent events, which may provide other evidence of the debt becoming bad or doubtful etc. (N.P.A.)

Q. 7(b) Auditor's Lien: **The auditor's right of lien on books of accounts of the company: [Marks -4]**

(i) The right of lien is exercised over the property of someone else when following conditions are met with:

(a) A person has lawful possession over the property of someone else,

(b) He has worked on that property,

(c) His dues for works done are outstanding, and

(d) It will remain till his dues are not squared off i.e. paid for.

(ii) The exercise of right of lien does not transfer the title of the property subject matter of lien therefore such property continue to belong to its real owner and he, within his rights, can exercise such statutory rights which can be exercised over the property bearing encumbrance.

(iii) U/s. 209 of the Companies Act, 1956 the company must keep its books of accounts at its registered office or the place decided in the resolution of Board of Directors of the company.

(iv) Legal and valid possession of books of accounts of the company in the hands of auditor is possible only when the company has authorized the auditor to relocate them through a resolution in BOD meeting.

So the auditor can exercise the right of lien on the books of accounts of the company if those books of accounts came into the possession by prescribed legal mode and the company has not paid his fees etc. for the work done by auditor. It is pertinent to mention here that during the course of lien exercised by the auditor, he should make available such books of accounts for inspection in official hours to the authorized persons of the company and to the statutory authorities like Tax authorities etc. whenever statutorily required so. In such situation, auditor should consider the first clause of Part I to second Schedule regarding confidentiality of information[1] and permissible circumstances of disclosure and also extent of disclosure. Since this provision is very stringent as disclosure less than required will amount to gross negligence in performing his duties while disclosure more than statutorily warranted and which is not authorized by the client is unauthorized disclosure of confidential information and amounts to break of confidentiality clause.

Taking an overall view of the matter it can be inferred that statutory provisions permit the auditor to exercise right of lien but practically it is a very difficult task due to legal constraints and cumbersome duty involved so it is advisable for auditor to exercise the right of lien as last recourse only.

Q. 7(c) Inherent risk: **[Marks -4]**

Answer: Inherent Risk:

1 Factors considered in assessment of inherent risk

(i) At the level of Financial Statement:

(a) The integrity of management.
(b) Management experience & knowledge, and change in management.
(c) Unusual pressure on management.
(d) The nature of entity's business.
(e) Factors affecting the industry in which the entity operates.

(ii) At the level of Account Balance and Class of Transactions:

(a) Quality of the accounting system.
(b) Financial statements are likely to be susceptible to misstatement.
(c) The complexity of underlying transactions and other events which might require hiring of an expert.
(d) The degree of judgment involved in determining account balances.
(e) Susceptibility of assets to misappropriation, embezzlement, theft etc.
(f) Transactions not subjected to ordinary processing.
(g) The completion of unusual and complex transactions, particularly, at or near end of financial period. [Para 13 of **SA 400]**

2 Considerations at Audit Phases:

(i) Auditor should assess inherent risk at the level of financial statements in developing overall audit plan.
(ii) Auditor should relate such assessment to material account balances and classes of transactions at the level of assertions in financial statements.
(iii) Auditor should document the reasons for assessment of inherent risk not high. [Para 12 of **SA 400**]

Q. 7(d) Cut-off arrangements: **[Marks -4]**

Answer: Cut-off Procedures/arrngements:

Cut-off procedures are the procedures designed to ensure that at the year-end, trading transactions are entered in the period to which they relate and there is a separation of transactions as at the end of one year from those at the commencement of the next year. The concept of preparing accounts for a business for a year ended on a particular date is somewhat artificial, because the flow of transactions continues unbroken over the year-end. Great care must, therefore, be taken and certain specific procedures are required to cut-off transactions at the end of one accounting period from those of the subsequent accounting period.

The auditor must establish that there are satisfactory internal controls in respect of cut off procedures by applying compliance tests [the objective is to ensure that these controls are functioning properly], or carry out appropriate substantive tests to find out correct profit for each relevant period.

Cut off procedures are very important for correct recognition of revenue income and cost matching concept. **Ex.** Let relevant FY is 01-04-X1 to 31-03 -X2 and Rs. 12,000/= insurance premium is paid on 01-07-X1 for the period 01-07-X1 to 30-06-X2 [i.e. for 12 months] out of which last 3 months do not fall in the relevant FY. Therefore insurance premium paid for 9 months [i.e. up to 31-03-X2] is chargeable to revenue and remainder i.e. Rs. 3,000/= should be disclosed as pre-paid asset in the balance sheet.

Cut off procedures related to sales and purchases are co-related with inventory/stock position, as hereunder;

Case I: Goods sold before the date of F.Y. and it is full-fledged sale transaction but delivery of these goods is made in the first week (say) of next year. In this case, these goods should not be included in closing stock (inventory) as their status is of customer's stock lying with us.

Journal Entry

Sundry debtor's Dr ....
To Sales Cr ....

Closing Stock:
Stock available physically ……….
Less : Goods of customer lying at our go-down………..

Case II: Goods purchased few days before the close/end of F.Y. but the delivery of goods have not been made by the seller up to the end of F.Y., such goods should be recorded as our closing stock (Goods-in-transit).

Journal Entry

Purchase Dr ....
To Sundry Creditors Cr ....

Closing Stock:
Stock available physically ....
Add : Goods-in-Transit ……………..

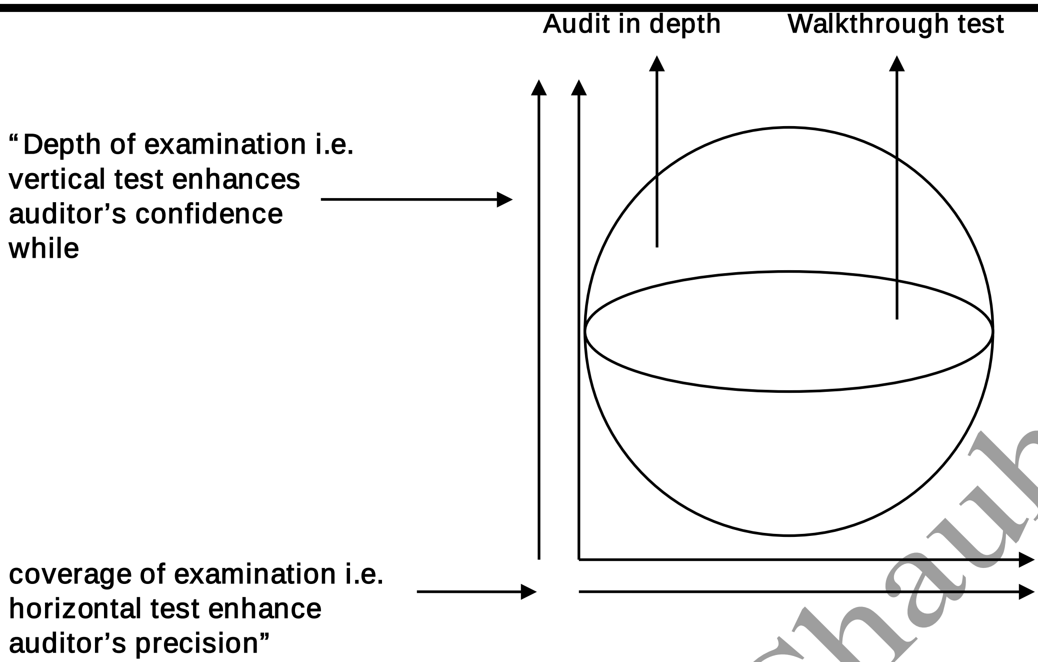
Case III: ***Stocktaking has been done/made few days;***

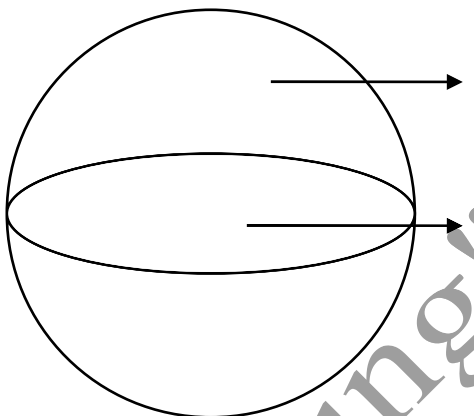
(i) Prior to closing date:		***(ii) Later to closing date:***	
Stock available physically	xxxxx	Stock available physically	xxxxx
Add : purchase belonging to remaining days of current F.Y.	xxxxx	***Less :*** purchases belonging to (*) days of next F.Y.	xxxxx
Less : Sale belonging to remaining days of current F.Y.	xxxxx	***Add :*** Sales belonging to (*) days of next F.Y.	xxxxx
⟶Stock to be taken in F.S.	xxxxx	⟶Stock to be taken in F.S.	xxxxx

(* up to the date of stock-taking)

Q. 7(e) Examination in depth: **[Marks -4]**

7. Examination in depth [Auditing in depth]:





Audit-in-depth is multi-dimensional examination In which auditor gains confidence as well as precision by establishing all assertions used in the financial statements.

Walkthrough test is horizontal examination of transaction and covers initiation, processing and disclosure of transaction. It provides more precision than confidence to the auditor.

Audit in depth ***Walkthrough test***

Basically, it is ***vertical as well as horizontal type audit evaluation technique*** in which all possible aspects of selective data are examined.

(i) It is an acceptable practice to check a slightly smaller number of transactions at each successive stage of depth test in the audit when the auditor's confidence level concerning the functioning of internal control and accounting system increases.

(ii) It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction i.e., from the initiation to the completion of processing of the transaction.

(iii) This examination consists of studying the recording of transactions at the various stages through which they have passed i.e. walk through test.

(iv) At each stage relevant records and authorities are examined to ascertain whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure.

(v) Emphasis is on mathematical accuracy, accuracy of underlying accounting principles, and proper compliance of relevant statutes and pronouncement of the Institute with regard to recording, processing and inclusion of transaction in financial statements.

(vi) Its technique of reconstruction of the audit trail and reveals more about the functioning or malfunctioning of the client's accounting and internal control system.

(vii) It is more reliable than haphazard, judgmental and mechanical approach of testing.