PAPER – 6 : AUDITING AND ASSURANCE

QUESTIONS

Nature of Auditing

1. (a) Briefly explain the relationship between Auditing and Behavioural Science.

   (b) "The auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements." In the light of the above statement briefly explain the circumstances and opinion expressed by an auditor, where he is unable to obtain sufficient audit evidence.

2. Auditors of M/s Santa Banta (P) Ltd. were changed for the accounting year 2010-11. However there was no change in the position of closing stock which remained at ₹ 400 lacs . The auditors of the company propose to exclude the audit of closing stock of ₹ 400 lacs from their audit programme on the understanding that it pertains to the preceding year which was audited by another auditor. Comment.

Basic Concepts in Auditing

3. Write a short note on the following

   (a) Fundamental Accounting Assumptions

   (b) Disclosure of Accounting Polices

   (c) Auditor's Independence

4. (a) XYZ Ltd sold scrap of ₹10,000 during the F.Y 2010-11. Auditor of the company wants to verify the sale proceeds from scrap but the accountant says that no need to verify the same because the company had a good accounting and costing system. Comment.

   (b) What is "Audit Evidence"? Discuss the principles, which are useful in assessing the reliability of audit evidence.

Preparation for an Audit

5. Briefly enumerate the circumstances where a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence.

6. Write a short note on the following

   (a) Knowledge of client's business

   (b) Audit working papers

   (c) Audit Notebook

Internal Control

7. (a) States the steps for proper internal control over stores of a large textile mill Co.

(b) What are the special steps involved in framing a system of Internal Check?

8. (a) "The overall objective and scope of an audit does not change in an CIS environment". Comment.

   (b) "The work of the internal auditors is likely to be adequate for the purpose of the audit". Comment.

Vouching &Verification of Assets and Liabilities

9. XYZ & Co. a Manufacturing company, manufactures shirts. The Company import raw materials and manufactured shirts from the same. During the financial year 2010-11 company pays a Custom and excise duty of ₹ 60,00,000 and ₹ 40,00,000 respectively. The Company maintains proper books of accounts. As an auditor of the company how will you vouch and/or verify the same ?

10. How would you vouch/verify the following?

    (a) Discounted bills receivable dishonoured

    (b) Bankruptcy Dividends

    (c) Payments controlled by the Companies Act, 1956

11. Write short notes on the following:

    (a) Impairment of Assets

    (b) Patterns, Dies, Loose Tools, etc

12. As an auditor, comment on the following situations/statements:

    (a) A Ltd wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue expenditure. The product did not pick up and the sales were negligible. It is anticipated that no material benefit will accrue in future from such heavy advertisement expenditure.

    (b) B Ltd. acquired a car for its Managing Director on hire-purchase basis. The interest payable as well as penalty for late payment of installments was added to the cost of the car.

    (c) Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under Sundry Creditors.

The Company Audit

13. As an auditor, comment on the following situation/statements:

    (a) Mr. Hari is a part time practising chartered accountant and is the Chief Executive Officer of the XYZ Ltd. The management of the company wants to appoint Mr. Hari as its auditor in the ensuing annual general meeting.

(b) PQR Private limited is incorporated on 1st August 2010. During the year ended 31st March 2011, it had issued shares (fully paid up) of ₹ 42 lakhs had borrowed ₹ 13 Lakhs each from 2 financial institutions and its turnover (Net of VAT of ₹ 50 Lakhs which is credited to a separate account) is ₹ 475 Lakhs. The company claims that CARO will not be applicable.

14. Give your comments on the following:

(a) The Board of Directors of Ram Ltd whose 25% Subscribed capital is held by Nationalised bank proposes to appoint Mr. Mohan (Chartered Accountant) as its statutory auditor in the next Annual General Meeting by passing an ordinary resolution.

(b) No depreciation provided on a machinery costing ₹ 60 Lakhs imported three year back, since it is yet to be put into use.

15. (a) White Ltd. was incorporated on 1.08.2011 and Mr. S who is related to the Chairman of the Company appointed as auditor by the Board of Directors in their meeting on 4.9.2011. Comment.

(b) M/s Ram Shyam Mohan, a firm of CA's has three partners Ram, Shyam and Mohan. Ram is also in whole time employment elsewhere. The firm is already having audit of 40 companies, including audit of 1 foreign company. The firm is offered the audit of ABC Ltd and its 20 branches. Decide and advise whether M/s Ram Shyam Mohan will exceed the ceiling prescribed u/s 224(1B) by accepting the above audit assignments.

16. (a) "The surplus arising from a change in the basis of accounting was set off by Morning Ltd. against a non recurring Losses". Comment.

(b) "The interest of a director in a transaction, entered into by the company has not been disclosed in the records maintained by the company." Comment.

Special Audits

17. (a) What considerations are to be kept in mind while conducting audit of leasing transaction of a leasing company?

(b) An Audit of expenditure is one of the major components of government audit. In this context, brief what do you understand by:

(i) Audit against Rules and orders

(ii) Audit against provision of funds

(iii) Performance audit

18. You are appointed as a auditor of XYZ & Co, a partnership firm. Mention 8 special points which you as an auditor would you look into while auditing the books of accounts of XYZ & Co.

Standards on Auditing and Guidance Notes

19. (a) In a company of 24,000 employees, the auditor faces the problem of judging the reasonableness of provision for leave encashment and employee cost. The company wants to take the help of the expert for the same. As an auditor how would you evaluate the adequacy of the work of the expert?

    (b) You have been appointed as an auditor of a company along with 2 other auditors. What steps would you like to take to ensure a smooth and effective audit? To what extent do you think you will be responsible in relation to the work performed by yours co-auditors and vice versa?

20. (a) Explain the meaning of the term "subsequent events" as used in the SA 560.

    (b) Should all type of subsequent events be considered by the auditor in his attest function?

    (c) Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in the financial statements.

SUGGESTED ANSWERS/HINTS

Nature of Auditing

1. (a) Relationship between Auditing and Behavioural Science: The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

   The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

   (b) Failure to obtain sufficient information: The auditor is required to obtain necessary information and explanation which he considers essential for performing his duties as an auditor. However, there may be instances when an auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements.

As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

(i) Circumstances beyond the control of the entity;

(ii) Circumstances relating to the nature or timing of the auditor's work; or

(iii) Limitations imposed by management.

The situation may arise when an auditor is not permitted to verify inventory at different locations, say, out side the city in which the company's office is located. It would also amount to restriction on the scope of the duties of an auditor. Further, the books of accounts of a company may be seized by the Income-tax authorities then the auditor would be unable to conduct an audit of the same.

An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures.

In view of these situations, the auditor would not be able to obtain sufficient information to reach at any conclusion. Under the circumstances, he would not be in a position to express any opinion on the financial statements.

Therefore, when the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

1. because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly,

2. the auditor does not express an opinion on the financial statements.

2. Verification of Stocks: SA 510 "Initial Audit Engagements – Opening Balances", requires that 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;

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

(c) appropriate accounting policies are consistently applied.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. The contention of the management that the stock has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the stock lying as it is might have deteriorated and the same need to be examined.

In the present case the auditor is advised not to exclude the audit of closing stock from his audit programme

Basic Concepts in Auditing

3. (a) **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.

   In this context, 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:

   (i) *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.

   (ii) *Consistency*: It is assumed that accounting policies are consistent from one period to another.

   (iii) *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.

(b) Disclosure of Accounting Policies: The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements.

The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by some cases.

The purpose of AS 1 is to promote better understanding of financial statements by establishing through an accounting standard and the disclosure of significant accounting policies and the manner in which such accounting policies are disclosed in the financial statements.

Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes which form part of financial statements.

Any change in accounting policy, which has a material effect, should be disclosed. The amount by which any item is in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies, which has not material effect on the financial statements for the current period, which is reasonably expected to have material effect in latter periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

(c) Auditor's Independence: Independence is the keystone upon which the respect and dignity of a profession is based. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest. The independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometime imposed by law. In the context of auditors, his independence is necessary so as to enable him to express unbiased opinion on financial statements. The user of the financial statement will rely on the opinion of the auditor only when he is convinced about his independence. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons.

The chartered accountant is not known personally to the third parties who rely on professional opinion and accept his opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act, 1956, has therefore enacted specific provisions to give concrete shape to this vital concept:

(i) The provisions disqualifying certain types of persons from undertaking audit of limited companies.

(ii) Provisions relating to ceiling on the number of audits that can be undertaken by a chartered accountant.

(iii) Provisions requiring special resolution for appointing auditors in certain cases.

(iv) Other provisions on appointment, re-appointment and removal of auditors, are designed with sufficient independence to carry out the audit in the larger interest of shareholders and other users.

(v) Power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence.

4. (a) Verification of Sale Proceeds of Scrap : An auditor is required to review the production and cost records for the determination of the extent of scrap materials that may arise in a given period. Normally speaking, in the ordinary course of his duties the auditor would expect that scrap generated in the company, if any, are properly accounted for. The existence of an accounting and costing system would provide evidence about the adequacy and reliability of accounting records. The records should adequately show the details of sale of scrap. Besides the rates at which the scrap have been sold, correct billing of the same and their identification that good quality material has not been mixed up, are the other aspects to be examined by the auditor. As per CARO, 2003, the auditor was required to report whether the company is maintaining reasonable records for the sale and disposal of scrap.

Therefore, just because the sale proceeds are not significant and the company has a good accounting and costing system, the auditor cannot overlook other aspects.

(b) Audit Evidence: As per SA 500 "Audit evidence" the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based is termed as Audit evidence.

Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Reliability of Audit Evidence: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Preparation for an Audit

5. As per SA 505, in certain circumstances, the auditor may identify an assessed risk of material misstatement at the assertion level for which a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence. Such circumstances may include where:

(i) The information available to corroborate management's assertion(s) is only available outside the entity.

(ii) Specific fraud risk factors, such as the risk of management override of controls, or the risk of collusion which can involve employee(s) and/or management, prevent the auditor from relying on evidence from the entity.

6. (a) Knowledge of client's business - As per SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" the auditor can obtain this information from:

(i) Clients annual report to shareholders.

(ii) Minutes of shareholders/board of directors.

(iii) Internal financial management reports of current & previous year.

(iv) Previous year audit working papers.

(v) Discussion with client.

(vi) Clients policy and procedure manual.

(vii) Publications like trade journals, magazines, news papers and

(viii) Visit to client's premises.

(b) Audit Working Papers: The audit working papers constitute the link between the auditor's report and the client's records. Documentation is one of the basic principles listed in SA 200. According to SA-230 , Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used). The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another. Therefore, working papers should provide for :

(i) means of controlling current audit work;

(ii) evidence of audit work performed;

(iii) schedules supporting or additional item in the accounts; and

(iv) information about the business being audited, including the recent history.

Working papers are varied in nature but the foundation of all working paper can be traced to :

(1) the basic constitutional documents like Memorandum and Articles of Association, Partnership Deed, Trust Deed, etc.;

(2) the contents of the minute books;

(3) the contents of the balance sheet and the profit and loss account; and

(4) the letter of engagement.

(c) 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.

Internal Control

7. (a) Steps for internal control over stores of a large textile mill co

(i) When the ordering level of any particular kind of stores has been reached, the storekeeper should send a purchase requisition to the buying department.

(ii) Two copies of each purchase order should be made out, one copy being sent to the storekeeper and the other retained in the buying department.

(iii) When a large quantity is to be purchased, it is advisable to invite tenders before placing an order.

(iv) On receipt of stores, details thereof should be entered in a Goods Inward Book kept at the gate and the goods should then be passed on to the storekeeper together with delivery notes.

(v) The storekeeper should then check the quantity and quality of stores with the copy of the order. He should make a detailed report on any deliveries which are not in accordance with the order.

(vi) The storekeeper should not issue any material to anyone unless a properly signed requisition is produced to him. Details of materials withdrawn from bins must be entered on the bin cards.

(vii) The payment of invoices should be passed by a responsible official of the company.

(viii) All stores returned to suppliers should be recorded in the Goods Outward Book kept at the gate of the factory. A credit note should be obtained from the suppler for each return store.

(b) General Considerations in Framing a System of Internal Check: The term “internal check” is defined as the “checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:

(i) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.

(ii) The duties/work 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 so that frauds successfully concealed by such a person can be detected in his absence.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.

(vi) The system of Budgetary Control should be introduced.

(vii) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.

(viii) The financial and administrative powers should be sub divided very judicially and the effect of such division should be reviewed periodically.

(ix) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.

8. (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 CIS 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 CIS environment. The computerisation of accounts would also have an impact on the increase in fraud and errors. Thus when auditing in CIS environment, the auditor should have sufficient understanding of computer hardware, software and processing systems to plan the engagement and to understand how CIS environment 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 CIS 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 CIS environment.

(b) Determining Whether and to What Extent to Use the Work of the Internal Auditors : The external auditor shall determine that whether the work of the internal auditors is likely to be adequate for purposes of the audit; and if so, the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures.

(1) In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

(i) The objectivity of the internal audit function;

(ii) The technical competence of the internal auditors;

(iii) Whether the work of the internal auditors is likely to be carried out with due professional care; and

(iv) Whether there is likely to be effective communication between the internal auditors and the external auditor.

(2) In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:

(i) The nature and scope of specific work performed, or to be performed, by the internal auditors;

(ii) The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and

(iii) The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

Vouching and Verification of Assets and Liabilities

9. (a) Customs and Excise Duties

The audit procedures for custom duties are listed below:

(i) Examine Cash Book: Examine the payment of custom duties in the cash book with reference to bill of entry.

(ii) Examine the Bill of Entry:

- Check the amount of custom duty was calculated correctly, i.e., in accordance with the applicable rate for dutiable goods.
- If the duty has been paid by dealing and forwarding agent, examine bill of entry with reference to agent's bill.
- If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of customs duty.

(iii) Examine Disputed Cases Carefully: In case of a dispute about the amount of duty payable, a provisional payment may have been made. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.

(iv) Verify for Duty Drawback: Duty drawback refers to a scheme under which central excise and customs duties paid for raw-materials and other inputs used in the manufacture of the product prior to its export are refunded to the exporter. The auditor should verify the claim of duty drawback with reference to acknowledgement issued by the Directorate of duty drawback.

Excise duty becomes payable at the time of releasing at excisable goods from the factory/godown from the manufacturer. Normally, the excise duty payable is deposited with the designated bank to the credit of the controller of excise and one copy of the challan is forwarded to him for obtaining the permit and another copy is sent to the dispatch department evidencing payment of required duty.

The auditor may adopt the following procedures to vouch the payment of excise duties:

(i) Verify payment of excise duties by examining the duly paid as per challans with reference to the quantity of goods in respect of which issue permits have been received.

(ii) Test check the accuracy of the amount of duty paid by multiplying the rate of excise duty with the value of goods issued as per the client's stock register.

(iii) In respect of excisable goods manufactured but remaining to be released, ensure that necessary provision for unpaid excise duty has been made.

(iv) Ensure that in every case CENVAT credit has been adjusted and only net excise duty has been paid.

10. (a) Discounted Bills Receivable Dishonoured

(i) Obtain the schedule of discounted bills receivable dishonoured.

(ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.

(iii) Verify the bills receivable returned by the bank along with bank's advice.

(iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the debtor is also debited.

(v) Check that bank commission, if any, charged by the bank has been recovered from the party.

(b) Bankruptcy Dividend: When a debtor has been sued for bankruptcy it is necessary to prove that the debt is due from him to the Official Receiver or Assignee before any amount can be recovered from his estate. The amounts of claim admitted are received subsequently, usually in parts, which are referred to, somewhat euphemistically, as dividends.

For the verification of these part amounts, it is necessary to refer to the correspondence with the Official Receiver or Assignee to find particulars of part amounts already collected and the balance outstanding at the beginning of the year. The advice, if any, received from the same authority along with the payment should be referred to

(c) Payments Controlled by the Companies Act, 1956

(i) Under sub-section (1A) of section 227 Clause (e) requires personal expenses charged to the revenue account of a company should be reported.

(ii) Under section 293, the Board of Directors of a public company or of a private company which is a subsidiary of a public company, shall not, except with the consent of such public company or subsidiary in general meeting.

(1) Sell, lease or otherwise dispose of the whole, or substantially the whole of the undertaking of the company, or where the company owns more than one undertaking, of the whole, or substantially the whole, of any such undertaking;

(2) remit, or give time for the re-payment of, any debt due by a directors (except in the case of renewal or continuance of an advance made by a banking company to its director in the ordinary course of business);

(3) invest, otherwise than in trust securities, (the amount of compensation received by the company in respect of the compulsory acquisition, after the commencement of this Act), of any such undertaking as is referred to

in clause (a), or of any premises or properties used for any such undertaking and without which it cannot be carried on or can be carried on only with difficulty or only after a considerable time;

(4) borrow monies where the amount borrowed together with monies already borrowed by the company apart from the temporary loans obtained from the company's bankers in the ordinary course of business, exceeds the aggregate of the paid up capital of the company and its free reserves ; and

(5) contribute amounts to charitable and other funds, not related to the business of the company or the welfare of the employees, the aggregate whereof exceeds in a financial year ₹ 50,000 or 5% of the average net profit, during the three financial years immediately preceding, whichever is greater.

(iii) Section 293A deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three years cannot contribute any amount directly or indirectly to any political party or for any political purpose to any person. In other cases, contribution should not exceed 5% of average net profits in any financial year determined in accordance with the provision of section 349 and 350 during the three immediately preceding financial years.

(iv) Section 293B permits the Board and other person to make contributions to the National Defence Fund to any extent as it thinks fit

11. (a) Impairment of Assets: Besides, charging annual depreciation on assets by the reason of normal wear and tear, effluxion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the asset can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as Impairment Loss. The treatment of impairment loss is similar to depreciation except the fact that impairment loss can be re-instated in future if the recoverable amount of the asset exceeds the carrying amount. Various external and internal sources of information can be taken as the basis of determining the impairment for Assets.

The auditor must ensure that provisions of AS 28, "Impairment of Assets" issued by the Institute are followed.

(b) Patterns, Dies, Loose Tools, etc: Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such asset although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused stock on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum stock account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing stock, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

12. (a) Treatment of Heavy Advertisement Expenditure: Advertisement expenditure is generally of revenue nature and is thus written off to the profit and loss account in the year it is incurred. However, A Ltd. has incurred "heavy" advertisement expenditure to launch a new product. In such a case, it is the normal expectation that the benefit of such expenditure is likely to bring benefits over a longer period. Therefore, heavy expenses for a new product, if campaign is successful, are normally treated as deferred revenue expenditure to be written off over a period of three to five years. Thus, deferral of expenditure is done only with the anticipation that benefit is likely to accrue in future accounting periods. It appears from the given facts that the product did not pick up and the sales were negligible. Therefore, it is almost established that the advertising effort is not going to succeed, i.e., no benefit is likely to flow in future. Thus, the entire expenses incurred should be written off to the Profit and Loss Account. Accordingly, the writing off of the entire expenditure to revenue is appropriate and correct.

(b) Car Purchased on Hire-Purchase Basis: The Managing Director's car was acquired on hire-purchase basis and, thus, the motor car account be debited with the cash price of car by raising a corresponding liability for the amount payable to the financing company. If the cash value is not readily available, it should be calculated by assuming an appropriate rate of interest. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account. In any case, the amount paid as penalty for late payment of installments should be debited as an expense instead of being added to the cost of the car. Under the circumstances, the auditor will have to qualify his report.

(c) Assets Purchased under Hire-Purchase System: Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest. Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. Thus the treatment followed by the company is correct.

The Company Audit – I

13. (a) Disqualifications of an Auditor: Section 226(3)(c) of the Companies Act, 1956 specifies that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company.

In the present case, Mr. Hari is Chief Executive Officer of the XYZ Ltd. Therefore, Mr. Hari is disqualified under section 226(3)(C) for appointment as an auditor of the XYZ Ltd.

(b) Applicability of CARO, 2003

The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:

(i) the paid up capital and reserves are ₹ 50 lakhs or less;

(ii) it has no outstanding loan of ₹ 25 lakhs or more from any bank or financial institution; and

(iii) its turnover does not exceed ₹ 5 crores.

In the case of PQR Private Limited., its paid-up capital is less than ₹ 50 lakhs, turnover is less than ₹ 5 crores since VAT is not taken into account if it is credited separately to VAT account. However, it fails to fulfill the condition relating to outstanding loan because as per the statement on CARO, 2003, issued by the Institute, requires that the amount of outstanding loan taken from bank/financial institution have to be considered on a cumulative basis. PQR Private Limited. has total borrowings of ₹ 26 lakhs and thus fails to satisfy all conditions and accordingly CARO, 2003 will be applicable.

14. (a) Appointment of Auditor by Passing an Ordinary Resolution: Section 224A of the Companies Act, 1956, provides that in case of a company in which not less than 25% of the subscribed share capital is held whether singly or in any combination, amongst others, by a public financial institution or government company or central or state government or nationalised bank or an insurance company carrying on general insurance business, the appointment or re-appointment of an auditor or auditors at each annual general meeting shall be made by a special resolution only.

In the given case, the nationalised bank held 25% of the subscribed share capital which is equal to the prescribed limit of 25%.

In view of the above provisions, the appointment of Mr. Mohan, Chartered Accountant, as auditor of the company is not valid, since as per law, special resolution is required in such circumstances. In such cases, it shall be deemed that no auditor has been appointed and thereupon the Central Government's power to appoint the auditor pursuant to Section 224(3) will become operative.

(b) Non-provision of depreciation: As per AS 6 on "Depreciation Accounting", depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.

Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the machinery has been imported by one entity, it means it was intended to be used for the purpose of business.

Depreciation in respect of this machinery ought to have been provided in the accounts for all the previous years. If there is an intention to use an asset, though it may not have actually been used, it is a 'constructive' or 'passive' use and eligible for claim of depreciation.

Further Part-II of Schedule VI to the Companies Act required that if no provision is made for depreciation, the fact that no provision has been made and quantum of arrears of depreciation computed in accordance with Section 205 (2) of the Companies Act should be disclosed. Provision of depreciation is essential to show a true and fair picture of financial statement.

Thus, the auditor should ensure compliance with all these requirements.

15. (a) Appointment of First Auditors by the Board: Apparently, there are two issues arising out of this situation, viz., first one relates to appointment of first auditor by the Board of Directors; and second, pertains to relation of such an auditor with the Chairman of the company. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditors, it may be noted as per the provisions of Section 224(5) of the Companies Act, 1956, the first auditor of a company shall be appointed by the Board of Directors within one month of the date of registration of the company. As per the facts given in the case, the Board has failed to appoint the first auditor within one month of the registration of company because the date of incorporation of White Ltd. is 1-8-2011 and the date of appointment of auditors by the Board of Directors is 4-9-2011. Therefore, provisio of Section 224(5) becomes operational. Accordingly if the Board fails to appoint the first auditor, the White Ltd. in general meeting has to make the appointment. Thus the appointment of Mr. S is not valid. Under the circumstances, the second issue

relating to relationship of auditor with the Chairman becomes redundant.

(b) Ceiling on Number of Company Audits: According to Section 224(1B) of the Companies Act, 1956 certain chartered accountants cannot hold more than the specified number of company audits. The specified number is to be computed in the following manner:

In the case of firm of chartered accountants, the specified number should be construed as twenty companies (out of which not more than ten may have a paid-up share capital of rupees twenty five lakhs or more) per such partner who is not in whole-time employment elsewhere.

In the firm of M/s Ram, Shyam Mohan, Ram is in whole-time employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. If Shyam and Mohan do not hold any audits in their personal capacity or as partners of other firms, the total number of company audits that can be accepted by M/s Ram, Shyam, Mohan, is forty, out of which not more than twenty companies may have a paid-up share capital of rupees twenty five lakhs or more.

Branch audits are not to be counted in computing this specified number. Therefore, it does not matter whether ABC Ltd. is having twenty branches. Audits of the accounts of foreign companies are also not to be included within the specified number as such companies are outside the scope of section 224.

Thus the acceptance of audit of ABC Ltd. and its twenty branches will accordingly be within specified limits.

16. (a) Adjustment and disclosure of surplus on account of changes in the basis of accounting and non-recurring losses : AS 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" states that any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.

Transactions which are of an abnormal on non-recurring nature may also be considered material, even though prima facie, they do not appear to be material.

Materiality is an important and relevant consideration in determining whether or not such exclusion/non-disclosure will distort the true and fair view of the financial statements. Thus, it would be important that users must know the quantum of non-recurring loss. In offsetting and aggregating items care need to be taken to ensure that material items are not offset against each other.

Accordingly, it would not be prudent to set off the surplus emanating from a 'change in the basis of accounting' against a 'non-recurring loss'. Accordingly, it would be better to disclose surplus on account of change in the basis of accounting and non-recurring loss separately.

(b) Non-disclosure of interest of directors in records maintained by the company
A company is required to maintain a register under section 301 in terms of section 297 of the Companies Act, 1956. While auditing the company accounts, the CARO 2003 requires the auditor to verify such transactions.

It is quite likely that there may be situations where the company has not properly maintained the register required to be maintained by it under section 301.

In such a case, the auditor should obtain the necessary information regarding the loans taken by the company from companies, firms or other parties in which the directors are interested, from the management of the company. However, while reporting on this clause, the auditor should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register.

If the interest of a director in a transaction, entered into by the company has not been disclosed in the record maintained by the company, as required by Section 301 of the Companies Act, 1956 the auditor would not be responsible for failure to track down the frauds, provided also that there did not exist any circumstances to arouse his suspicion that some information had been held back deliberately and had duly reported the violation of the legal requirements. So long as there is no such suspicion, he is only expected to exercise normal caution and care.

Special Audits

17. (a) Audit of Leasing Transactions : In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor.

(i) the object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure whether company can undertake financing activities or not.

(ii) Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.

(iii) The lease agreement should be examined and the following points may be noted:

(1) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or makings to be attached to the equipment).

(2) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

(3) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.

(4) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

(iv) Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.

(v) Ensure that the invoice is retained safely as the lease is a long-term contract.

(vi) Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.

(vii) See the Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.

(viii) See that the copies of the insurance policies have been obtained by the lessor for his records.

(b) Government Expenditure Audit: Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

(i) *Audit against Rules & Orders*: The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) *Audit against Provision of Funds*: It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iii) *Performance Audit*: This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. 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.

18. Special Points in Audit of a Partnership Firm: Matters which should be specially considered in the audit of accounts of a partnership firm are as under:

    (i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

    (ii) Examine the partnership deed signed by all partners and its registration with the registrar of firms. Also ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.

    (iii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans, purchase of assets, extraordinary contracts entered into and other such matters which are not of a routine nature.

    (iv) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

    (v) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

    (vi) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreement.

    (vii) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners. Also see various requirements of legislations applicable to the partnership firm like Section 44(AB) of the Income-tax Act, 1961 have been complied with.

    (viii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

Standards on Auditing and Guidance Notes

19. (a) As per SA 620, "Using The Work of an Auditor's Experts", The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

    (i) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;

    (ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

(iii) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(1) Agree with that expert on the nature and extent of further work to be performed by that expert; or

(2) Perform further audit procedures appropriate to the circumstances.

(b) As per SA 299,"Responsibility of Joint Auditors", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.

However, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(v) for ensuring that the audit report complies with the requirements of the relevant statute

20. (a) Meaning of Subsequent Events: SA 560 "Subsequent Events", defines the term 'subsequent events" as events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report., "subsequent events" also refer to significant events which occurred upto the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor.

(b) Consideration of Subsequent Events by the Auditor: SA 560 requires that the auditor should consider the effect of subsequent events on the financial statements and the auditor's report. However, the exact manner of treatment would depend upon whether the event falls in the category of 'adjusting event' or 'non-adjusting event'. As per Accounting Standard (AS) 4, events occurring after the date of the balance sheet are of two types, viz., adjusting events which provide further evidence of conditions that existed at the date of the balance sheet; and, non-adjusting events are those which are indicative of conditions that arose subsequent to the date of the balance sheet.

Therefore, an auditor is required to consider all subsequent events while discharging his duties and determine whether those shall have to be adjusted or simply required to be disclosed. However, the auditor should perform work as near as practicable to the date of the auditor's report.

(c) Audit Procedures: The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedure to identify "subsequent events" requiring adjustment or disclosure in financial statements as laid down in SA 560 is as under:

(i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(ii) Inquiring of management and, where appropriate, those change with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

Ø Whether new commitments, borrowings or guarantees have been entered into.

- Ø Whether sales or acquisitions of assets have occurred or are planned.
- Ø Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Ø Whether there have been any developments regarding contingencies.
- Ø Whether there have been any developments regarding risk areas and contingencies.
- Ø Whether any unusual accounting adjustments have been made or are contemplated.
- Ø Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Ø Whether any events have occurred which are relevant to the measurement of estimates or provisions made in the financial statements.
- Ø Whether any events have occurred which are relevant to the recoverability of assets.

  (1) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

  (2) Reading the entity's latest subsequent interim financial statements, if any.

  (3) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

  (4) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or

  (5) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.