PAPER – 2 : AUDITING AND ASSURANCE

QUESTIONS

1. State the number of companies in which a person can be appointed as an auditor?
2. Does the death of a partner of a firm result in disqualification of the firm to act as an auditor?
3. Discuss the steps in case of audit of Situations of Missing or Incomplete Records.
4. What is meant by 'Analytical Review Procedures' and to what extent they can be relied upon. State different types of analytical reviews carried out in connection with the verification of Inventories and Debtors, Loans and Advances.
5. How will you vouch and/or verify the following?
   (a) Goods sent on consignment
   (b) Sale proceeds of Scrap Material.
   (c) Bank Balances
   (d) Sales Commission Expenditure
   (e) Purchase return
   (f) Assets Abroad
   (g) Plant and Machinery
6. Write short note on:
   (a) Surprise Check
   (b) Management Representation
   (c) Capital Expenditure
   (d) Appointment of the first auditor
   (e) Audit Risk
7. What is the meaning of contingent liabilities? What are the general procedures those may be useful in verifying contingent liabilities?
8. (a) What is a Government Company?
   (b) How the auditor is appointed in a Government Company?
   (c) Provisions applicable to the appointment of auditor of government companies also apply to another category of companies, even though they are not government companies as contained in section 619B of the Companies Act. Enumerate these companies.
9. (a) The overall objective and scope of an audit does not change in an EDP environment. Comment .
   (b) 'Doing an audit in an EDP environment is simpler since the trial balance always tallies'. Comment.
10. (a) Discuss whether it is practicable and desirable, within the limits of procedures and costs, for the auditor to accept a general responsibility to detect fraud and other irregularities.
    (b) What procedure an auditor should follow in case there is an indication that fraud or error may exist?
11. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use 'Questionnaire' to help him to know and assimilate the system and evaluate the same. Comment.
12. Mention the provisions under the Companies Act, 1956 relating to:
    (i) Appointment of Branch Auditors.

(ii) Steps to be taken by the auditor before accepting the appointment.

(iii) Qualifications and disqualifications of Auditors.

13. Write a note on the Audit of Impersonal Ledger.

14. State briefly Audit Procedures and Audit Techniques?

15. (a) While auditing a partnership firm, what are the different provisions of the Partnership Act which concern the auditor, in the absence of a partnership agreement?

    (b) What are the advantages of audit of accounts of a partnership firm?

16. (a) What is the meaning of accounting estimates? Give some examples.

    (b) Who is responsible for making accounting estimates?

    (c) Discuss the audit procedures for evaluating accounting estimates.

17. (a) What is the meaning of "Opening Balances"?

    (b) What will be the auditor's responsibility regarding opening balances?

    (c) You are appointed as an auditor of PQR Ltd. What will be your opinion in the following circumstances?

        (i) You are not able to obtain sufficient appropriate audit evidence concerning opening balances.

        (ii) If the opening balances contain misstatements which materially affect the financial statements for the current period.

18. Discuss the provisions of the Companies Act, 1956, regarding the maintenance of proper books of accounts in respect of the following:

    (a) What are the items with regard to which the proper books of accounts should be maintained?

    (b) Where should these books be maintained?

    (c) What are the special provisions, where the company has a branch?

    (d) What are the circumstances in which proper books are not deemed to be kept?

SUGGESTED ANSWERS/HINTS

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

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

   Explanation II after sub-section (IC) of section 224 further amplifies the manner of identifying the audit units for calculating the specified number. Under this explanation, when an auditor is appointed to audit even a part of a company's accounts, the part will be considered as a unit of audit for the purpose of calculation of the ceiling. In case of joint auditor each of the joint auditor is considered a part auditor for the purpose. Any joint audit held by an auditor will be included a one audit unit for the purpose of calculating the ceiling of audits. However, audit of a branch of company is not included in the computation of the ceiling. Similarly, audit of corporations which are not companies and foreign companies are also not to be included. Further, it may be noted that even non-profit companies would be counted for the purpose of ceiling. However, guaranteed companies not having share capital, special audit and investigation of companies will not be counted for the purpose.

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

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

Where any of the partners of a firm dies, a change in constitution of the firm take place. However, the firm is not dissolved and thus no casual vacancy arises. The remaining partners can carry on the existing audits. The firm must continue to be in practice and the fact of death of the partner must be known to the company. Same will apply in case of admission of a partner.

3. Audit of Incomplete Records: Normally, the audit of incomplete records may be necessitated under two circumstances viz. (i) when accounts have been maintained on single entry basis or (ii) accounting records may be destroyed by fire, flood, etc. or seized by government authorities. Under either of the circumstance the audit objective would remain the same and, thus, auditor would have to follow extensive audit procedure before expression of an opinion on such financial statements. Steps which may be followed in this regard are as under:

   (i) Ascertain the exact status of accounting records available including memoranda records, if any. Also obtain a list of records i.e. accounting, memoranda, statistical, etc.

   (ii) Ensure that the management compiles/reconstructs accounting records to the extent practicable. In case of single entry the accounts may be converted to double entry basis.

   (iii) Perform compliance procedure to assess whether any control system is in operation. Generally, it is difficult rather almost impracticable that any control worth the name would be in existence.

   (iv) Vouch transaction recorded in books of account with reference to appropriate audit evidence. Check positing, casting, etc. in depth. Auditor may also obtain external evidence as far as possible like confirmation from third parties. Bank reconciliation should also be examined in detail.

   (v) Examine the system in operation in respect of custody managed cash memos, receipts, cheque books, etc.

   (vi) Conduct surprise checks to verify cash in hand, inventory, etc.

   (vii) Verify fixed assets by observing physical verification.

   (viii) Obtain indirect evidence to verify the existence of fixed assets e.g. payment of local taxes to municipal authorities, electrical bills, etc. in case of building.

   (ix) Check veracity of memoranda records and obtain further evidence to confirm the same.

   (x) Apply analytical review procedures in depth and notice deviations to investigate in detail. Ratio analysis shall be of particular importance since it would provide substantive audit evidence.

   (xi) Formulate an appropriate audit opinion based on above findings. A disclaimer of opinion may be appropriate in case there is any restriction on the scope of an audit. (See Annexure)

4. According to AAS-14 on "Analytical Procedures" it means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

   The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

   The extent of reliance that the auditor places on the results of analytical procedure depends on the following factors:

   (a) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

   (b) other audit procedures directed toward the same audit objectives for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an aging schedule of customer's accounts;

   (c) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

   (d) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

   Inventories:

   (i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;

   (ii) comparison of closing stock quantities and amounts with those of the previous year;

   (iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;

   (iv) comparison of the composition of the closing stock (for example) raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;

   (v) comparison of current year gross profit ratio for the previous year;

   (vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;

   (vii) comparison of yield with the corresponding figure for the previous year;

   (viii) omparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;

   (ix) comparison of significant ratios relating to inventories with the industry norms if available. It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

Debtors, Loans and Advances:

The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances:

(a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;

(b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding figures for the previous year;

(c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule with the corresponding figures for the previous year;

(e) comparison of significant ratios relating to debtors, loans and advances with the similar ratios for other firms in the same industry, if available;

(f) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor.

5. (a) Goods Sent on Consignment

(i) Verify the accounts sales submitted by the consignee showing goods sold and stock of goods in hand.

(ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the proforma invoices and accounts sales received during the year. If any consignment stock was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the stock in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown distinctly under stocks.

(b) Sale Proceeds of Scrap Material

(i) Review the internal control on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.

(ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of scrap materials.

(iii) Review the production and cost records for determination of the extent of scrap materials that may arise in a given period.

(iv) Compare the income from the sale of scrap materials with the corresponding figures of the preceding three years.

(v) Check the rates at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.

(vi) See that scrap materials sold have been billed and check the calculations on the invoices.

(vii) Ensure that there exists a proper procedure to identify the scrap material and good quality material is not mixed up with it.

(viii) Make an overall assessment of the value of the realisation from the sale of scrap materials as to its reasonableness.

(c) Bank Balances

(i) Verify bank balance by reference to bank statements.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation state~ents which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment! write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) Check the fonn of Balance Sheet as per Part I of Schedule VI which requires that the bank balance should be segregated as follows: (i) With Scheduled Banks. And' (ii) With others. In the last mentioned case, the nature of interest, if any, of a director or his relative with each of the bankers should be disclosed. The nature of deposit in each case should be stated, e.g., current, fixed, call, etc. in case of a non-scheduled bank, its name and the maximum balance that was held by it during the year should also be disclosed.

(d) Sales Commission Expenditure

(1) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes the commission should be in accordance with the terms and conditions as specified.

(2) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.

(3) Ensure that the sales in fact have taken place and the same has been charged to profit and loss account.

(4) Compare the amount incurred in previous years with reference to total turnover.

(e) Purchase Return

(i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.

(ii) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in these documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.

(iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.

(iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

(f) Assets Abroad

(i) Examine the title deeds of immovable properties abroad.

(ii) Ensure that the immovable properties abroad have been properly classified and disclosed.

(iii) Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.

(iv) Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

(g) Plant and machinery:

(i) Verify the existence of plant and machinery by reference to documentary evidence available and by evaluation of internal controls. Plant and machinery in existence at the commencement of the year is normally verified by examining the schedule of plant and machinery and the fixed assets register. Acquisition during the year can be verified by reference to the Board's minutes, purchase invoice and entry in the fixed assets register.

(ii) Vouch the cost price of any plant and machinery including freight and insurance plus any cost of installation with relevant invoices, etc. The auditor should verify that due provision for depreciation has been made. When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value. The mode of disclosure in the balance sheet should also be seen. Check that requirement of relevant accounting standards, viz., AS 6, AS 10, etc. regarding accounting treatment, presentation and disclosures have been followed.

(iii) See that the various items of plant and machinery possessed by the client at the year end are recorded in the financial ledger and in the fixed assets register. Proper inquiry should be made to ensure that plant and machinery scrapped, destroyed or sold during the year has been properly adjusted in the books of account as also in the fixed assets register. If on physical verification material discrepancies are found, the auditor should see that the discrepancies have been properly adjusted in the books of account.

(iv) Comment on physical verification made by the management. Under the Manufacturing and Other Companies Auditor's Report Order applicable to companies, physical verification of the fixed assets including plant and machinery is the responsibility of the management. This they can do by examination of physical verification instruction programme and working papers.

6. (a) Surprise Check: Surprise checks are a part of normal audit, and the results of such checks are therefore important to the auditor in deciding the scope of his audit and submission of his report. An element of surprise can significantly improve the audit effectiveness.

Wherever practical, an element of surprise should be incorporated in the audit programme. The element of surprise in an audit may be both in regard to the time of audit, that is selection of date, when the auditor will visit the client's office for audit, and selection of the areas of audit. Surprise checks are mainly intended to ascertain whether the internal control system is working effectively, and whether all accounting and other records are kept up to date and as per the statutory regulations. Such checks and surprise visit can exercise good moral checks on the client's staff.

Surprise checks also determines whether errors, or frauds exist, and if they exist, bring the matter promptly to the attention of the management so that corrective action can be taken at the earliest. Surprise checks are very effective in case of organizations having weak internal control system, very large, diversified and well spread out organizations, etc.

Frequency and extent of surprise checks would depend on the extent to which the auditor feels necessary, depending upon system of internal control complications of transactions, importance of items like cash, investments, stock, etc. The results of surprise checks should be communicated to the management if internal control weakness, fraud, or error is found.

The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

(b) Management Representation: AAS 11, "Representations by Management", establishes standards on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations, and the action to be taken if management refuses to provide appropriate representations. As per AAS 11, management representation constitutes audit evidence furnished by management to auditor in respect of any transaction entered into by the entity. Management Representation is of great use to the auditor when other sufficient appropriate audit evidence cannot reasonably be expected to exist. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

(c) Capital Expenditure: A capital expenditure is that which is incurred for the undermentioned purposes:

(i) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits. (ii) Making additions to the existing fixed assets. (iii) Increasing earning capacity of the business. (iv) Reducing the cost of production. (v) Acquiring a benefit of enduring nature of a valuable right.

(ii) Expenses which are essentially of a revenue nature, if incurred for creating an assets or adding to its value or achieving higher productivity, are also regarded as expenditure of a capital nature. For example material and wages expenditure when expended on the construction of a building or erection of machinery.

(iii) Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

(d) The first auditor of a company can be appointed by the Board of Directors within one month of the date of registration of the company to hold office till the conclusion of the first annual general meeting. If the Board fails to appoint the first auditor, the company in general meeting is empowered to make the appointment. The first auditor or auditors to hold office, until the conclusion of the first annual general meeting, should be appointed by the Board of directors within one month of the date of registration of the company. But the company may, at a general meeting, remove such an auditor or all or any of them and appoint another or others in his or their place, on a nomination being made by any member of the company, notice being given to the members of the company, not less than fourteen days before the date of the meeting.

If the first auditor(s) is not appointed by the directors, within one month of registration, the company in general meeting may appoint the first auditor. The auditor of a company normally is appointed by the shareholders by passing a resolution at the annual general meeting; once appointed, he holds office from the conclusion of that meeting to the conclusion of the next annual general meeting. An auditor once appointed may be re-appointed in the next annual general meeting or a new auditor may be appointed in his place. It is obligatory on the part of a company to annually make such an appointment, as well as to give, within seven days of the appointment, intimation thereof to every auditor so appointed or re-appointed.

(e) Audit Risk : Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. An auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheets items. There are three components of audit risk:

(i) Inherent risk: is a risk that material errors will occur. Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(ii) Control Risk: is the risk that the client's system internal control will not prevent or correct such errors, to assess control risk, the auditor should consider the adequacy of control design as well as test adherence to control procedure.

(iii) Detection Risk: is the risk that an auditor's procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes. The level of detection risk relates directly to the auditor's procedures, Some detection risk would always be present.

The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptable low level.

7. The term 'contingent liabilities' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities. Some of the instances giving rise to contingent liabilities are:

(i) law suits, disputes and claims against the entity not acknowledged as debts.

(ii) membership of a company limited by guarantee.

The following general procedures may be useful in verifying contingent liabilities.

(i) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.

(ii) Review of contracts, agreements and arrangements.

(iii) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.

(iv) Review of terms and conditions of grants and subsidies availed under various schemes.

(v) Review of records relating to contingent liabilities maintained by the entity.

(vi) Enquiry of, and discussions with, the management and senior officials of the entity.

(vii) Representations from the management.

The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

8. (a) As per section 617 of the Companies Act government company means any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government company.

(b) Appointment of auditor of a government company is governed by the provisions of section 619 of the Companies Act. According to this section, the auditor of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. However, the limits specified in sub-section (1B) of section 224 shall apply, i.e., the auditor can conduct the audit of a maximum of 20 companies out of which not more than 10 companies shall have a paid up capital of Rs. 25 lakhs or more.

(c) The aforesaid provisions applicable to the appointment of auditor of government companies also apply to another category of companies, even though they are not government companies as contained in section 619B of the Act. Accordingly, the provisions of section 619 apply to a company in which not less than 51% of the paid-up share capital is held by one or more of the following or any combination thereof:

(i) the Central Government and one or more government companies;

(ii) any State Government or Governments and one or more government companies;

(iii) the Central Government, one or more State Governments and one or more government companies;

(iv) the Central Government and one or more corporations owned or controlled by the Central Government;

(v) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;

(vi) one or more corporations owned or controlled by the Central Government or the State Government;

(vii) more than one government company;

the auditor of such a company shall be appointed by the Central Government on the advice of the Comptroller and Auditor General of India.

9. (a) The principal objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to ensure that the financial statements reflect a true and fair view. The scope of an audit of financial statements is determined by the auditor having regard to the terms of the engagement, the requirements of relevant legislation and the pronouncements of the Institute. This would involve assessment of reliability and sufficiency of the information contained in the accounting records and other source data by study and evaluation of accounting system and internal controls in operation.

The overall objective and scope of an audit does not change in an EDP environment but the use of a computer changes the processing and storage of financial information and may affect the organisation and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Thus when auditing in an EDP environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how EDP affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The auditor should also have sufficient knowledge of EDP to implement the auditing procedures, depending on the particular audit approach adopted.

Thus, it is clear from the above that overall objective and scope of audit does not change irrespective of fact that whether the accounting information is generated manually or through EDP.

(b) Though it is true that in an EDP environment the trial balance always tallies, the same cannot imply that the job of an auditor becomes simpler. There can still be some errors of omissions like omission of certain entries, compensating errors, duplication of entries, etc. in the books of account even when the trial balance tallied. In today's complex business environment, the importance of trial balance in an audit has has to be gauzed not from the view point of arithmetical accuracy but the nature of transaction to be recorded which in fact have become very complex. The emergence of new forms of financial instruments like option and futures, derivatives, off-balance sheet financing, etc. have given rise to further complexities in recording and disclosure of transactions. In an audit besides the tallying of a trial balance, there are also other issues like estimation of depreciation, valuation of inventories, etc. which still require judgement to be exercised by the auditor. The total time taken in an audit may still be considerably higher even though the trial balance has tallied than an audit where the trial balance has not tallied. That responsibility will still remain even in an EDP environment. Therefore, simply because of EDP environment and the trial balance has tallied do not make the audit simpler.

10. (a) (i) The auditors have a responsibility to plan the audit so that they have a reasonable expectation of detecting material mis-statements in the financial statements resulting from irregularities or fraud.

(ii) The primary responsibility for preventing and detecting fraud must always be with the management of the enterprise.

(iii) One of the problems that may arise is the difficulty of defining fraud. Associated with this is the need for the auditor to determine an appropriate level of materiality. Currently the auditor assess this in relation to true and fair view shown by financial statements. This may no longer be the correct basis if all or most frauds have to be detected.

(iv) The desirability of changing the auditor's responsibility has to be considered in the light of different types of organisations and different interest parties. The auditors of public companies should have a greater responsibility than those of private companies.

(v) The widening to the auditor's role would mean that additional audit costs would be incurred by all organisations to detect fraud. Perhaps more effort should go into informing management how to prevent and detect fraud and into increasing the penalties for it so that there is greater deterrent.

(vi) If the auditor's objective was changed, whilst the method would principally be the same, the amount of work necessary would increase significantly. The auditor could not accept a greater responsibility for detecting fraud without a substantial fee increase. It is unlikely that this would be worthwhile for most organisations.

(vii) Auditors have the skills necessary to detect most types of fraud but the cost of so doing may exceed the cost of the fraud itself. The best approach is for the auditor to make recommendations to management about how they could reduce the likelihood of fraud or irregularities and increase the possibility of their detection.

(b) According to AAS 4 on "Fraud and Error" if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes that the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. The extent of such modifications or additional procedures depends on the auditor's judgement as to:

(i) the types of fraud or error that could occur;

(ii) the relative risk of their occurrence;

(iii) the likelihood that a particular type of fraud or error could have a material effect on the financial information.

However, the auditor may be unable to obtain evidence either to confirm or dispel a suspicion of fraud. In these circumstances, the auditor should consider the possible impact on the financial information and the effect on his report.

If the fraud or error could have been prevented or detected by the system of internal control, the auditor should reconsider his prior evaluation of that system.

When fraud or error involves a member of management, the auditor should reconsider the reliability of any representations made by that person to the auditor.

11. Internal Control Questionnaire : This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

    An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

    The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

12. Appointment of Branch Auditors: Sub-section (1) of Section 228 of the Companies Act, 1956 requires that the accounts of the branch office of a company must be audited either by the company's auditor appointed under Section 224 or by a person qualified for appointment as an auditor as contemplated by Section 226 or where the branch office is situated in a foreign country outside India either by the company's auditor or by a person qualified as aforementioned or by an accountant duly qualified to act as an auditor in accordance with the laws of that foreign country.

    (i) A company may at general meeting decide whether it have accounts of its branch office audited by a person other than the company's auditor. Upon such a decision being taken, the company may either appoint a person who may be a person qualified under Section 226 or in the case of a foreign branch a person qualified according to the laws of that country to audit the accounts of the branch or authorise the Board of Directors to appoint such an auditor in consultation with the company's auditor, as required by clause (a) of Section 228(3) of the Companies Act.

    (ii) Steps to be taken by the auditor before accepting the appointment:

        (a) Issuing a certificate that on appointment by the company, the limit on holding of company audit as contemplated under Section 224 (1B) will not be exceeded.

        (b) Ensuring that the requirements of Sections 224 and 225 of the Companies Act have been complied with as discussed below:

            (i) If the appointment of the auditor is being made for the firs time after incorporation of the Company, the auditor should verify as to whether Board of Directors have passed the resolution for his appointment within one month of the date of registration of the company.

            (ii) If the Board of Directors have not appointed the first auditor but the appointment is being made by a general meeting of the company, the auditor should verify as to whether a proper notice convening the general meeting has been issued by the Company and whether the resolution has been validly passed at the general meeting of the company.

(iii) If the appointment is being made to fill a casual vacancy, the incoming auditor should verify as to whether the Board of Directors have powers to fill the casual vacancy and whether the Board of Directors have passed the resolution filling the casual vacancy.

(iv) If the vacancy has arisen due to resignation of the auditor, the incoming auditor should see as to whether a proper resolution filling the vacancy has been passed at the General Meeting of the Company.

(v) If the vacancy has arisen as a result of removal of the auditor before the expiry of his term of office, the incoming auditor should see that proper resolution has been passed at the General Meeting of the company and that the previous approval of the Central Government has been obtained by the company.

(vi) If the provisions of Section 224A apply to the company, the incoming auditor should verify as to whether a special resolution as required under the said Section has been duly passed.

(vii) Where the auditor other than the retiring auditor is proposed to be appointed, the incoming auditor should ascertain whether the provisions of Section 225 have been complied with.

(viii) Communicating with the previous auditor, if any.

(iii) Qualifications and Disqualifications of Auditors: They are governed by Section 226 of the Act. The main provisions are stated below:

A person shall not be qualified for appointment as an auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949; provided that a firm whereof all the partners practising in India are qualified for appointment, as aforesaid may be appointed by its firm name to be the auditors of a company in which case any partner so practising may act in the name of the firm.

Under Sub-Section (3) of Section 226 the following persons are not qualified for appointment as auditors of a company;

(a) a body corporate;

(b) an officer or employee of the company;

(c) a partner or employee of an officer or employee of the company;

(d) a person who is indebted to the company for more than Rs.1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs.1,000.

(e) A person holding any security carrying voting rights.

It is further laid down in sub-section 226 that a person is not eligible for appointment as auditor of any company, if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.

Sub-section (5) of section 226 provides that if an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), he shall be deemed to have automatically vacated his office.

13. The impersonal ledger contains the whole of the accounts affecting the composition of the Trading and Profit and Loss Account and all accounts representing assets and liabilities, other than those contained in the personal ledgers. The impersonal ledger is variously known in common usage as the private ledger, general ledger or nominal ledger, these terms generally being interchangeable although in many business a private ledger is utilised to contain only accounts of an essentially private nature. The term impersonal ledger is here employed to cover all those accounts not included in the personal ledgers.

Except in very large business, the amount of detail in the impersonal ledger is not excessive, and the auditor will be able to check the whole of the entries therein. This is important, because, if the auditor is able to verify the correctness of the impersonal accounts, this fact in itself will go a long way towards proving the accuracy of the personal accounts, at any rate in total ; one of the commonest methods of concealing manipulations in personal accounts being to make a corresponding fictitious entry in an impersonal account.

The entries in the impersonal ledger will come either from the totals of books of prime entry or their equivalents, the Journal or from the Cash Book. The casts of the various books of prime entry or machine lists, having been verified, the totals thereof should be checked to the accounts in the impersonal ledger to which they relate. Where the totals have been subjected to analysis, the analysis should be cast and proved, and the individual items checked to their respective accounts in the impersonal ledger.

The auditor should be particularly careful with entries coming from the Journal since many important transactions are recorded through the Journal.

It should also be ascertained that balances in all the income and expense accounts have been adjusted (i) according to standard accounting practices; and (ii) on a considerationof the legal provisions which are applicable to the organisation. Each ledger balance finally should be examined on a consideration of its position in the Final Accounts to see how the financial position of the concern would be affected by the inaccuracy in the balance.

Wherever practicable, the balances in the Impersonal Ledger should be traced simultaneously into the trial balance, the grouping schedules and the Final Accounts. At the same time, by way of comparision, the corresponding balances in the previous year's Final Accounts in the balance.

It should be confirmed that the accounts have been kept according to accepted principles and the Balance Sheet and the Profit and Loss Account have been drawn upon the same basis as in the previous year.

Special attention should be given for the scrutiny of the Impersonal Ledger to cut-off transactions. Such adjustments which affect the Impersonal Ledger are:

(a) Pre-payments like municipal taxes, etc. By scanning the account, it should be ascertained that the charge only for the full year has been included in the account

(b) Provision for liability in respect of purchases, rent and taxes, freight charges and salary etc. Thus if account payable at the close of the year has been paid in the succeeding period, a provision therefor should be made.

(c) Accrual of income adjustments should be seen. For instance, all rent receivable due or accrued to the date of the Balance Sheet should be calculated and brought into account, after a provision has been made for doubtful or irrecoverable arrears of rent allowances, etc. Similarly interest, dividends and payment of insurance premium should also be examined.

(d) Adjustment of advances should be scrutinised. Amount paid as advances should be included as an asset.

The relevant expenses and income accounts should be thoroughly scrutinised to make sure that only such costs and revenue which relate to the period under audit have been carried to the Profit and Loss Account.

The scrutiny of the impersonal ledger also should cover the review of valuation of assets. The auditor should make sure that generally accepted accounting principles have been followed for charging of depreciation and that the current assets have been valued at lower of cost or net realisable value. The ascertainment of cost should be done consistently from year to year.

14. As per AAS 1 on Basic Principles Governing an Audit states, “the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the

financial information. Therefore, audit procedures are broadly classified in two categories, viz., compliance procedures and substantive procedures.

Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. In obtaining audit evidence from compliance procedures, the auditor is concerned with assertions that the control exists, the control is operating effectively and the control has so operated throughout the period of intended reliance. So the auditor is concerned with the existence, effectiveness and continuity of the control system.

Substantive procedures are tests designed to obtain evidence as to the completeness, accuracy and validity of the data produced by accounting system. They are of two types :

(1) tests of details of transactions and balances.

(2) analysis of significant ratios and trends including the resulting investigation of unusual fluctuations and items.

Audit techniques on the other hand refers to collection and accumulation of audit evidence. Some of the techniques commonly adopted by the auditors are the following:

- Posting checking
- Casting checking
- Physical examination and count
- Confirmation
- Inquiry
- Year-end scrutiny
- Re-computation
- Tracing in subsequent periodBank Reconciliation

The two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence.

15. (a) In the absence of a partnership agreement, the provisions of the Partnership Act which concern the auditor are the following :

(i) The partners share equally in profits and losses.

(ii) The partners are not entitled to any interest on capital.

(iii) Where a partner is entitled to interest on the capital subscribed by him, such interest will be payable only out of profits.

(iv) A partner is entitled to interest at 6 per cent per annum on his advances and loans over and above the capital.

(v) Every partner can take part in the management of the business. A partner is, however, not entitled to receive any remuneration for taking part in the conduct of the business.

(vi) Every partner has the right to inspect and to take a copy of any of the books of the firm.

(vii) A partner is entitled to be indemnified for all payments made and liabilities incurred by him in the ordinary course of business or in the preservation of the firm's property.

(viii) The property of the firm must be held and used by the partners exclusively for the purpose of business.

(ix) If a partner derives any profit for himself from any transaction of the firm or from the use of the property or business connections of the firm or the firm name, he must account for that profit and pay it to the firm; also the profit from any competing business carried on by a partner without other partners' consent must also be accounted for and paid to the firm.

(x) In the absence of any usage or custom of trade to the contrary, the implied authority of partner does not empower him to :

(a) submit a dispute relating to the business of the firm to arbitration;

(b) open a bank account on behalf of the firm in his own name;

(c) compromise or relinquish any claim or portion of a claim by the firm;

(d) withdraw a suit or proceeding filed on behalf of the firm;

(e) admit any liability in a suit or proceeding against the firm;

(f) acquire immovable property on behalf of the firm;

(g) transfer immovable property belonging to the firm; or

(h) enter into partnership on behalf of the firm.

(xi) The firm is liable to third parties :

(a) if a partner, acting within the scope of his apparent authority, receives money and misapplies it, or

(b) if the firm in the ordinary course of the business receives money, which is misapplied by a partner.

(xii) No person can be introduced as a partner without the consent of the other partners.

(xiii) Any differences arising as to ordinary matters connected with the business are to be decided by the majority of the partners, but no change can be made in the nature of the business without the consent of all the partners.

(xiv) If, on the death or retirement of a partner, no final settlement has been effected and the business is carried on by the surviving or continuing partners, the outgoing partner or his estate has the option of claiming :

(a) such share of profits as may be attributable to his share of the assets; or

(b) interest at 6 per cent per annum on his share of partnership assets.

(xv) On dissolution of the partnership, every partner has the right to have the goodwill of the business sold for the common benefit of all the partners.

(xvi) On a dissolution of the firm, the losses, including deficiencies of capital must be made good :

a. first out of profits;

b. next out of capital; and

c. lastly, by the partners individually in the proportion in which they share profits.

(xvii) On the dissolution of the firm, assets are to be applied in the following order :

a. in paying the firm's liabilities to third parties;

b. in repaying partner's advances and loans;

c. in repaying partner's capital; and

d. the residue if any, is to be divided amongst the partners in the proportion in which they share profits.

(b) The advantages of audit of accounts of a partnership could be stated as follows :

(1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among

them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

(2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

(3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners and also for the settlement of their liability in respect of Wealth Tax.

(4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

16. (a) As per AAS 18 "Accounting estimate" means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:

- Allowances to reduce inventory and accounts receivable to their estimated realisable value.
- Provisions to allocate the cost of fixed assets over their estimated useful lives.
- Accrued revenue.
- Provision for taxation.
- Provision for a loss from a lawsuit.
- Insurer's liability for outstanding claims.
- Losses on construction contracts in progress.
- Amortisation of certain items like goodwill and deferred revenue expenditure.
- Provision to meet warranty claims.
- Provision for retirement benefits in the financial statements of employers.

(b) As per AAS 18, Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment.

(c) The auditor should follow the following audit procedures to evaluate the accounting estimates:

(i) The auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and, when required, is appropriately disclosed in the financial statements. The evidence available to support an accounting estimate will often be more difficult to obtain and less conclusive than evidence available to support other items in the financial statements.

(ii) The auditor should understanding the procedures and methods, including the accounting and internal control systems, used by management in making the accounting estimates. It is important for the auditor to plan the nature, timing and extent of the audit procedures.

(iii) The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:

A. Review and test the process used by management to develop the estimate:

This involves:

1. Evaluation of the data and consideration of assumptions on which the estimate is based:

   - The auditor would evaluate whether the data on which the estimate is based is accurate, complete and relevant.
   - External evidence is, usually, more reliable for the purpose of an audit than internal evidence. Accordingly, obtaining external evidence may be warranted in certain circumstances.
   - The auditor would evaluate whether the data collected is appropriately analysed to form a reasonable basis for determining the accounting estimate. For example, the analysis of the age of accounts receivable to estimate the provision for doubtful debts and advances.
   - The assumptions used in the accounting estimate will be specific to the entity and would be based on internally generated data, while in other cases, the assumptions may be based on industry or government statistics. The auditor would evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate.
   - In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are reasonable in light of actual results in prior periods, consistent with those used for other accounting estimates, consistent with management's plans which appear appropriate.

   The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

   - In the case of complex estimating processes involving specialised techniques, it may be necessary for the auditor to use the work of an expert, for example, engineers for estimating quantities in stock piles of mineral ores.
   - The auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates. For this purpose, the auditor's knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor would be useful.

2. Testing of the calculations involved in the estimate :The auditor would test the calculation procedures used by management. The nature, timing and extent of the auditor's testing will depend on such factors as the complexity involved in calculating the accounting estimate, the auditor's evaluation of the procedures and methods used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

3. Comparison of previous estimates with actual results : When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in obtaining evidence about the general reliability of the entity's estimating procedures; considering whether adjustments to estimating formulae may be required and evaluating whether differences between actual

results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

4. Consideration of management's approval procedures: Material accounting estimates are ordinarily reviewed and approved by management. The auditor would consider whether such review and approval is performed by the appropriate level of management and that it is evidenced in the documentation supporting the determination of the accounting estimate.

(b) Use an independent estimate for comparison with that prepared by management: The auditor may make or obtain an independent estimate and compare it with the accounting estimate, prepared by management. When using an independent estimate, the auditor would ordinarily evaluate the data, consider the assumptions and test the calculation procedures used in its development. It may also be appropriate to compare accounting estimates so made for prior periods with actual results of those periods.

(c) Review subsequent events which confirm the estimate made: Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and test the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

17. (a) As per AAS 22 "Opening balances" means those account balances which exist at the beginning of the period. Opening balances are the closing balances of the preceding period brought forward to the current period and reflect the effect of:

(i) transactions and other events of the preceding periods; and

(ii) accounting policies applied in the preceding period.

(b) As per AAS 22 "Opening balances", it is the responsibility of the auditor to obtain sufficient appropriate audit evidence that:

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

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

(iii) appropriate accounting policies are consistently applied.

(c) (i) If, after performing procedures, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor should, as appropriate, express:

a. a qualified opinion, or

b. a disclaimer of opinion.

The auditor may also express an opinion which is qualified or disclaimed regarding the profit or loss and unqualified regarding state of affairs, as appropriate.

(ii) If the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

18. (a) Section 209(1) of the Companies Act, 1956 requires that a company shall maintain proper books of account with respect to the following items:

(i) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure take place;

(ii) all sales and purchases of goods by the company;

(iii) the assets and liabilities of the company; and

(iv) in the case of a company pertaining to any class of companies engaged in production, processing, manufacturing or minuting activities, such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of account.

(b) Every company is required to keep proper books of account at its registered office. It is, however, provided in sub-section (1) of section 209 that all or any of the books of account may be kept at such other place in India as the Board of Directors may decide and when the Board of Directors so decides, the company shall within seven days of this decision, file with the Registrar a notice in writing giving the full address of that other place.

(c) Sub-section (2) of section 209 of the Companies Act, 1956 states that where a company has a branch office, whether in or outside India, the company shall be deemed to have complied with the provision or sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns, made up-to-date at intervals of not more than three months, are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1) of section 209.

(d) According to sub-section (3) of section 209, a company shall not be deemed to have kept proper books of account under the following circumstances:

(i) if there are not kept such books as are necessary to give a true and fair view of the state of the affairs of the company or branch office, as the case may be, and to explain its transactions; and

(ii) if such books are not kept on accrual basis and according to the double entry system of accounting.

ANNEXURE

Announcement

Audit in Situations of Missing or Incomplete Records

1. Members of the Institute while carrying out audit assignments might come across a situation where the records of the client are incomplete or destroyed (partially or completely) on account of a natural calamity or otherwise. While guidance on reporting responsibilities of the members in such cases has been provided to the members by way of publications such as Auditing and Assurance Standard (AAS) 28, The Auditor’s Report on Financial Statements”, the Statement on Qualifications in Auditor’s Report, opinions of the Expert Advisory Committee, and a publication titled, “Study on Audit and Certification in Case of Missing Records”, issued by the Institute, the Council, for the benefit of the members, wishes to reiterate the guidance in the following paragraphs.

2. The auditor should, first, obtain a representation from the management that the original accounts are not available for audit. The letter should also include the fact whether the accounts of the entity have been reconstructed by the management. If yes, the extent thereof (partial or complete) and the details of the items of financial statements that have been reconstructed should also be specified in the said letter. In case the accounts have been reconstructed, the members must consider the limitation of scope in audit imposed by the circumstances. Limitation on scope of audit can be of two types, firstly, inability of the management to reconstruct some or all of the items of the financial statements either for the whole financial year or for a certain period during the financial year and secondly, lack of corroborative evidence to support certain or all the entries in the reconstructed accounts. In case of completely reconstructed accounts, the lack of supporting evidence will pose a greater risk of limitation on scope, whereas, for partially reconstructed accounts, both types of limitations, i.e., inability of the management to reconstruct accounts and lack of supporting evidence, can be material. While auditing the reconstructed

accounts (partial as well as complete), the auditor should analyse the limitation imposed on application of audit procedures required to be applied in the given situation and use his professional judgment to determine whether to issue an unqualified opinion, qualified opinion or disclaimer of opinion. Further, the fact of scope limitation must clearly be mentioned in the scope paragraph of the audit report.

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

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

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

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

In situations of Qualified Opinion

"We have audited ………..

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

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

In situations of Disclaimer of Opinion

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

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

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

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

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

(a) reducing the assessed degree of control risk, where this is possible, and supporting the reduced degree by carrying out extended or additional tests of control; or

(b) reducing detection risk by modifying the nature, timing and extent of planned substantive procedures."

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

   "Inquiry and Confirmation

   14. Inquiry consists of seeking appropriate information from knowledgeable persons inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

   15. Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records. For example, the auditor requests confirmation of receivables by direct communication with debtors."

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

6. The auditor, if he himself was not the auditor in the immediately preceding financial year, must apply the principles laid down in AAS 22, "Initial Engagements - Opening Balances" while verifying the figures of opening balances.

7. Paragraph 4 of the AAS 28, "The Auditor's Report on Financial Statements", provides that the auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. An unqualified opinion can be expressed only if the auditor is able to satisfy himself, by way of application of sufficient appropriate compliance and substantive procedures, that the financial statements give a true and fair view. The scope limitation imposed by lack of supporting evidence implies a particular emphasis on obtaining alternative corroborative evidence.

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

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

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

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

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

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

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

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

(i) in the case of the balance sheet, of the state of the ___________ (name of the client) affairs as at the end of its financial year;

(ii) in the case of the profit and loss account, of the profit or loss for its financial year; and

(iii) In the case of the cash flow statement, of the cash flows for the year ended on that date."

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

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

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

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

10. Illustrative audit report in situations where the reconstruction of the accounts is not possible:

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

Since we have not been able to examine the books of account as well as the financial statements of ___________________(name of the client), we are unable to form any opinion on the financial statements."

11. Members' attention is also invited to the opinion given by the Expert Advisory Committee in September 1988 in situation of an audit where the records etc., had been seized by the income tax authorities and released after four years and records were reconstructed for the interregnum. The Committee, apart from the opinion on the type of the opinion to be expressed by the auditor in such cases, has also opined that the auditor should not normally rely on the management's certificate as to the opening balances unless the information therein can be corroborated by other supporting document.