

PAPER – 2 : AUDITING

Answer Question Nos. 1 and 2 and any four questions from the rest.

Question 1

As an Auditor, comment on the following:

- (a) Company has debited Rs. 1,75,000 to Delivery Van Account received from a customer against credit sales of Rs. 1,50,000 to him who is now is not able to pay the amount. The Delivery Van has not been registered in the name of the company with R.T.O. till date of Finalisation of accounts. (5 Marks)
- (b) PQ Ltd. has given donations of Rs. 50,000 each to a charitable school and a trust for blinds, during the year ended 31.3.2007. The average net Profit of the company during last three Financial years amounts to Rs. 12 lacs. (5 Marks)
- (c) AAS Limited had provided for doubtful debts to the extent of Rs. 23 lakhs during the year 2004-05. The amount had since been collected in the year 2006-07. Another debt of Rs. 25 lakhs had been identified to be doubtful during the year 2006-07. The Company made an additional provision of Rs. 2 lakhs during the year. The Profit and Loss account for the year ended 31.3.2007 disclosed in Debit side-provision for doubtful Debts Rs. 2 lakhs. (4 Marks)
- (d) Alagar Limited is a company engaged in the business of chassis building and bus transportation services. It accounts all expenses and income in Profit and Loss account under various heads explaining clearly the nature of the operations. The auditor of the company requires that the Profit and Loss account should depict the Profit or Loss from the businesses of assembly as well as of operation of bus services separately. (4 Marks)

Answer

- (a) AS 10 “ Accounting For Fixed Assets”: As per AS-10 “Accounting for Fixed Assets” When a fixed asset is acquired in exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident.

The delivery van has been acquired in exchange for another assets i.e. receivables. The fair value of delivery van is Rs 1,75,000 and that of receivable were Rs.1,50,000. Here fair market value of the asset given up is more clearly evident. Therefore the delivery van should be valued at Rs.1,50,000. Also the delivery van should be recognized as an asset of the company even though it is not yet registered in the name of the company. This is because legal title is not necessary for an asset to exist. What is necessary is control over the asset as per the framework for preparation and presentation of financial statements. Applying substance over form, we find since price has been settled, and the company has control of assets, hence it should be reflected as an asset alongwith a note

to the effect that the registration in the name of the company is pending.

- (b) Contribution To Charitable Funds: As per the provisions of section 293 of the Companies Act, 1956 the Board of Directors of a Public Ltd. Co., with the consent of the Company in general meeting can contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed fifty thousand rupees or five per cent of its average net profits as determined in accordance with the provisions of sections 349 and 350 during the three financial years immediately preceding, whichever is greater.

In the given case company gave two donations of Rs.50,000 each to a charitable school and a trust for blinds i.e. Rs.1,00,000, those are not directly relating to business of the company or the welfare of its employees. According to given situation Board of directors can contribute either (i) Rs.50,000 or (ii) 5% of average net profit of least 3 financial years i.e. Rs. 60,000 whichever is greater.

Therefore Board of Directors can contribute maximum of Rs.60,000 to both Charitable institutions with the consent of the Company in general meeting. The action of Board of directors is not correct. It has violated the provision of section 293 of the Companies Act, and as an auditor, this matter should be reported in the auditor's report.

- (c) Disclosure of certain ordinary activities under AS 5 : AS per AS 5 "Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies" When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

During the relevant year, the company had collected the amount of Rs.23 lakhs for which provision had already been made earlier in the accounts. The said provision should be reversed to that extent during the relevant year. The company estimates a doubtful debt to the extent of Rs.25 lakhs in the current year which must be provided for during the relevant year. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 of AS 5 include reversals of provisions. The company had netted off the reversal and additional provision and had shown the net debit of Rs.2 lakhs in P&L account. This practice does not seem to be good as per AS 5. Company may show the net debit in P&L account but should disclose the facts of write back and additional provision made during the year by way of note. The Company's accounting treatment is wrong and it may warrant audit qualifications.

- (d) Segmental reporting : As per AS 17, the company accounts must be presented according to the primary classification based on nature of income and expenses and therefore segment results are to be disclosed accordingly. The result of segment should be disclosed in terms of segment revenue and segment expense.

In the instant case, the company has two business segments namely assembly and transportation. These two segments should be properly identified.

In this case, company should add note to show segment result after computation. It is not

necessary that segment-wise details of each and every expenditure and revenue should be specified.

Question 2

Comment on the following:

- (a) M/s. Seeman & Co. had been the company auditor for Amudhan Company Limited for the year 2006-07. The company had three branches located at Chennai, Delhi and Mumbai. The audits of branches-Chennai, Delhi were looked after by the company auditors themselves. The audit of Mumbai branch had been done by another auditor M/s Vasan & Co., a local auditor situated at Mumbai. The branch auditor had completed the audit and had given his report too. After this, but before finalization, the company auditor wanted to visit the Mumbai branch and have access to the inventory records maintained at the branch. The management objects to this on the grounds of the company auditor is transgressing the scope of audit areas agreed. (5 Marks)
- (b) "AB & Associates" the Auditor of Ajanta Ltd. refused to deliver the Books of account of the company, which were given to them for the purpose of audit, as the audit fees is not paid to them in full. (4 Marks)
- (c) Mr. A was appointed as an auditor of X Ltd. for the year ended 31.3.2008 in the AGM held on 16.8.2007. Mr. A had indebted to the company for a sum of Rs. 2,500 as on 1.4.2007, the opening date of the accounting year which had been the subject to his audit. Upon learning that he might be appointed as the auditor, he repaid the amount on 14.8.2007. Mr. B, a shareholder complained that the appointment of Mr. A as auditor was invalid and he incurred disqualification under Section 226 of the Indian Companies Act, 1956 and his independence had been vitiated in relation to the accounting year of his audit. (4 Marks)
- (d) The Financial Controller of AS Limited refuses to provide for proposed dividend in books of accounts for the year ended 31.3.2007 on the ground that it is pending approval of shareholders in Annual General Meeting to be held on 16th September 2007. (5 Marks)

Answer

- (a) Right of access of company auditor for branch records : The audit of the branch of a company is dealt with in section 228 of the Companies Act, 1956. According to this section, the audits of the branches can be done by the company auditor himself or by another auditor. Even where, the branch accounts are audited, the company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor.

He has also right of access at all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the report of the branch auditor in framing his main report. He will disclose how he had dealt with the branch audit report.

In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor.

Applying the above provisions, to the instant case, management's objection that the company auditor is transgressing the scope of audit areas agreed, is absolutely, wrong. The right of company auditor in visiting and accessing the records of branch can not be forfeited. Even where the branch accounts are audited by an another local auditor, the company auditor has right to visit the branch and can have access to the books and vouchers of the company maintained at the branch office.

- (b) Auditor's lien: As per general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. Thus, an auditor also can exercise such lien on books and documents placed at his possession by the client for non payment of his fees for work done on the books and documents. In this regard it is necessary that

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.
- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

As per the provisions of law, AB & associates can retain books of accounts & documents connected with the work on which fees have not been paid.

Under section 209 of the Companies Act, 1956 books of account of a company must be kept at the registered office of the company and if removed from the registered office, a resolution to this effect must be passed in BOD's meeting, and should have informed this removal to the Registrar of Companies. If this is done then only the auditor can have lawful possession.

In all other cases, it will be considered as unlawful possession of the books and in such circumstances, he can not exercise such lien.

In the given case, AB & associates retains the books of accounts of Ajanta Ltd., as they have not received their audit fees. They can do so subject to the above provisions of company Law.

- (c) Debt as disqualification for auditor: According to Section 226 of the Companies Act, 1956, a person who is indebted to the company for an amount exceeding Rs 1,000 shall be disqualified to be an auditor of such company and he will vacate office when he incurs this qualification subsequent to his appointment.

Though not expressly said, the fact clearly tells that the relevant date for reckoning disqualification is the date of appointment viz the date of resolution passed by the company to effect such appointment.

Where the person has liquidated his debt before appointment date, there is no disqualifications to be construed for his appointment.

In the given case, Mr. A was appointed as an auditor of X Ltd. for the year ended 31-03-2008 in the AGM held on 16-08-2007. He repaid the loan amount of Rs. 2500 fully to the company on 14-08-2007 before the date of his appointment.

In view of the above provision of law, Mr. A's appointment as an auditor is valid and it is as per the provision of the above section.

- (d) Proposed dividend accounting : Normally, the dividend is proposed first by Board before adoption of the accounts in AGM. It is the shareholders in AGM who may approve the dividend proposed by BOD. It is also correct that as on the date of balance sheet or subsequent to it, but before approval of the financial statements in AGM, the dividend declaration is a contingent one.

But according to AS-4, Contingencies and Events occurring after the Balance Sheet date, even though certain events occur after balance sheet date, they are included/provided in the accounts because of their special nature or statutory requirement. Schedule VI to the Indian Companies Act, 1956 requires disclosure of proposed dividend specifically.

According to AS-4, the proposed dividend pertaining to the period covered by the financial statements, should be included in the financial statements although they are declared after the approval of the accounts.

In the circumstances, applying the above provisions, the contention of the Financial controller of AS Ltd. is wrong. Hence proposed dividend should be provided in the books of accounts for the year ended 31-03-2007, as the same is a statutory requirement of the law.

Question 3

- (a) (i) Explain, what do you mean by Analytical procedures. How such procedures are helpful in auditing? (4 Marks)
- (ii) Explain concept of 'Materiality' and factors which act as a guiding measure to this concept. (4 Marks)
- (b) Give your assertions for the following items appearing in Balance – sheet of a Limited Company:

		Rs.
(i)	Cash on hand	10,000
(ii)	Investments	1,00,000
(iii)	Secured Loans	10,00,000
(iv)	Machinery:	
	Opening cost	13,00,000
	Less: depreciation	
	Current depreciation	1,30,000
		11,70,000
		(8 Marks)

Answer

- (a) (i) AAS-14 'Analytical Procedures': Analytical procedures 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 fluctuation or relationship are investigated when the ratio or trend analysis show deviant data or relationship. The analytical procedures include consideration for comparison of financial information of the entity with other relevant figures and also consideration for relationship.

Analytical procedures are used for the following purposes:

- (a) to assist the auditor in planning the nature, timing and extent of other audit procedures;
- (b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and
- (c) as an overall review of the financial statements in the final review stage of the audit.

The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business. The conclusion drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

However in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

- (ii) **Concept of Materiality** : This concept is fundamental to the process of accounting. It covers all the stages from the recording to classification and presentation. It is therefore, an important and relevant consideration for an auditor who has constantly to judge whether a particular item or transaction is material or not.

AAS 13 on audit materiality lays down standard on the concept of materiality and its relationship with audit risk. It requires that the auditor should consider materiality and its relationship with audit risk while conducting an audit and therefore an auditor requires more reliable evidence in support of material items i.e. the knowledge of which would influence the decision of the users of the financial statements. Financial statement materially effected if such statement is erroneously stated or omitted to be stated therein and economic decision of the users taken on the basis of such information is influenced by such misstatement or omission.

Auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

Factors to be considered for determining materiality:

- (1) The item of materiality may be determined individually.
 - (2) The materiality may be determined in aggregate.
 - (3) The materiality depends also on the regulatory or law considerations. For example, in cases where the appointment of directors is not according to law, the remuneration paid to them is a material item even if the financial implication is low.
 - (4) Materiality is also decided as to the degree of relevance in relation to the overall accounts or in relation to the group to which it relates or in relation to the classes of transactions to which it pertains.
 - (5) The materiality is not often reckoned with respect to quantitative details alone. It has qualitative dimensions as well. Improper description, for example, of accounting policy in the notes, is a material misstatement that may affect economic decisions.
 - (6) Even insignificant items in terms of quantity may be material in special circumstances. For example, it is not the quantum of deviation but presence of the deviation itself may be material factor to determine the correct functioning of logic in a system (computer) driven accounting areas.
 - (7) Sometimes, the materiality of an item is described in law itself. For example, the schedule VI requires disclosure of items of expenditure which is in excess of 1% of turnover or Rs.5,000 whichever is higher.
 - (8) An item whose impact in present is insignificant but whose effect in future may be significant may be a material item.
- (b) (i) Cash on Hand Rs. 10,000
- This is the item of current assets, exhibited on the Asset side of balance sheet .It implies:
- (1) that the firm concerned has Rs.10,000 in hand in valid notes and coins on the balance sheet date.
 - (2) that the cash was free and available for expenditure to the firm.
 - (3) that the books of accounts show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.
- (ii) Investments Rs.1,00,000
- This is also the item to be exhibited on the asset side of balance sheet as per Schedule VI as prescribed by Company Law .This description is not giving us a complete picture of investment. We, as an auditor, must know:
- (1) Nature of Investment, type of Investment; whether it is short term or long term investment or trade investment or non-trade investment.

- (2) Rate of interest receivable.
- (3) Face value or market value of investments as on balance sheet date.

(iii) Secured Loan Rs.10,00,000

It Implies that the company has secured loan from some parties, worth Rs. 10,00,000. The description does not give us a complete picture. We, as an auditor, must know :

- (1) the name of the lender,
- (2) the nature of security provided; and
- (3) the rate at which interest is payable.

(iv) Machinery Rs. 11,70,000.

- (1) The Company owns the Plant and Machinery whose WDV as on date of balance sheet is Rs. 11,70,000. Gross block is Rs. 13,00,000.
- (2) The Machinery physically exists.
- (3) The asset is being utilized in the business of the company productively.
- (4) Charge of depreciation on this asset is Rs.1,30,000 relates to the year in respect of which the accounts are drawn up.
- (5) The amount of depreciation, has been calculated on recognized basis and the calculation is correct.

Question 4

How will you vouch/verify the following :

- (a) Advance given to a director of a Company
- (b) Repayment of amount of foreign loan for purchase of an asset
- (c) Grant received for reimbursement of revenue expenditure
- (d) Deferred Tax Liability. (4X4 = 16 Marks)

Answer

- (a) Advance given to a director of a company
 - (1) Verify articles of association for powers of the company to grant advances to director.
 - (2) Refer section 295 of the Companies Act, 1956 if the company is a public company or a private company being a subsidiary of a public company. According to the section any loan or advance to director requires prior permission of central government.(Directors are often provided with advance money for expense for the purpose of the business of the Company. Such advances are outside the scope of Section 295).

- (3) Check the bank book/cash book entries with vouchers.
 - (4) Study the contract /loan agreement, terms, rate of interest and inquire whether they are prejudicial to the interest of the company.
 - (5) Check the confirmation received from the director for outstanding advances.
 - (6) Check interest had been duly charged for the outstanding unless it is an interest free advance.
 - (7) The loan or advances made to the directors should be distinctly shown in the balance sheet.
 - (8) Check the related party transaction with director is disclosed in notes to the account.
- (b) Repayment of amount of foreign loan for purchase of an asset
- (1) Check the loan agreement, rate of interest, terms of security.
 - (2) Check the remittances made during the year towards installments of repayments made.
 - (3) Check the receipted voucher/account confirmation for the balance of outstanding.
 - (4) The year end liability of foreign loan should be translated to the rate of exchange prevalent as on the closing date.
 - (5) The gain or loss arising on exchange conversion is to be credited or debited to Profit and Loss account in accordance with the Accounting standard 11 .
 - (6) Check banker exchange rate chart for correctness of the conversion.
 - (7) Check RBI or other agencies' permission for remittances outside India.
- (c) Grant received for reimbursement of revenue expenditure
- (1) Check the amount of receipt, donor details etc. from relevant voucher.
 - (2) Study the terms of grant for its utilization and check whether they had been complied with.
 - (3) Check the nature of grant, amounts have been duly disclosed in accounts in accordance with Accounting Standard 12.
 - (4) Check the provisions of law, if any, affecting foreign contributions if the grant comes from abroad.
- (d) Deferred Tax Liability
- (1) The deferred tax liability is created when there is timing difference which result in deferred tax payable with reduction in current tax to the same extent. For example, when more depreciation amount is claimed in Income tax profits than in accounting profits, the current tax payable will be less with an liability to pay more tax in future. This is called Deferred Tax Liability.
 - (2) Check the creation of Deferred Tax Liability and its actual working.

- (3) Check how much Deferred Tax Liability is reversed during the year.
- (4) Check that Deferred Tax Liability is disclosed as relating to depreciation and as relating to others.

Question 5

- (a) From where and how auditor can obtain knowledge of Client's business to enable him to develop an overall Audit Plan? (8 Marks)
- (b) What are the focus points in doing propriety audits by C&A G as regards government expenditure? (8 Marks)

Answer

- (a) Knowledge of Client's Business: The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things. The auditor can obtain such knowledge from:
 - (1) The client's annual reports to shareholders.
 - (2) Minutes of meeting of shareholders, board of directors and important committees.
 - (3) Internal financial management reports for current and previous periods, including budgets if any.
 - (4) Previous year's audit working papers, and other relevant files.
 - (5) Firm personnel responsible for non audit services to the client who may be able to provide information on matters that may affect the audit.
 - (6) Discussion with client relating to–
 - (i) Change in Mgt., Organisational Structure and activities of client.
 - (ii) Current govt. legislation, rules, regulation & directives affecting the client's business.
 - (iii) Current business development affecting client.
 - (iv) Current or impending financial difficulties or accounting problems.
 - (v) New or closed premises & plant facilities.
 - (vi) Recent changes in technology, types of products or services and production or distribution methods.
 - (vii) Significant matters arising from previous year's financial statements, audit report and management letters.
 - (viii) Changes in the accounting practices and procedures and in the system of internal control.

- (7) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies; industry publications, trade journals, magazines, newspapers or text books.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

- (b) Focus points for doing propriety audits of government expenditure: The Propriety audit is to vet the expenditure in the annals of financial wisdom and uprightness. It is to check to bring out the improper, avoidable, or infructuous expenditure even though such expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit in so far as the various formalities regarding rules and regulations are concerned but may still be highly wasteful. It is not audit of sanction or against norms. It is a qualitative, opinion-based expression of auditor's findings as regards the efficiency, effectiveness and economy dimensions of expenditure.

In this regards, the following main points should be kept for consideration:

- (1) The expenditure should not be prima facie more than what the occasion demands. Public money should be spent by the officers as of his own with utmost diligence and care.
- (2) No order for sanction of an expenditure should be made by an authority which results in pecuniary gains directly or indirectly.
- (3) Public moneys should not be utilised for the benefit of a particular person or section of the community unless :
 - (i) the amount of expenditure involved is insignificant; or
 - (ii) a claim for the amount could be enforced in a Court of law; or
 - (iii) the expenditure is in pursuance of a recognised policy or custom; and
 - (iv) the amount of allowances, such as traveling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.
- (4) There should not be profiteering by the authority or anybody where the expenditure is in the nature of compensating.
- (5) Wastages are avoided in expenditure. The cost of administering should not eat off the benefits of the expenditure.
- (6) The expenditure should percolate down the beneficiary without corruption.
- (7) The expenditure should bring out optimum, enduring benefits instead of mere frittering away the public money on meeting day to day needs repeatedly.

Question 6

- (a) How does an audit programme help to plan and perform the audit? (8 Marks)
- (b) Draft an audit programme to audit the receipts of a cinema theatre owned by a partnership firm. (8 Marks)

Answer

- (a) The role of audit programme in audit plan and performance: The audit programme is helpful both in planning and performance stages of audit:
- (1) The audit programme lists down areas of audit before commencement.
 - (2) The audit timing is built therein, thereby it becomes a schedule of audit plan.
 - (3) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.
 - (4) It specifies the procedures to be checked during the audit.
 - (5) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.
 - (6) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.
 - (7) The working papers of the audit staff can be reviewed against the audit programme which helps as a base of reference for evaluation of the performance before reporting on the financial statements.
 - (8) It also helps in preparing a diary of the performance and plan and also as a base for billing the clients for the time and manpower involved in the audit.
- (b) Programme for receipts of cinema theater of a firm: Audit programme for checking the receipts of a cinema theatre of a partnership firm.
- (1) The partnership deed should be first scrutinized.
 - (2) The receipts of the cash from partners on capital and current accounts should be vouched with reference to the relative terms in the deed.
 - (3) The internal control for collections from sale of tickets should be checked.
 - (4) See that the tickets are serially numbered and effective custody of un-issued tickets are in existence.
 - (5) Check the rough cash book and reconcile from the stock of ticket books issued, the cash to be collected each day.
 - (6) Check that the cash balance and ticket sales from stock is daily checked by the manager.
 - (7) Check that the collections are banked daily, the very next day.

- (8) See rates for each class and the ticket rates are as per current prices.
- (9) The entertainment tax collected should be separately accounted for its subsequent payment to the government agencies.
- (10) Check the relation between the amounts of tax collected and sales.
- (11) The collections from the advertising and publicity materials should be checked with reference to the terms of agreement.
- (12) Income from canteen, stalls, parking facilities should also be checked and see that the income are fairly booked without any seepage.
- (13) The cash collections should not be used for meeting petty cash expenses. There should be separate imprest system.
- (14) Do surprise checking of cash balances.
- (15) See that cash collections are insured and the policy is in force.

Question 7

- (a) What are audit working papers? Discuss various contents of Permanent Audit File and Current File. (8 Marks)
- (b) What is clean audit report? Explain, how it is different from qualified report affecting Auditor's opinion. (8 Marks)

Answer

- (a) **Audit Working Papers:** Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit. Working papers are the property of the auditor.

Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

In case of recurring audits, auditors generally prepare two types of audit files.

- (1) **Permanent Audit file :** It includes –
 - (i) Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
 - (ii) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
 - (iii) A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
 - (iv) Copies of audited financial statements for previous years.
 - (v) Analysis of significant ratios and trends.

- (vi) Copies of management letters issued by the auditor, if any.
- (vii) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- (viii) Notes regarding significant accounting policies.
- (ix) Significant audit observations of earlier years.
- (2) Current Audit file : 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 are relevant to the audit.
 - (iii) Evidence of the planning process of the audit and audit programme.
 - (iv) Analysis of transactions and balances.
 - (v) A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.
 - (vi) Evidence that the work performed by assistants was supervised and reviewed.
 - (vii) Copies of communications with other auditors, experts and other third parties.
 - (viii) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
 - (ix) Letters of representation or confirmation received from the client.
 - (x) Conclusions reached by the auditor concerning significant aspects of the audit.
 - (xi) Copies of the financial information being reported on and the related audit reports.
- (b) Clean audit report and Qualified audit report: A clean audit report is a report issued by an auditor in case he does not have any reservation in respect of matters contained in the financial statements. In such a case, the audit report may state that the financial statements give a true and fair view of the state of affairs and of profit and loss account during the period. A clean report may be without any modifications or with modifications which are just for matter of emphasis.

Under the following circumstances an auditor is justified in issuing a clean report:

- (a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
- (b) the financial information complies with relevant regulations and statutory requirements; and
- (c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Qualified audit report, on the other hand, is one when auditor does not give a clean chit

about the truthfulness and fairness of the financial statements but makes certain reservations. A qualified report is a modified report as to the auditor's opinion.

A qualified report is issued when there is limitation on the scope of audit or disagreement with management, regarding the acceptability of accounting policies selected or the method of application or the adequacy of financial statement disclosure.

The auditor uses the word to indicate his qualification or reservation by placing the word "subject to" or "except to". The qualifications should indicate impact on profits and account balances and should be specific, clear and self explanatory. The auditor should also give reasons for qualification. In case of companies, there is also a legal requirement u/s 227(4) of the Companies Act which provides that where the auditor answers any of the statutory affirmations in negative or with qualification, his report shall state the reasons for such answer.

Thus, it is clear from the above that in case of a clean report, the auditor has no reservation in respect of various matters contained in the financial statements but a qualified report may involve certain matters involving difference of opinion between the auditor and the management.

Question 8

Write short notes on the following:

- (a) Change in Accounting Policies
- (b) Management representation as an audit evidence
- (c) Audit Risks
- (d) Cut-off Arrangement.

(4 X 4 = 16 Marks)

Answer

(a) Change in accounting policies:

- (1) The consistency is the fundamental accounting assumption. Therefore the accounting policies should consistently be applied and followed from years to years.
- (2) Change in accounting policy is permitted only if such change is to bring accounts in line with accounting standards, provisions of law or for better presentation of financial statements.
- (3) When change in accounting policies or method is effected, the fact of such change and its impact on accounts must be disclosed.
- (4) If change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

- (b) The management representation as an audit evidence:
- (1) During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to some specific enquiries.
 - (2) The auditor also should obtain representation from management, where considered appropriate and necessary.
 - (3) The management representation is taken to corroborate audit evidence, but representations by management can not be a substitute for other audit evidences that the auditor could reasonably expect to be reasonably available.
 - (4) In certain cases, where knowledge of facts is confined to management, a representation by management may be the only audit evidence, which can reasonably be expected to be available.
 - (5) If a management representation is contradicted by an available other audit evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by management.
- (c) Audit risks : "Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components:
- (1) "Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
 - (2) "Control risk" is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.
 - (3) "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated with misstatements in other balances or classes.
- The auditor can modify the nature, timing and extent of audit procedures to reduce detection risk from the appreciation and assessment of the risks associated with inherent and control risks.
- (d) Cut-off Arrangement: Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separate from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for the purpose is technically known as "Cut-off arrangement". It essentially forms part of the internal check of the organisation.

Accounts, other than sales, purchases and stock are not usually affected by the continuity of the business and, therefore, this arrangement is generally applied only to the aforesaid accounts. For this purpose, the auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that :

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

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and after the cut off date and check whether stocks represented by those documents were included or excluded, as appropriate, during stock taking because this directly affects the profitability of the business.