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PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

*Attempt any **five** questions from the remaining **six** questions.*

Question 1

Discuss the following:

- (a) *Despite of several disadvantages, audit programme is required to start an audit. (5 Marks)*
- (b) *The discipline of behavioural science is closely linked with the subject of auditing. (5 Marks)*
- (c) *The reliability of audit evidence is influenced by its source, nature and circumstances under which it is obtained. (5 Marks)*
- (d) *As per SA 530, meaning of audit sampling, sample design, sample size and selection of items for testing. (5 Marks)*

Answer

- (a) Despite several disadvantages, audit programme is required to start an audit.**
Despite of several disadvantages, the audit programme is required to start an audit due to the following considerations:
- (i) The audit programme lists down areas of audit before commencement.
 - (ii) The audit timing is built therein; thereby it becomes a schedule of audit plan
 - (iii) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.
 - (iv) It specifies the procedures to be checked during the audit.
 - (v) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.
 - (vi) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.
 - (vii) The working papers of the audit staff can be reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting on the financial statements.
 - (viii) It also helps in preparing a diary of the performance and plan and also base for billing the clients for the time and manpower involved in the audit.
- (b) The discipline of behavioural science is closely linked with the subject of auditing:**
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. However, 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.

- (c) The reliability of audit evidence is influenced by its source, nature and circumstances under which it is obtained. 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, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

- (d) **As per SA 530 on “Audit Sampling”**, the meaning of the term Audit Sampling is the application of audit procedures to less than 100% of 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.

As per SA 530, Requirements relating to Sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Question 2

State with reason (in short) whether the following statements are correct or incorrect. (any Eight)

- (a) *Rajat, an auditor recovers his fees on progressive basis is said to be indebted to company.*
- (b) *“Examination in depth” implies that the auditor vouches almost all transactions in a manner that the chances of not checking any transaction are left at minimum.*
- (c) *Branch auditor of a company should give photocopies of his working papers on demand by Company Auditor.*
- (d) *The first auditor of PQR Ltd., a Government company was appointed by the board of directors of company.*
- (e) *Mr. ‘R’, a practicing Chartered Accountant, is appointed as a “Tax Consultant” of MN Ltd., in which his father Mr. ‘C’ is the managing director.*
- (f) *Inherent and control risk, and detection risk have same meaning.*
- (g) *Deviation in accounting policies are to be reported in auditor’s report.*
- (h) *Financial Statements should show “True and correct” view of the affairs of the entity.*
- (i) *Events occurring after the balance sheet date must be disclosed in the financial statements.*
- (j) *Audit of Private Limited Companies are to be excluded while calculating ceiling on number of audits.*

(8 x 2 = 16 Marks)

Answer

- (a) **Incorrect.** According to the Research Committee of the Institute, a question often arises as to whether indebtedness arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed by the general meeting) the auditor recovers his fees on a progressive basis as and when a part of work is done without waiting for the completion of the whole job. Where in accordance with such terms, the auditor recovers his fees on a progressive basis, he cannot be said to be indebted to the company at any stage.

In view of the above, Rajat cannot be said to be indebted to the company.

- (b) **Incorrect.** Examination in depth implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction. 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.
- (c) **Incorrect.** As per SA 230 on "Audit Documentation", audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Main auditor does not have right of access to the working papers of the branch auditor. In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working papers and therefore, the branch auditor is under no compulsion to give photocopies of his working papers to the principal auditor of the Company.

- (d) **Incorrect.** Section 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". Thus, the first auditor of a company can be appointed by the Board of Directors within one month from the date of registration of the company. However, in the case of a Government Company, the appointment or re-appointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. Hence in the case of PQR 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 PQR Ltd., is null and void.

- (e) **Correct.** A chartered accountant appointed as an auditor of a company, should disclose his interest while making the audit report. If this disclosure is not made, it would amount to "misconduct" under the Chartered Accountants Act, 1949.

In this case, Mr R is a "Tax Consultant" and not a "Statutory Auditor" of MN Ltd., hence he is not liable to disclose his relationship with Managing Director of the company except as required by Section 349 of the Companies Act, 1956.

- (f) **Incorrect.** Inherent and control risks differ from detection risk in that they exist independently of an audit of financial information. Inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce an acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.
- (g) **Incorrect.** It is not that all deviations in accounting policies be reported in the auditor's report. Only those deviations in accounting policies are to be reported in the auditor's report in respect of which proper disclosure regarding such deviations in the accounting policies have not been made.
- (h) **Incorrect.** Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. The application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. A statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

- (i) **Incorrect. As per AS-4 on "Contingencies and Events Occurring After the Balance Sheet Date"**, Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.
- (j) **Incorrect.** The Companies (Amendment) Act, 2000 has amended Section 224(1B) by adding a proviso that audit of private companies are not to be counted in computation of ceiling limit. An auditor can accept audit of any number of private companies. This, however, is subject to guidelines of the Institute which provide restriction in respect of private companies as well. The Council of ICAI has specified a ceiling of 30 audit assignments per person, whether in respect of private companies or other companies.

Question 3

- (a) *Explain inherent limitations of internal control systems.* (8 Marks)
- (b) *With reference of SA 250 give some examples or matters indicating to the auditor about non compliance of laws & regulations by management.* (8 Marks)

Answer

- (a) Internal control can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as:-
- (i) Management's consideration that cost of an internal control does not exceed the expected benefits.
 - (ii) Most controls do not tend to be directed at unusual transactions.
 - (iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.
 - (iv) The possibility that control may be circumvented through collusion with employees or outsiders.
 - (v) The possibility that a person responsible for exercising control may abuse that authority.
 - (vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.
 - (vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.
 - (viii) Inherent limitations of Audit.
- (b) As per SA 250 on "Consideration of Laws and Regulation in an Audit of Financial Statements", the following are examples or matters indicating to the auditor about non-compliance with laws and regulations by management :
- ◆ Investigations by regulatory organisations and government departments or payment of fines or penalties.
 - ◆ Payments for unspecified services or loans to consultants, related parties, employees or government employees.
 - ◆ Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
 - ◆ Purchasing at prices significantly above or below market price.
 - ◆ Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
 - ◆ Unusual payments towards legal and retainership fees.
 - ◆ Unusual transactions with companies registered in tax havens.
 - ◆ Payments for goods or services made other than to the country from which the goods or services originated.
 - ◆ Payments without proper exchange control documentation.

- ◆ Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- ◆ Unauthorised transactions or improperly recorded transactions.
- ◆ Adverse media comment.

Question 4

How will you vouch and verify the following?

- (a) *Remuneration paid to directors.*
 - (b) *Assets acquired on hire purchase.*
 - (c) *Profit or loss arising on sale of plots held by real estate dealer.*
 - (d) *Advertisement expenses.*
- (4 x 4 = 16 Marks)

Answer**(a) Remuneration paid to Directors**

- (i) Refer to General Meeting or Board meeting resolution for the appointment and terms of appointment of the director.
- (ii) Examine Articles of Association and general meeting resolution to determine the mode of payment-monthly, quarterly, or by way of commission.
- (iii) Check agreement with the director.
- (iv) Verify director's attendance in the board meetings.
- (v) Ensure compliance with the provisions of Sections 198, 309, 349 and 350 and Schedule XIII of the Companies Act, 1956, where appropriate.
- (vi) Check computation of the net profits and the commission payable to directors in terms of Revised Schedule VI to the Companies Act, 1956.
- (vii) Computation of net profit under section 349 with details of the commission payable as percentage of profits to the directors including Managing Directors/Manager (if any) should be stated by way of note.

(b) Assets acquired on Hire purchase

- (i) Examine the Board's minutes book approving the purchase on Hire Purchase terms
- (ii) Examine the Hire Purchase Agreement carefully & note the description of the machinery and cost of machinery, Hire Purchase charges, terms of payment and rate of purchase
- (iii) Assets acquired under Hire Purchase system should be recorded at 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

- (iv) Hire Purchased assets are shown in Balance Sheet with appropriate narration to indicate that the enterprise does not have full ownership thereof. The interest payable along with each installment, whether separately or included therein, should be debited to the interest account, and not to the asset account.

(c) Profit or loss arising on sale of plots held by real estate dealer.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less.

Profit or loss arising on sale of plots of land by Real Estate Dealer should be verified as follows:

- (i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.
- (ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.
- (iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.
- (iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.
- (v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.
- (vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

(d) Advertisement Expenses: The following steps may be taken by the auditor to vouch/verify the different items:

- (i) Ascertaining the value of advertisement expenses to ensure that the said expense has been properly allocated.
- (ii) Examining that such expenses relate to the client's business.
- (iii) Review and examination of the complete list of media of advertisement indicating the dates, location, timing, etc., along with the amounts paid in respect of each category.
- (iv) Examination of the receipts for amounts paid.

- (v) Reviewing the contracts with the different agencies and ensuring that the billing conforms to the term and conditions specified therein.
- (vi) Ensuring that all such outstanding expenses have been properly accounted for.

Question 5

- (a) *What are the general considerations about the duties of an auditor that can be summarized on the basis of legal decisions taken by court so far?* (5 Marks)
- (b) *Under what circumstances the retiring auditor can not be reappointed?* (6 Marks)
- (c) *LMN Ltd., forfeited 1,000 equity shares because of non payment of final call money. On 1st November, 2013 directors reissued all these forfeited shares. As an auditor how will you verify the transaction?* (5 Marks)

Answer

- (a) **General considerations:** The statutory duties of the auditor cannot be limited in any way either by the Articles or by the directors or members but a company may extend them by passing a resolution at the general meeting or making a provision in the articles. [*Newton v. Birmingham Small Arms Co. Ltd.*]

An auditor is expected to determine the scope of his duties on a consideration of the nature of business carried on by the concern, provisions of the law that govern the organisation and the system of internal control in operation. Under the Companies Act, sub-sections (1A), (2), (3) (4) and (4A) lay down scope of auditor's duties. However, on taking into account the legal decisions in the cases which so far have been taken to courts, his duties and responsibilities can be summarised as follows :

- (i) To verify that the statements of account are drawn up on the basis of the books of the business : The auditor is not responsible for failure to disclose the affairs of the company kept out of the books and concealed from him which could not be known in the ordinary course of exercise of reasonable care and diligence. However, it is his duty to check the books for finding out that the position, as shown by the books of account, is true and substantially correct.
- (ii) To verify that the statements of account drawn up on the basis of the books exhibit a true and fair state of affairs of the business : The duty of the auditor is not limited to mere verification of the arithmetical accuracy of the statements of account. He must find out that these are substantially correct, having regard to provisions in the Articles and the statute governing the business of the organisation under which it is being carried on.
- (iii) To confirm that the management has not exceeded the financial administrative powers vested in it by the Articles or by any specific resolution of the shareholders recorded at a general meeting

- (iv) To investigate matters in regard to which his suspicion is aroused as to the result of a certain action on the part of the servants of the company - He is, however, not required to start an audit with a suspicion or to prove in the manner of trying to detect a fraud or an irregularity unless some information has reached him which excites his suspicion or should arouse suspicion in a professional man of reasonable competence. This is because his duty is verification and not primarily detection of fraud.
- (v) To perform his duties by exercising reasonable skill and care - For the verification of matters which are not capable of direct verification, he can rely on what he believes to be honest statements of the management. He must, however, review the verification of assets by the company and not rely merely on the statement made by the persons appointed by the company.

(b) In the following circumstances, the retiring auditor cannot be reappointed:

- (i) A specific resolution has not been passed to reappoint the retiring auditor.
- (ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 226.
- (iii) The proposed auditor suffers from the disqualifications under section 226(3) and 226(4).
- (iv) He has given to the company notice in writing of his unwillingness to be reappointed.
- (v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
- (vi) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 224(1B).

(c) Re-issue of Forfeited Shares: The auditor should:

- (i) ascertain that the Board of Directors has the authority under the Articles to re-issue forfeited shares;
- (ii) refer to the resolution of the Board of Directors, realloiting forfeited shares;
- (iii) vouch the amounts collected from person to whom the shares have been allotted and verify the entries recorded from realloiment and see that the total amount received on the share, including that received prior to forfeiture, is not less than the par value; and
- (iv) verify that computation of the amount of surplus resulting on the reissue of shares credited to the Capital Reserve Account; and
- (v) where partly paid shares are forfeited for non-payment of call, and are re-issued as fully paid, the re-issue is treated as an allotment at a discount (Biochemical and Synthetic Products Ltd. v. Registrar of Companies) . In such a case the provisions of Section 79 would require compliance.

Question 6

- (a) *What procedure may be adopted by an auditor, while auditing leasing transactions entered into by the leasing company?* (8 Marks)
- (b) *Mention any eight important points which an auditor will consider while conducting audit of club?* (8 Marks)

Answer

(a) 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 that 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 markings 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) Audit of Club: A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 1956 relating to the audit of accounts of companies are also applicable to its audit. The special steps involved in such an audit are stated below:

- (i) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- (ii) Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
- (iii) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- (iv) Check totals of various columns of the Register of members and tally them across.
- (v) 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 should be mentioned in the Audit Report.
- (vi) 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 services rendered, such as billiards, tennis, etc.
- (vii) 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.
- (viii) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective stock registers.
- (ix) Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The stock of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
- (x) 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.
- (xi) 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.
- (xii) Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

Question 7

Write short notes on any **four** of the following:

- (a) *Basic standards set for audit of Government expenditure.*
- (b) *Use of flow charts in evaluation of internal control.*
- (c) *Importance of audit working papers.*
- (d) *Identification of significant related party transaction outside business.*
- (e) *Verification of issue of sweat equity shares.* (4 x 4 = 16 Marks)

Answer

(a) Basic standards set for audit of Government Expenditure: The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are :—

- (i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.
- (ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.
- (iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.
- (iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.
- (v) 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. Such an audit is termed as the *performance audit*.

(b) Use of Flow Charts in evaluation of internal control: It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and

materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

(c) Importance of Audit Working Papers

- (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.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

(d) Identification of significant related party transaction outside business: As per SA 550 on "Related Parties", for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

- (i) Inspect the underlying contracts or agreements, if any, and evaluate whether:
 - (1) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
 - (2) The terms of the transactions are consistent with management's explanations; and
 - (3) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- (ii) Obtain audit evidence that the transactions have been appropriately authorised and approved.

(e) Verification of Issue of Sweat Equity Shares: As per explanation to section 79A, the expression "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 Exchange Board of India in this behalf:

Provided that in the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

For the purposes of this sub-section, the expression "a company" means the company incorporated, formed and registered under this Act and includes its subsidiary company incorporated in a country outside India.