

Test Series: February, 2012

MOCK TEST PAPER – 1

IPCC/PCC: GROUP – II / GROUP – I

PAPER – 6/2: AUDITING AND ASSURANCE

Question No.1 is compulsory.

Attempt any five questions from the remaining six questions.

Time Allowed – 3 Hours

Maximum Marks – 100

1. Give your comments and observations on the following
 - (a) In a system based audit, test checking approach provides a good base for the auditor to form his opinion on the financial statement. (5 Marks)
 - (b) Auditor is responsible for expressing opinion on financial statements in statutory audit. (5 Marks)
 - (c) The first auditors of Public Ltd, a Government company was appointed by the Board of directors. (5 Marks)
 - (d) 'Doing a statutory audit is full of risk'. Narrate the factors which cause the risk. (5 Marks)
2.
 - (a) Discuss briefly the features of an effective system of internal control over wages and salaries in a large factory. (8 Marks)
 - (b) With reference to Government Audit, what do you understand by "Audit of Commercial Accounts"? (8 Marks)
3.
 - (a) Megaworld Pvt Ltd. is a in the business of multiplex and restaurant. Restaurant is adjoining to the multiplex. There has been a theft from ticket collection box. State how as an auditor you would conduct the audit of Megaworld Pvt Ltd. (8 Marks)
 - (b) The management of Smita Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. It wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management. Comment. (8 Marks)
4.
 - (a) M/s. XYZ, a partnership firm, approaches you and enquires, whether it is necessary for them, under any statute or otherwise, to get their accounts audited. You are required to advise them, explaining briefly the advantages of audit of a partnership firm. (8 Marks)

- (b) SK Ltd. has fully computerised its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories at the year end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. (8 Marks)
5. As an auditor, comment on the following situation/statements:
- (a) Government of India has appointed Mr. M, a retired Finance Director and a non-practising member of the Institute of Chartered Accountants of India, as an auditor to conduct special audit of ABC Ltd. on the ground that the company was not being managed on sound business principles. The Managing Director of the company contends that the appointment of Mr. M is not valid because he does not hold a certificate of practice. (8 Marks)
- (b) Sri & Company, a firm of Chartered Accountants was appointed as statutory auditors of Aaradhana Company Ltd.. Aaradhana Company Ltd. holds 51 % shares in Sarang Company Ltd.. Mr. Sri, one of the partners of Sri & Company, owed ₹ 1,500 as on the date of appointment to Sarang Company Ltd. for goods purchased in normal course of business. (8 Marks)
6. Answer the following:
- (a) AB Ltd. is a company in which 20% of the paid up share capital is held by a State Government and 31% of the paid up share capital is held by a Government Company. Who will appoint the auditor of AB Ltd? Also state other categories of companies to which provision of section 619B is applicable. (8 Marks)
- (b) State the matters which the statutory Auditor should look into before framing opinion on accounts on finalisation of audit of accounts? Discuss over all audit approach. (8 Marks)
7. Write short notes on any four of the following:
- (a) Internal evidence and External evidence.
- (b) Substantive Procedures
- (c) Importance of Working Papers
- (d) Reissue of redeemed debentures.
- (e) Cut-off procedure. (4 × 4 = 16 Marks)

MOCK TEST PAPER – 1
IPCC/PCC: GROUP – II /GROUP – 1
PAPER – 6/2: AUDITING AND ASSURANCE
SUGGESTED ANSWERS/HINTS

1. (a) **Test Checking in System Based Audit:** System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that:
- (i) All the transactions and information have been recorded,
 - (ii) Fraud and errors, if any, in preparing the accounts will be identified,
 - (iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,
 - (iv) There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he resorts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

- (b) The objective of the audit of the financial statements prepared within a framework of recognized accounting policies and practices and relevant statutory requirements if any, is to enable an auditor to express an opinion on such financial statements. As per the requirements of section 227 of the Companies Act, 1956, the Auditor is required to express his opinion on (i) whether books of account as required by law have been kept by the company so far as it appears from the examination of the

books and proper returns adequate for the purpose of audit have been received from branches not visited by them (ii) Whether the accounts give the information required by the act in the manner so required (iii) whether the accounts give a fair view in case of the balance sheet, the state of the companies affairs and in case of the profit and loss account of the profit and loss for the year. The auditor is responsible for forming and expressing his opinion on the financial statements. However, the responsibility for their preparation is that of the management of the enterprise. Management responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application statements do not relieve the management of its responsibilities....

- (c) Sec.224 (5) of the companies Act 1956(the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company”. However, in the case of a government Company, the appointment or reappointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. Hence in the case of Public Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India. Thus the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd. is null and void.
- (d) 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 may cause 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 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.

2. (a) (i) Personnel Department should keep record for each employee showing particulars of employment, retirement or dismissal, rates of pay, increment, leave, specimen signatures etc.
- (ii) Identity cards should be issued to all employees at the time of employment.
- (iii) Time keeping and attendance recording function should be separated from pay roll preparation.
- (iv) Overtime should be authorised by a competent official.
- (v) Preparation of wages and salary bills should be done by members of the staff who are not connected with maintaining a record of their attendance.
- (vi) Gross pay for each wage period should be compared with the corresponding amount for the previous wage period and differences due to increments, promotions etc. should be reconciled.
- (vii) Duties of different clerks employed for preparation of wages and salaries bills should be rotated so that the calculations, additions & extensions are not carried out by same clerk every month.
- (viii) Supervisor authorities should be present at the time of payment to identify the employees.
- (ix) The system of engaging casual Labourers should receive particular attention. Functions like engagement of casual labour, record of their work, and payment of their wages should be properly segregated.
- (x) Signatures of the employees to whom the payment is being made should also be obtained. In case the payment is made to someone else, written authority should be obtained.
- (xi) Surprise checks should be conducted at the time of wage payment by a responsible official independent of the wages and salaries department.
- (xii) Unclaimed wages and salaries should be immediately recorded in the unpaid wages and salaries register & their subsequent payment should be made only on the specific claim of the employees.
- (xiii) Deductions on account of Provident funds, Employees State Insurance contributions etc. should be regularly made. A responsible person should satisfy himself whether remittances of such deductions have been properly made to the statutory authorities.
- (xiv) Recoveries in respect of loans towards house building, P.F. loans etc. should be regularly made.

- (xv) Examine reimbursement of certain expenses like conveyance charges, mileage claims etc.
- b. **Audit of Commercial Accounts:** The government also engages in commercial activities and for the purpose it may incorporate following types of entities:
 - (i) Departmental enterprises engaged in commercial and trading operations, which are governed by the same regulations as other Government departments such as defence factories, mints, etc.
 - (ii) Statutory corporations created by specific statutes such as LIC, Air India, etc.
 - (iii) Government companies, set up under the Companies Act, 1956.

All aforesaid entities are required to maintain accounts on commercial basis. The audit of departmental entities is done in the same manner as any Government department, where commercial accounts are kept. Audit of statutory corporations depends on the nature of the statute governing the corporation. In respect of government companies, the relevant provisions of Companies Act, 1956 are applicable. As per section 619 of the Companies Act, 1956 the statutory auditor of a Government company shall be appointed or re-appointed by the CAG. Such an auditor must be a chartered accountant. Further, the Companies Act, 1956, provides that the CAG shall have the powers:

- (i) to direct the manner in which the company's accounts shall be audited by the auditor, and to give the auditor instructions in regard to any matter relating to the performance of his functions; and
- (ii) to conduct a supplementary or test audit of the company's accounts by such person, as he may authorise in this behalf, and for the purposes of such audit to require information or additional information to be furnished to any person or persons, so authorised on such matters by such person or persons, and in such form as the CAG may direct.

The statutory auditor shall submit a copy of his audit report to the CAG, who shall have the right to comment upon or supplement the audit report in such manner he may think fit.

Any such comments upon or supplement to the audit report shall be placed before the company, at the same time, and in the same manner, as the audit report. Thus, it is seen that there is a two layer audit of a Government company, by the statutory auditors, being qualified chartered accountants, and by the CAG. The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

3. (a) As an auditor Megaworld Pvt Ltd. following must be taken into account:

Constitution:

- Noting the financial powers of the executives and the managing committee;
- Checking the Rules, Regulations and Bye laws applicable to the Theatre;
- Ascertainment of the objects for which the license have been issued have been complied with or not;

Minute Books :

Scrutinize the minutes of the meetings of Managing committee as regards various financial decisions including various decisions and resolutions affecting accounts requirement etc.

Income Sale of Tickets:

Since there has been a theft from the ticket collection box auditor must ensure the effectiveness of the internal control with respect to ticket collection. Surprise physical verification of cash collection must be made at the end of any show to ensure that the collections received are recorded in the books. Other points which must be considered are as follows:

- Ensure that entry to the Cinema Hall during the show is through printed tickets only which are serially numbered and bound into books;
- Verify whether the printed tickets have been endorsed by Commercial Tax Authorities;
- Separate series of tickets is used for Advance Bookings & Free Passes are properly authorized;
- Stock of unsold tickets have been kept in the custody of Responsible Official;
- Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows, based on Daily Statements;
- Reconcile the amount of Entertainment Tax collected with the total number of tickets are issued for each class;

Advertisement Receipts:

Verify the advertisement charges collected with reference to the Agreements entered into with the Advertisers; Cross verify the Advertisement Income based on Register of Slides & Shots Exhibited kept at the Cinema Hall;

Refreshment & Restaurant Income:

Enquire the arrangement for collection of share in the restaurant income, i.e. fixed % sharing or Fixed Amount charged etc. Ensure whether the income is

properly accounted for; Ensure closing stock of food stuffs, cold drinks, etc. have been duly considered and issues and purchases have been properly authorized;

Rental & Investment income:

Rental income with Rent receipts and agreements;

Dividend and Interest income, verify the securities in respect of investments held; Verify whether purchase and sale of investment have been properly authorized.

Expenditure:

Ascertain the operation of internal control system over various heads of expenditure;

Vouch the expenditure incurred on advertisement, repair and maintenance;

Verify whether proper sanction exists in respect of regular administrative expenditure like salaries, printing, stationery etc.; Verify whether adequate distinction has been made between capital and revenue expenditure; Vouch payments towards film hire, with bills of distributors and underlying agreements;

Taxation & Statutory Compliance:

Verify whether proper tax liability has been assessed and Return of Income was filed within due date; All taxes collected have been remitted to proper authorities on timely basis; All statutory obligations have been remitted to proper authorities on timely basis;

General

Verify the fixed assets and ensure that adequate depreciation is provided; Examine unadjusted balances out of advances paid to the distributors against film hire contract, to see they are good and recoverable; Verify that all advances in respect of films already run have been duly adjusted; Ensure that income against advance tickets sold have been duly accounted for and that at the end of year are shown under liability; Verify all the Balance sheet items and verify whether appropriate provisions have been made for replacement of current assets; Compute significant Ratios and seek appropriate explanation for significant deviations; Verify whether the form and manner of presentation of Financial Information conforms to Accounting Standards and applicable legal requirements; Obtain appropriate management representations and certificates in respect of various aspects covered during the course of audit.

- (b) **Management Representation:** The management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. There cannot be any restriction on scope of audit in case of statutory audit.

The management representation, according to SA 580 - Written Representations, cannot substitute other audit evidence that the auditor could reasonably expect to be available to the auditor.

The audit evidences available for checking receivables- say, invoices, debt acknowledgement documents, receipts, statement of accounts, confirmations etc., are available evidences which auditor is duty bound to verify.

Just because management had owned responsibility for the correctness of its evaluation of receivables, the auditor cannot shirk his responsibility. This is negligence on his part if he relies on the management representation without assessing the corroborative available evidences.

4. (a) The Indian Partnership Act, 1932 does not prescribe audit of a partnership firm. Nevertheless, for the verification of adjustment in the accounts of partners made in respect of profits and losses, interest and remuneration of partners, their contribution to capital, etc. It is necessary that the auditor should have a knowledge of the provisions in this regard under the Act—especially that of powers and audit of partners and their right to profit and capital under different situations and circumstances. The auditor may, particularly, ensure application of accounting standards prescribed by the Institute. In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards. Alternatively, only disclosure of non-compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

Advantages

On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

- (i) Audited accounts provide a convenient and reliable means of settling accounts between the partners and thereby possibility of dispute among them is mitigated.
- (ii) On the retirement/death of a partner, audited accounts constitutes a reliable evidence for computing the amount due to the retiring partner or representative of deceased partner.
- (iii) Audited accounts are generally accepted by the Income tax authorities for computing the assessable income.
- (iv) Audited accounts are relied upon by banks for advancing loan.
- (v) Audited accounts can be helpful in the negotiation for sale or admission of a new partner.
- (vi) It is an effective safeguard against any undue advantage being taken by a working partner as against the non working partners.

- (b) On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at stocktaking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management. CARO 2003 requires specific comment by auditor as to the adequacy, reasonableness of the physical verification of inventory. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for. In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year. Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. If the management does not accept to the auditor's view the auditor may appropriately make qualifications in his audit report.
5. (a) **Appointment of Special Auditor:** Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.
- Amongst others, one of the circumstances specified is, in case, a company is not being managed in accordance with sound business principles or prudent commercial practices.
- Such an audit aims at providing the government with a critical appreciation of the company and its financial position.
- The audit may be conducted either by the company's auditor or another Chartered Accountant who may or may not be engaged in a practice, appointed by the Central Government. The auditor appointed has the same power and duties in the matter of special audit as the statutory auditor of a company has, except for the fact that he must report to the Central Government in place of member of the company. .
- Conclusion:** In view of the above provisions of the Companies Act, 1956, the appointment of Mr. M, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Managing Director is not correct.
- (b) Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees.
- This provision aims to ensure that the auditor is independent and under no financial obligation to the company.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company.

Sub section(4) of the Section 226 further lays down that a person is not eligible for appointment as auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company. Similarly A firm of auditors acts through its partners hence no partner should be indebted even in his personal capacity to the entity being audited the debt arising from normal course of business of the entity should also be record for indebtedness.

Conclusion: Accordingly, the partner Mr Sri is disqualified to be appointed as auditor of the company as he is indebted to the company for an amount exceeding Rs. 1000. This disqualification is attracted even if it exists on any date during the relevant accounting year.

Due to disqualification of Mr. Sri, Sri & Co., is also disqualified to be appointed as an auditor of Aaradhana Company Ltd.

6. (a) Section 619 of the Companies Act, 1956, the auditor of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. The provision applicable to the appointment of auditor of government companies also apply to another category of companies, even though they are not government companies as contained in section 619B of the Act. As per section 619B of the Companies act 1956 the provisions of section 619 apply to a company in which not less than 51% of the paid up share capital is held by one or more of the following or any combination thereof:
- (i) the Central Government and one or more government companies;
 - (ii) any State Government or Governments and one or more government companies;
 - (iii) the Central Government, one or more State Governments and one or more government companies;
 - (iv) the Central Government and one or more corporations owned or controlled by the Central Government;
 - (v) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;
 - (vi) one or more corporations owned or controlled by the Central Government or the State Government;

- (vii) more than one government company; the auditor of such a company shall be appointed by the Central Government on the advice of the Comptroller and Auditor General of India.

Therefore provisions of section 619 will be applicable to AB Ltd. as a Government Company and the State Government hold 51% of the paid-up share capital of AB Ltd. together.

- (b) **Formation of opinion on accounts:** The principal aspect to be covered in an audit to form an opinion, an auditor has to look into following matters:
 - (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.
 - (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
 - (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
 - (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
 - (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
 - (vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
 - (vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
 - (viii) Verification of the liabilities stated in the balance sheet.
 - (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
 - (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.

- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties of auditor are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

7. (a) **Types of Audit Evidence:** There are two types of Audit evidence:

Internal evidence and external evidence: Evidence which originates within the organization being audited is internal evidence. Example – sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization; for example, purchase invoice, supplier's challan and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g., an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

(b) **Substantive Procedures:** These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions

- (i) The asset or a liability should exist at a given date.
- (ii) The asset should be owned by the entity and the liability is an obligation of the entity at a given date.
- (iii) There should not be any unrecorded assets, liabilities or transactions.
- (iv) Assets or liabilities should be recorded at appropriate carrying values.
- (v) Transaction or event that took place should pertain to the entity during the relevant period.
- (vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period.
- (vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

(c) **Importance of Working Papers**

Audit working papers constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and the clients record.

These includes retention of permanent record in the nature of a document to show the actual audit work executed , the nature of work, the extent of work and the important points, facts, dates and decisions having bearing on the audit of the accounts audited. The audit working papers are found very useful in the following aspects as they:

- (i) It provides guidance to the audit staff with regard to the manner of checking the schedules.
- (ii) The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.
- (iii) It acts as evidence in the court of law when a charge of negligence is brought against the auditor.
- (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

- (d) **Re-issue of redeemed debentures:-** A company may issue debentures previously redeemed, either by reissuing the debentures or by issuing others in their place unless the Articles or a contract or resolution, recorded at a General Meeting, or terms of issue or some other act of the company expressly or impliedly manifest the intention that, on redemption, the debentures shall be canceled. However, the re-issue of redeemed debentures or the issue of others in their place are treated as a new issue for the purpose of stamp duty and the rights and privileges attaching to the debentures that re-issued shall be the same as if the debentures had never been redeemed. On these considerations, it is necessary for the auditor to verify the re-issue of debentures in the same manner as those issued for the first time.
- (e) **Cut off procedure:** - Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as “cut-off arrangement”. It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and stock are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and stock. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:
- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
 - (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of stock into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking for perfect and correct presentation in the financial statements.

Test Series: March, 2012

MOCK TEST PAPER – 2

IPCC/PCC: GROUP – II / GROUP – I

PAPER – 6/2: AUDITING AND ASSURANCE

Question No.1 is compulsory.

Attempt any five questions from the remaining six questions.

Time Allowed – 3 Hours

Maximum Marks – 100

1. Give your comments and observations on the following:
 - (a) One customer from whom ₹ 10 lakhs are recoverable for credit sales gives a motor car in full settlement of dues. The directors estimate that the market value for the motor car transferred is ₹ 10.50 lakhs. As on the date of the balance sheet the car has not been registered in the name of auditee.
 - (b) “In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed” Comment.
 - (c) Pepsi Ltd. installed a new water treatment plant at its factory on 1.10.2010. The company estimated that the new plant will become obsolete after 4 years only and hence charged depreciation at a rate higher than that envisaged in Schedule XIV to the Companies Act. During the year 2010-11, the company therefore had written off 1/4th of the cost.
 - (d) PQR Ltd. having ₹ 40 lacs paid up capital, ₹ 9.50 lacs reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 4.90 crores, ₹ 4.50 crores and ₹ 6 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. (4 × 5 = 20 Marks)
2.
 - (a) Write a short note on audit risk. (2 Marks)
 - (b) What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool. (8 Marks)
 - (c) Can the External Auditor rely upon the work of an Internal Auditor? (6 Marks)
3.
 - (a) “The Auditor should consider the effect of subsequent events on the financial statements and on auditors report” according to SA 560-Comment. (8 Marks)
 - (b) What are Audit Working Papers and why they should be carefully preserved by the Auditor? (8 Marks)
4.
 - (a) When can a Company change its accounting policy? (4 Marks)
 - (b) Write a short note on Sweat Equity Shares. (4 Marks)

- (c) What are the special steps involved in framing a system of Internal Check? (8 Marks)
5. Give your comments and observations on the following:
- (a) XYZ Ltd. appointed Mr. Mohan as an auditor in the Annual General Meeting. Mr. Mohan refused to accept the appointment, whether the board of directors could fill up the vacancy..
 - (b) *NM & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Various co-operative and term lending institutions held 51% of the paid-up share capital of the company.*
 - (c) The auditor of Trilok Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.
 - (d) Mr. L, a chartered accountant in full-time practice, was acting as the statutory auditor of a public limited company, till it was wound up. Mr. L was appointed as the liquidator for purposes of winding up proceedings. (4 × 4 = 16 Marks)
6. (a) How will you vouch and/or verify the following ?
- (i) Trade Creditors.
 - (ii) Wages paid to seasonal labourer. (4 × 2 = 8 Marks)
- (b) Draft an Audit Programme to audit the accounts of a Recreation Club with facilities for indoor games and in-house eating. (8 Marks)
7. Write short notes on any four of the following:
- (a) Concept of materiality.
 - (b) Advantages of statistical sampling in Auditing.
 - (c) Contents of Audit Note Book
 - (d) Examination in Depth. (4 × 4 = 16 Marks)

MOCK TEST PAPER – 2
IPCC/PCC: GROUP – II /GROUP – 1
PAPER – 6/2: AUDITING AND ASSURANCE
SUGGESTED ANSWERS/HINTS

- 1 (a) According to AS – 10, Accounting for Fixed Assets, when fixed asset is acquired in exchange or in part exchange for another asset, the cost of asset acquired should be recorded either at fair market value or at the net book value of the asset given up. In the present case the latter is more evident (₹ 10 lakhs given up) than the fair value of motor car (₹ 10.50 lakhs estimated by the directors). Hence, the Customer's account should be credited with ₹ 10 lakhs and the motor car recorded at the same account.

AS – 1, Disclosure of Accounting Policies, the accounting treatment and presentation in the financial statements of transactions and events should be governed by their substance and not merely by legal form. The motor car has not been registered in the name of the company on the date of the balance sheet in the present case. Taking accounting principle of substance over form into consideration as laid down by AS – 1 the auditor should ensure that the car's acquisition is recorded in the present year though the car is not registered in the name of the auditee.

- (b) **Selection of Audit Sample:** Audit Sampling means the application of audit procedures to less than 100% of the items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

- (c) As per AS-6 on Depreciation Accounting, assessment of depreciation and the amount to be charged in respect thereof in an accounting year/period are usually based on the following three factors:-

- (i) Historical Cost.
- (ii) Expected useful life of the asset.
- (iii) Estimated residual value of the asset.

If the management's estimate of the useful life of an asset is shorter than that envisaged under the relevant statute (Companies Act) the depreciation is appropriately computed by applying a higher rate. The depreciation rate provided in Schedule XIV is the minimum rate and a company can charge higher than those prescribed. Hence, in the instance case decision of Pepsi Ltd., to write off the cost of water treatment plant over four years is absolutely correct and as per AS-6.

However, the company has wrongly charged full year's depreciation during 2010-11 instead of half year's depreciation as per requirement of Schedule XIV. The auditor should highlight this to the company and ask to rectify the same.

- (d) Internal Audit System and CARO, 2003: As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies. For other companies, it is applicable if either of the following conditions is satisfied:

- a. The company has a paid-up capital and reserves exceeding ₹ 50 lakhs at the commencement of the financial year, or
- b. The company has an average annual turnover of ₹ 5 crores or more for a period of 3 years preceding the current financial year.

In the instant case, the second condition has been fulfilled by JKT Ltd. Hence, the auditor will have to mention in his report the fact of not having such internal audit in his report by the Company.

2. (a) Audit Risks: As per "SA 200 (Revised) Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- (b) Audit Trail: 'Audit trail' refers to a situation where it is possible to relate, on a "one – to –one" basis, the original input with the final output. In a manual accounting system, it is possible to relate the recording of a transaction of each successive

stage enabling an auditor to locate and identify all documents from beginning to end for the purposes of examining documents, totalling and cross – referencing. In first and early second generation computer systems, a complete audit trail was generally available. However, with the advent of modern machines, the EDP environment has become more complex. This led to use of exception reporting by the management which effectively eliminated the audit trail between input and output. The lack of visible evidence may occur at different stages in the accounting process, for example:

- i. Input documents may be non-existent where sales orders are entered online. In addition, accounting transactions such as discounts and interest calculations may be generated by computer programmes with no visible authorization of individual transactions.
- ii. The system may not produce a visible audit trail of transactions processed through the computer. Delivery notes and suppliers invoices may be matched by a computer programme. In addition, programmed control procedures such as checking customer credit limits, may provide visible evidence only on an exception basis. In such cases, there may be no visible evidence that all transactions have been processed.
- iii. Output reports may not be produced by system or a printed report may only contain summary totals while supporting details are retained in computer files.

Special audit Techniques: In the absence of audit trail, the auditor needs the assurance that the programmes are functioning correctly in respect of specific items by using special audit techniques. The absence of input documents or the lack of visible audit trail may require the use of Computer Assisted Audit Techniques (CAATs) i.e. using the computer as an audit tool. The auditor can use the computer to test:

the logic and controls existing within the system, and
the records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. The effectiveness and efficiency of auditing procedure may be enhanced through the use of CAATs. Properly, two common types of CAATs are in vogue, viz., test pack or test data and audit software or computer audit programmes.

- (c) **Reliance on the Work of Internal Auditor:** The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors ", factors that may affect the external

auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external

auditor; and

- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

3. (a) **Effect of Subsequent Events:** SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of financial statements and the date of the audit report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events, the auditor should:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) 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 that are relevant to the measurement of estimates or provisions made in the financial statements.
 - Ø Whether any events have occurred that are relevant to the recoverability of assets.
- (c) 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.
- (d) Reading the entity's latest subsequent interim financial statements, if any.
- (e) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
- (f) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or
- (g) 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.

- (b) **Audit Working Papers:** As per SA 230(Revised) "Audit Documentation" Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

Working papers are the

- (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and
- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides they serve a number of additional purposes, including the following:

- Ø Assisting the engagement team to plan and perform the audit.

- Ø Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Ø Enabling the engagement team to be accountable for its work.
- Ø Retaining a record of matters of continuing significance to future audits.
- Ø Enabling the conduct of quality control reviews and inspections.
- Ø Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Retention of working papers: Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

4. (a) **Change in Accounting Policies:** Same accounting policies are adopted for similar events or transactions in each period so as to enable the user to compare the financial statements of an enterprise over a period of time. However, Accounting Standard 5, "Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies" provides that accounting policies can be changed under the following circumstances:
 - (1) if the adoption of a different accounting policy is required by statute; or
 - (2) for compliance with an accounting standard; or
 - (3) if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise. AS 5 also requires any change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by AS 5 should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. For instance, how an enterprise should deal with intangible items appearing in its balance sheet when it applies AS 26, Intangible Assets, for the first time.

- (b) **Sweat Equity Shares:** The Companies (Amendment) Act, 1999 recognised that in the wake of globalisation of corporate sector, the employees will have to be rewarded suitably to share in the growth of a company.

By insertion of new section 79A, the employees may be compensated in the form of 'Sweat Equity Shares'. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled:

- (i) the issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;
- (ii) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (iii) not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;
- (iv) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

However, in the case of a company where equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the prescribed guidelines.

- (c) **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:

- (1) 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.
- (2) 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.
- (3) 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.
- (4) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

- (5) 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.
 - (6) The system of Budgetary Control should be introduced.
 - (7) 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.
 - (8) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
 - (9) Finally, the system must be capable of being expanded or contracted to correspond to the size of the concern.
5. (a) **Board's Powers to Appoint an Auditor:** The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is empowered to fill such a vacancy. Section 224(3) of the Companies Act, 1956, empowers the Central Government to fill up a vacancy in case no auditors are appointed or re-appointed at an annual general meeting (AGM). (It is also opined that the appointment of an auditor having been made by shareholders, sub-section (3) cannot be invoked Thus the auditor could only be appointed by shareholders at general meeting). Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor (s) appointed at the Annual General Meeting refuse to accept the appointment.
- (b) **Appointment of Auditors:** The implication of shareholding of 51% of paid-up capital by various co-operative and term lending institutions is two fold as discussed below:
- In terms of Section 224A of the Companies Act, 1956, a company in which not less than 25% of the subscribed share capital is held, whether singly or in any combination, by:
- (i) a public financial institution or a Government company or the Central Government or any state government; or
 - (ii) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or
 - (iii) a nationalised bank or an insurance company carrying on general insurance business,

the appointment or re-appointment of an auditor in the Annual General Meeting shall be made only by passing a special resolution.

In this case, NM & Co. were appointed as auditors of the public limited company where 51% of the paid-up share capital was held by co-operatives and term lending institutions. Presuming that such institutions are covered by the aforesaid criteria, passing a special resolution was necessary. Hence, the appointment of NM & Co., chartered accountants, was null and void provided such institutions are covered by Section 224A.

Section 619 B read with Section 619 of the Companies Act, 1956 requires that a company in which the central government or any state government or any government company or any government corporation hold either singly or jointly not less than 51% of the paid-up share capital, the auditors of such companies are to be appointed by the central government on the advice of the Comptroller and Auditor General of India.

However, the co-operative and term lending institutions are not covered within the definition of corporation/institution owned by the Central/State Government. Accordingly, the provisions of Section 619 will not apply in this case, although the co-operatives and term lending institutions hold majority share capital.

- (c) **Comment on Matters Contained under Section 227(1A) of the Companies Act, 1956:** Section 227(1A) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in non-reporting on the matters specified in Section 227(1A).
- (d) **Appointment of auditor as a liquidator:** Regulation 191 of the Chartered Accountants Regulations, 1988 allows a chartered accountant in practice, subject to the control of the Council, to act as a liquidator. But a chartered accountant at the same time cannot act both as liquidator and auditor of the company.

The Institute of Chartered Accountants of India, in order to establish a healthy convention, recommended that in cases where a chartered accountant acts as a liquidator, the statement of accounts to be filed u/s 551(1) of the Companies Act, 1956 should be audited by a qualified chartered accountant other than the chartered accountant who is the liquidator of the company.

The appointment of Mr L, chartered accountant, to carry out both the functions as a liquidator and as an auditor will not be proper having regard to the concept of auditor's independence. Thus Mr L, chartered accountant, cannot act both as the liquidator and the auditor.

6. (a) (i) **Trade creditors:**
- (a) Check the adequacy of cut off procedure to ensure that transaction of next period are not accounted and all transactions of year end are accounted.
 - (b) Check posting in the bought ledger from books of prime entry.
 - (c) Compare the balances in the schedule of creditors with balances in bought ledger.
 - (d) Compare the balances with the confirmation or statement of account received from trade creditors.
 - (e) Pay special attention to long outstanding items and enquire about the reason thereof.
 - (f) Verify subsequent payments and reversal entries in the bought ledger of year end entries.
 - (g) See that trade creditors are classified and shown in the balance sheet as per requirement of Schedule VI to the Companies Act 1956.
- (ii) **Wages Paid to Seasonal Labourers**
- (a) Ascertain and evaluate the internal control system for recruitment and usage of seasonal labourers.
 - (b) Examine that these labourers are hired on proper authority and the rates of pay are authorized at appropriate levels.
 - (c) Ensure that the attendance is properly checked by the Time Keeping Department.
 - (d) Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis.
 - (e) Check the computation of wages payable to the labourers, after taking into account the deductions.
 - (f) Confirm that all the payment to the labourers have been acknowledged.
 - (g) See the time and job records, to ensure that the labourers have been paid for time worked. See the treatment of abnormal idle time.
 - (h) Reconcile the number of seasonal labourers on payroll as per the Personnel Department's records vis-à-vis the number of labourers to whom the wages have been paid, to ensure that there are no ghost workers. This assumes

greater importance, if the seasonal labourers are hired on temporary basis, and not on permanent payroll.

- (b) (i) Examine the constitution, powers of governing body and relevant rules relating to preparation and finalisation of accounts. In case, it is constituted as a company limited by guarantee, application of provisions of the Companies Act, 1956 should also be seen.
- (ii) Vouch the receipt on account of entrance fees with members applications, counterfoils issued to them, and minutes of the Managing Committee.
- (iii) Vouch Members' subscription with the counterfoils of receipts issued to them. Trace receipts for a selected period to the Register of members; reconcile the amount of total subscription due with the amount collected and the outstanding. Check totals of various columns of the Register of Members and tally them across. See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery. The amount considered irrecoverable, if any should be written off.
- (iv) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscription received in advance have been correctly adjusted.
- (v) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests as well as with the fees chargeable for the special service rendered such as billiards, tennis, etc. Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
- (vi) Vouch purchase of sports items, furniture, crockery, etc., and trace their entries into the respective stock registers. Vouch purchases of food-stuffs, cigars, wines, etc. and test their sale price so as to confirm that the normal rates of profit have been earned on their sales.

The stock of unsold provisions and stores, at the end of the year should be verified physically and its valuation checked.
- (vii) Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.
- (viii) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts, also ascertain that the arrangements for their safe custody are satisfactory, check the accrual of income therefrom and provision of income tax thereon.

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

SA 320 on Materiality in Planning and Performing an Audit deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. SA 450 explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. Financial statement materially effected if such statement is erroneously stated or omitted to be stated therein and economic decision of the users taken on the basis of such information is influenced by such misstatement or omission.

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

- (b) **'Advantage of statistical sampling in auditing'**

- (i) The sample size does not increase in proportion to the increase in the size of population.
- (ii) The selection of more objective and is based on mathematical law of probability.
- (iii) This method gives a minimum sample size associated with a specified risk and precision level.
- (iv) It also provides a means for taking a calculated risk and corresponding precision i.e., the probable difference in the result due to checking of transaction on sample basis in lieu of checking the entire universe.
- (v) It may provide a better description of large mass of data than a complete examination of all the data.

- (c) **Contents of Audit Note book:** Audit note book contains large variety of matters observed during the course of audit. Significant matters observed during audit which should be recorded in audit note book are normally the following:

- (i) Audit queries not cleared immediately.
- (ii) Mistakes or irregularities observed during the course of audit.
- (iii) Unsatisfactory book-keeping arrangements, costing method.
- (iv) Important information about the company which is not apparent from the accounts.
- (v) Special points requiring consideration at the time of verification of annual accounts.

- (vi) Important matters for future reference.
- (d) **Examination in Depth:** It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt or payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, a purchase of goods may commence when a predetermined re-order level has been reached. The ensuing stages may be summarised thus:
 - (i) Requisitions are pre-printed, pre-numbered and authorised;
 - (ii) official company order, also sequentially pre-numbered, authorised and placed with approved suppliers only;
 - (iii) receipt of supplier's invoice;
 - (iv) receipt of supplier's statement;
 - (v) entries in purchases day book;
 - (vi) postings to purchase ledger and purchase ledger control account;
 - (vii) cheque in settlement;
 - (viii) entry on bank statement and returned "paid" cheque (if requested);
 - (ix) cash book entry;
 - (x) posting from cash book to ledger and control account, taking into account any discounts.
 - (xi) receipt of goods, together with delivery/advice note;
 - (xii) admission of goods to stores;
 - (xiii) indication, by initials or rubber stamp on internal goods inwards note, of compliance with order regarding specification, quantity and quality;
 - (xiv) entries in stores records.

It should be noted that the above list is not necessarily comprehensive, nor does its constituent stages inevitably take place in the sequence suggested. The important point to note is that from the moment it was realised that once a re-order level had reached, a chain of events was put in motion, together leaving what may be termed as "audit trail". Each item selected for testing must be traced meticulously, and although sample sizes need not be large, they must, of course, be representative.

It is an acceptable practice to check a slightly smaller number of transactions at each successive stage within a depth test, on the statistical grounds (based on

probability theory) that the optimum sample size decreases as the auditor's "level of confidence" concerning the functioning of the system increases. Examination in depth has been found indispensable in modern auditing practice and, if intelligently conducted, its reconstruction of the audit trail reveals more about the functioning (or malfunctioning) of the client's system in practice than the haphazard and mechanical approach to testing.