

PAPER – 2 : AUDITING

QUESTIONS

1. Comment on the "An opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted the affairs of the enterprise".
2. (a) 'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defence as an auditor?
(b) 'Doing a statutory audit is full of risk. 'Narrate the factors which cause the risk.
3. Write short note on Errors of Commission?
4. What is the importance of having the accounts audited by independent professional auditors?
5. Write short notes on:
(a) Preliminary Expenses
(b) Fundamental Accounting Assumptions
6. Write short notes on " Audit Note-book".
7. State General considerations in framing a system of Internal check.
8. 'Doing an audit in an EDP environment is simpler since the trial balance always tallies' Analyse critically?
9. Write short notes on Audit Trail?
10. How will you vouch and/or verify the following?
(a) Trade Marks and Copyrights
(b) Recovery of Bad Debts written off
(c) Goods sent out on Sale or Return Basis
(d) Borrowing from Banks
11. Give your comments and observations on the following:
(a) Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the year-end.
(b) The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.
(c) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses.

12. As an auditor comment on the following situation:
A company had a branch office, which recorded a turnover of Rs.1,99,000 in the earlier year. The auditor's report of the earlier year had no reference regarding the branch although, the branch audit had not been carried out by the statutory auditor.
13. 'At the AGM of Leela Ltd., Mr Joshy was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry.
State, how the new auditor will be appointed by Leela Ltd.
14. Comment on the Interest on share capital was paid to the shareholders as the company had a long gestation period before it could become operational.
15. As an auditor comment on the following situations:
 - (a) A company had acquired a 10 Tonner delivery van valued at Rs.6.5 lakhs on instalment basis from a dealer. During the year, the company paid Rs.1.5 lakhs being the instalment for the year and provided depreciation on the said amount paid.
 - (b) A sum of Rs.15,000 per month has been paid as remuneration to a Director, who is not in the whole-time employment of the company.
 - (c) A company received a subsidy of Rs.1 crore for establishing an undertaking in the backward/notified area.
16. Write short note on Performance Audit?
17. Mention the special points in the case of an audit of the entity from Incomplete Records.
18. What are accounting estimates according to Auditing and Assurance Standards — AAS — 18 (SA 540)? Give examples.
19. Write short note on the Initial Engagements?
20. What is meant by external confirmation? Mention four situations where external confirmation may be useful for auditors.

SUGGESTED ANSWERS/HITS

1. According to AAS-2 (SA 200A) on "Objective and Scope of the Audit of Financial Statements" states that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. Further, the AAS states that such an opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise.

It is not possible for an auditor to provide absolute assurance in relation to the future viability, efficiency and effectiveness on account of the following:

The objective of an audit is to enable an auditor to express his opinion on the financial statements. The auditor's opinion helps in determining the true and fair view of the financial statements and the operating results of an enterprise. The objective of the audit process is not to examine transactions from the view points of efficiency, effectiveness or the future viability

The audit process cannot confirm the viability of the operating effectiveness as the subject matter of audit i.e. financial statements itself are outcome of several judgements and accounting estimates on the part of the enterprise.

It must also be appreciated that the process of auditing suffers from certain inherent limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures.

It may however be noted that over a period of time, the scope of audit extended quite considerably by inclusion of certain matters of proprietary nature in Section 227(1A) and MAOCARO issued under Section 227(4A) of the Companies Act, 1956 as well as international regulations such as Sarbanes Oxley Compliance.

The auditor has been primarily concerned with carrying out what may be termed as verifactory audit. Thus, the auditor did not sit on judgement on management decisions, policies or the commercial prudence of transactions. However, with the introduction of aforesaid provisions, the auditor is required to express opinion on certain aspects of management decisions involving propriety aspects as well.

2. (a) The responsibility for the prevention and detection of fraud and error rests with management through the implementation and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error. In forming his opinion, the auditor carries out procedures designed to obtain evidence that will provide reasonable assurance that the financial information is properly stated in all material respects. Consequently, the auditor seeks reasonable assurance that fraud or error which may be material to the financial information has not occurred or that; if it has occurred, the effect of fraud is properly reflected in the financial information or the error is corrected. The auditor, therefore, plans his audit so that he has a reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error. The degree of assurance of detecting errors would normally be higher than that of detecting fraud, since fraud is usually accompanied by acts specifically designed to conceal its existence. Due to the inherent limitations of an audit there is a possibility that material misstatements of the financial information resulting from fraud and, to a lesser extent, error may not be detected. The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and

reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

- (b) An independent audit whether performed in terms of relevant statutory legislation or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks. Factors which can such risk in conducting an audit are discussed below:
 - (i) Exercising judgement on the part of the auditor: The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.
 - (ii) Nature of audit evidence: The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such an evidence may far exceed the benefits.
 - (iii) Inherent limitations of internal control: Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite nature that an audit suffers from control risk on account of inherent limitations of internal control risk and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

- 3. Errors of Commission: When a transaction has been misrecorded either wholly or partially it is called as a error of commission. Error of commission can happen in the following ways:

Errors in posting,

Errors in Casting

Errors in carrying forward

Errors occurring during extraction of balances, etc.

Posting errors may be of a wrong account, wrong amount or wrong file. For example, amount received from Mr X and credited to Mr Y, purchase of Rs.360 from Mr A posted in his account at Rs.630 or sales returns from Mr X posted as the debit of his account, etc.

The first type of errors will not affect the trial balance, however, the other two will affect the agreement of trial balance.

Casting errors are the errors committed while making the totals. This error affects the trial balance.

Error of carry forward and errors of extraction of balances also affect the trial balance.

Error of duplication is another type of error of commission which means recording the same transaction twice.

Such errors however, do not affect the trial balance but they will affect the Profit and Loss A/C(Over statement of expenditure).

4. Importance of Audit by an Independent Professional Auditor: The principal advantage of an independent audit lies in the fact that the society is able to get an informed, objective and forthright opinion on the financial statements of enterprises which are used in making significant economic decisions by interested segments of the society, e.g., shareholders, creditors, bankers, etc. Irrespective of the fact whether audit is compulsory, statutory or voluntary, the audit of accounts by an independent professional auditor becomes important for every individual and every type of organisation.

It is only through audited accounts by an independent professional auditor that the shareholders of a company are assured that the funds invested by them are safe and they are being used for only the purposes for which they were raised and collected. The chief utility of audit lies in ensuring reliable financial statements on the basis of which the state of affairs may be easy to understand. Information contained in the statement of accounts of a business are primarily intended for the owners.

However, many others make use of the information for different purposes.

- Management of the business uses it for decision-making purposes.
- Lenders and creditors examine it to establish the degree of safety of their money.
- Government levies tax putting a prima facie reliance on the statements and regulates the socio-economic state of affairs on a summary view of the information contained in various accounting statement made available to it.
- Investors review the information for making investment decisions
- Financial analysts can use the information to assess the performance of an entity.

Financial statements are of great significance to workers as well; they want to be assured that reasonable and legitimate share of the revenue earned by the organisation has been paid to them as bonus and the distribution pattern has not violated the norms of social justice.

To ensure the acceptable degree of reliability and accuracy of the financial statements, examination and appraisal of accounts and the financial picture by an independent auditor is necessary.

In the company form of organisation, there is a divorce between ownership and management - shareholders are so scattered that they have no direct control on the day-to-day administration of the company while in a proprietary concern, accounts may be audited to get funds from financial institution, etc. and a partnership firm may get its accounts audited to decide questions such as valuation of goodwill at the time of admission, retirement and death of a partner.

The report of an independent auditor is, therefore, the only real safeguard available to the various parties interested in the financial affairs of the entity. It is due to the independence of the auditor, leading to an objective report, that the risk of people being misled by untrue or fraudulent financial statement is minimised. As a by-product, managements get attuned to open and truthful financial statements.

5. (a) Preliminary Expenses: This term is applied to expenses incurred in connection with the formation of a limited company. They generally include the following expenses:
 - (i) Legal costs in drafting the memorandum and articles of association;
 - (ii) Capital duty and other fees on registration of the company;
 - (iii) Cost of printing the memorandum and articles of association;
 - (iv) Cost of statutory books and the companies seal, etc; and
 - (v) Any other expense incurred to bring into existence the statutory books of the company.

Preliminary expenses in so far as they have not been written off to date must be shown separately in the balance sheet of the company under the heading "Miscellaneous Expenditure".

The auditor should verify these expenses with reference to supporting documents such as invoices and contracts relating to these expenses. In the case of a company, the auditor should also examine that the reimbursement of such expenses to promoters is in accordance with the disclosures made in the prospectus. Compliance with legal provisions regarding reimbursement of the promoters' expenses should be specifically examined.

- (b) Fundamental Accounting Assumptions: As per AS 1 on "Disclosure of Accounting Policies" accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the

enterprise in the preparation and presentation of financial statements. There is no single list of accounting policies which are applicable to all circumstances.

The choice of the appropriate accounting principles and the methods of applying those principles in specific circumstances calls for judgement by the management. The profit or loss can be significantly affected by the accounting policies followed. Therefore disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

AS-1 states that certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed. The following have been generally accepted as fundamental accounting assumptions:

- (a) Going Concern: The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
- (b) Consistency: It is assumed that accounting policies are consistent from one period to another.
- (c) Accrual: Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

Thus, if the fundamental accounting assumptions, viz., Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

6. **Audit Note Book :** An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. Audit note books form part of audit working papers and for each year a fresh audit note book is maintained. In case an auditor classifies his working paper into permanent and current, then audit note book shall form part of the current file. It is in any case a part of the permanent record of the auditor available for reference later on, if required.

The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily. It is also used for recording the various queries raised in the course of the work and their state of disposal. In respect of disposed queries, explanation obtained and evidence seen would be recorded in the said book, while queries remaining undisposed of would be noted for follow up.

7. **General Consideration in framing a System of Internal Check :** Internal check is a part of the overall internal control system and operates as a built-in device as far as

the organisation of the staff and job allocation aspects of the control system are concerned. A system of internal check in accounting implies organisation of system of book keeping and arrangement of staff duties in such a manner that no one person can completely carry through a transaction and record every aspect thereof. Some of the general considerations in framing a system of internal check are as under:

- (i) No single person should have an independent control over any important aspect of the business.
 - (ii) The duties of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
 - (iii) Every member of the staff should be encouraged to go on leave at least once in a year.
 - (iv) Persons having physical custody of assets must not be permitted to have access to the books of account.
 - (v) To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.
 - (vi) Budgetary control would enable the management to review from time to time the progress of trading activities.
 - (vii) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.
 - (viii) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.
 - (ix) Accounting procedures should be reviewed periodically, for, even well-designed and carefully installed procedures, in course of time, cease to be effective.
8. 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 to be gauged 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.

9. **Audit Trail:** An audit trail refers to a situation where it is possible to relate 'one-to-one' basis, the original input along with the final output. The work of an auditor would be hardly affected if "Audit Trail" is maintained i.e. if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail.

For example, the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

In first and early second-generation computer systems, such a complete and trail was generally available, no doubt, to management's own healthy scepticism of what the new machine could be relied upon to achieve – an attitude obviously shared by the auditor.

10. (a) **Trade Marks and Copyrights**
- (a) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.
 - (b) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trade marks and copyrights have been duly registered.
 - (c) Verify existence of copyright by reference to contract between the another and noting down the terms of payment of royalty.
 - (d) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trade marks and copyrights have been capitalised.
 - (e) Verify existence of copyright by reference to contact between the author and the entity and to check the payments of royalty made to author.
 - (f) Ascertain that the legal life of the trade marks and copyrights have not expired.
 - (g) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations.
- (b) **Recovery of Bad Debts written off**
- (i) Ascertain the total amount of bad debts.

- (ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.
 - (iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.
 - (iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.
- (c) Goods sent out on sale or return basis
- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
 - (ii) See that price of such goods is unloaded from the sales account and the debtor's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
 - (iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.
 - (iv) Confirm that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing stock.
- (d) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:
- (i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
 - (ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
 - (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
 - (iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

11. (a) Confirmation of Balances: Direct confirmation of balances from debtors/creditors in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor. Guidance Note on Audit of Debtors, Loans and Advances issued by the Institute recommends that the "debtors may be requested to confirm the balance either

As at the date of the balance sheet, or

As at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the debtors at a date other than the balance sheet date, he should examine the movements in debtor balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that debtor balances stated in the balance sheet are not materially mis-stated".

Therefore, it is not necessary that balances of debtors/ creditors should necessarily be verified only at the end of the year only. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically, i.e., December, 31st as a cut-off date in one year and June 30 in another year and so on. Therefore, the statement that balance confirmation from debtors/creditors can only be obtained for balances standing in their accounts at the year-end is not correct.

- (b) Certificate from an Expert: The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of an expert. AAS-9 (SA 620) on "Using the Work of an Expert" also states that an expert may be engaged/employed by the client. It further requires the auditor to assess skill, competence and objectivity of the expert amongst other factors and evaluate the work of an expert independently to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of AAS-9 (SA 620) before relying upon the certificate obtained by the management from the actuary.

(c) **Revaluation of Fixed Assets:** The revaluation of fixed assets is a normally accepted practice which involves writing up the book value of fixed assets. AS-10 on 'Accounting for Fixed Assets' requires that "an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution". Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealised gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not the capital reserves. Therefore, the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

12. **Reference to branch audit in the audit report:** Under Section 228(4) of the Companies Act, 1956, the Central Government has formulated Companies (Branch Audit Exemption) Rules, 1961 to exempt any branch office of a company from being audited having regard to quantum of activity.

These Rules require that, if during the said financial year, the average quantum of activity of the branch does not exceed Rs.2 lakhs or 2% of the average of total turnover and the earnings from other sources of the company as a whole, whichever is higher, the said branch is exempted.

In the case under review, the turnover is below Rs. 2 lakhs and other information has not been furnished. Accordingly, it may be presumed, exemption may have been granted but still it is necessary that the fact must be mentioned in the audit report.

Since, reference to branch is called for in the auditor's report even if the same has been exempted by the Central Government, the auditor remains responsible. The auditor has, however, no responsibility in respect of the audit of earlier period accounts.

13. Section 224(6) of the Companies Act, 1956 deal with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instance case, Mr. Joshy has been validly appointed and thereafter he had resigned.

Thus a casual vacancy had been created on account of resignation. The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the Board cannot fill in that vacancy. The company in a general meeting can only fill the same.

Thus, in this case Leela Ltd will have to call an extraordinary general meeting (EGM) and appoint another auditor. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

The provisions of the Companies Act, 1956 applicable for the appointment of an auditor in place of a retiring auditor would equally applicable in the instant case are given below:

- (i) Section 225(1): Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.
 - (ii) Section 190(2): Special notice is to be sent to all members of the company at least 7 days before the date of the AGM.
 - (iii) Section 225(2): On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
 - (iv) Section 225(3): Representation if any, received from the retiring auditor should be sent to the members of the company.
 - (v) Section 224A: Special resolution as required under this section should be duly passed.
 - (vi) Section 224(1B): Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 224(1B).
 - (vii) The incoming auditor should also satisfy himself that the notice provided for under Sections 224 and 225 has been effectively served on the outgoing auditor.
14. Payment of interest out of capital: Section 208 of the Companies Act, 1956 permits payment of interest to shareholders out of capital, where there is a long gestation period. Payment of interest on capital is, however, capitalised as part of cost of construction of the project. The auditor should ensure that following conditions have been complied whenever such interest has been paid:
- (i) Payment is authorised by the Articles or by special resolution of shareholders in general meeting;
 - (ii) Payment is approved by the Central Government;
 - (iii) It is paid only for the period determined by the Central Government not exceeding six months after the half-year in which the project has been completed.
 - (iv) The rate shall not exceed 12% p.a. or such other rate as may be prescribed by the Government.
 - (v) The payment of interest shall not operate as a reduction of the amount paid-up on the shares in respect of which it is paid.
15. (a) Purchase of van on instalment basis: The delivery van was purchased at Rs.6.5 lakhs on instalment basis and accordingly, the property passed on to the purchaser immediately whereas in the case of hire-purchase basis, property in goods passes

only after payment of last instalment.

Therefore, the gross book value of the delivery van will be Rs.6.5 lakhs. Depreciation should, thus, be provided on Rs.6.5 lakhs and not on the instalment amount of Rs.1.5 lakhs paid. Under the circumstances, the auditor will have to qualify the audit report.

- (b) Remuneration paid to a Director: Under Section 309 (4) of the Companies Act, 1956, a Director who is not in the whole-time employment of the company, may be paid on a monthly/quarterly/annual basis with the approval of the Central Government or by way of commission if the company passes a special resolution.

However, the remuneration so paid shall not exceed: (i) 1% of the net profits of the company if the company has a managing or whole-time director or a manager; or (ii) 3% of the net profits of the company in any other case. However, company with the approval of the Central Government in general meeting may approve payment exceeding these specified percentages.

Therefore, the auditor has to examine whether the sum paid conform to the above norms and requirements. In case, the payment has not been so approved and sanctioned, the Directors who have approved payment of the said Rs.15,000 p.m. would have to personally reimburse the amount or the amount in excess paid. A qualification is also called for in the audit report as well.

- (c) Subsidy received by the company: The company had received a subsidy of Rs.1 crore, for establishing an undertaking in the backward/notified area.

The accounting treatment of such subsidy shall depend upon the nature and purpose for which it has been given. As per AS-12 on "Accounting for Government Grants", the grant given for acquisition of fixed assets is in the nature of promoter's contribution.

As per facts of the case, the grant has been given with reference to the total investment in the undertaking by way of contribution towards its total capital outlay for the establishment of the undertaking which is having similar characteristics to those of promoter's contribution.

In such cases, no repayment is ordinarily expected and thus the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Accordingly, the amount of Rs.1 crore should be kept in a special reserve account and treated as a part of shareholders' funds.

16. Performance Audit: The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit. Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results

expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

Economy audit looks into whether the entity has acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy and effectiveness. The procedure for conducting performance audit covers identification of topic, preliminary study, planning and execution of audit, and reporting. Normally speaking, the performance audit is conducted by the government in respect of various expenditure incurred. While the trend towards a comprehensive approach for conducting performance of full scope audit is visible, the coverage and depth of evaluation vary according to the statutory limitations, and the organisational constraints of C & AG.

17. The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor.

An auditor may face the situation of incomplete records under the following circumstances:

- (i) Where records are kept on single entry basis; or
- (ii) Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditors examination due to similar reasons.

Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete, but may still contain useful information for the auditor.

On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system.

In any case, the following steps would be required to conduct an audit:

- (i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained.
- (ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary.
- (iii) Check that all entries on the payment side of cash book are posted in the ledger.
- (iv) Confirming that all entries appearing in bank account are posted in the ledger.
- (v) Analyse personal accounts of debtors. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonoured, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtors accounts.

Similarly, it would be necessary to analyse the creditors' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonoured, etc., to relevant accounts.

From an auditor's view point, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures.

18. According to AAS-18 (SA 540), "Audit of Accounting Estimates" accounting estimate means an approximation of the amount of an item in the absence of a precise means of measurement. Some examples are:
- (i) Allowances to reduce inventory and accounts receivable to their estimated realisable value.
 - (ii) Provisions to allocate the cost of fixed assets over their estimated useful lives.
 - (iii) Accrued revenue.
 - (iv) Provision for taxation.
 - (v) Insurer's liability for outstanding claims.
 - (vi) Provision for loss from a lawsuit.
 - (vii) Losses on construction contract in progress.
 - (viii) Amortisations of certain items like goodwill and deferred revenue expenditure.
 - (ix) Provision to meet warranty claims.
 - (x) Provision for retirement benefits in the financial statements of employers.

19. Initial Engagement: As per AAS 22 (SA 510), "Initial Engagements – Opening Balances", initial audit engagements mean:

- (i) When the auditor is engaged to carry out the audit of Financial Statements of an entity for the first time; or
- (ii) When the financial statements of the entity for the preceding period were audited by another auditor.

The situation mentioned in (i) above arises when the auditor is appointed to take up the audit for the first-time or no audit was carried out of the financial statements of the entity for the immediately preceding period. The situation mentioned in (ii) above arises whenever there is a change of auditor. For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

- (a) the closing balances of the preceding period have been correctly brought forward to the current period; and
- (b) appropriate accounting policies are consistently applied.

20. External confirmation: It is the process of obtaining and evaluating audit evidence through a direct communication from a third party, who is not related to the entity – in response to a request for information about a particular item affecting assertions made by management in the financial statements.

The auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. Following are examples of situations where external confirmations may be useful.

- (i) Bank balances and other information from bankers
- (ii) Account receivables balances
- (iii) Stock held by third parties
- (iv) Account payable balances.